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Home office deductions are among the most discussed issues of the US tax laws. A majority of the estimated 40 million Americans who work from their homes are self-employed small business owners. In addition, many professionals maintain two offices, and a growing number are equipping their home computers with modems that allow them access to their office computer files. Many large corporations are also expanding experiments in "telecommuting," which enables employees to work from home, using modem-equipped computers, just as they would in the office. So, if you are self-employed or an employee and you meet the IRS guidelines for deducting your home office, you can expect to get a hefty tax break.

In order to qualify for deductions, home office must be used **exclusively** and **regularly** as a **principal place of business** and serve as a place to meet or deal with clients, customers, etc., in the normal course of **trade or business**. In case of a separate structure that is not attached to home, deduction is also available if such place is used in connection with trade or business. An employee who uses a part of his/her home for business may qualify for a deduction for its business use if such use is for the **convenience of the employer** and any part of the home is **not rented out to the employer**.

Qualifying for a Deduction:

To qualify under the **exclusive use test**, taxpayer must use a specific area of home only for her/his trade or business. The space does not need to be marked off by a permanent partition but it does need to be used exclusively for business. Now suppose, if the taxpayer uses a specific area both for business and for personal purposes, taxpayer does not meet the requirements of the exclusive use test. However, s/he can set aside a portion of a larger room to be used only for business and meet the requirement of exclusive test- as long as her/his personal activities don't stray into it.

Let us take another example. Jeff, a lawyer, uses a den in his home to write legal briefs and prepare contracts. He also uses the den for poker games and hosting a book club. As he uses the den for both business and pleasure, he can't claim business deductions for using the den.

However, there are two exceptions to the exclusive use rule. They are (1) storage of inventory or product samples if the home is the sole fixed location of the trade or business, and (2) certain daycare facilities. Space used for these purposes can also be used for personal purposes [IRC Sec. 280A(c)(2) and (4)]. IRS has given a good example in this regard. Suppose your home is the only fixed location of your business of selling mechanics' tool at retail. You regularly use half of your basement for storage of inventory and product samples. Sometimes you use the area for personal purposes. The expenses for the storage space are deductible even though you do not use this part of your basement exclusively for business.

To qualify under the **regular use test**, taxpayer must use a specific area of home for business on a regular basis. Incidental or occasional business use is not regular use. The IRS doesn't offer a clear definition of regular use - only that you must use a part of your home for business on a continuing basis, not just for occasional or incidental business. Now assume that you use one room in your home exclusively for your side business of selling insurance. You engage in this business only occasionally. As you don't use the office on a regular basis, you won't qualify for the home office deduction. You can probably meet this test by working a couple of days a week from home, or a few hours each day. You must consider all facts and circumstances in determining whether your use is on a regular basis.

To qualify under the *trade-or-business use test*, taxpayer must use part of the home in connection with a trade or business. However, if the taxpayer uses the home for a profit seeking activity that is not a trade or business, taxpayer can't claim a deduction for its business use. A good example given by the IRS is research you undertake for your own private stock market investments. Although this is a profit-seeking activity, you are not involved in the trade or business of stock broking or dealing and so you cannot claim the home office deductions.

To qualify to deduct the expenses for the business use of home under the *principal place of business test*, the home must be the principal place of business for the trade or business. Now, how do you know if your office can be determined as your principal place of business?

Your home office will qualify as your principal place of business if you use it exclusively and regularly for the administrative or management activities associated with your trade or business. There must be no other fixed place where you conduct substantial administrative or management activities. If you use both your home and other locations regularly in your business, you must determine which location is your principle place of business, based on the relative importance of the activities performed at each location. If the relative importance factor doesn't determine your principle place of business, you can also consider the time spent at each location.

In the landmark *Soliman case*, a Virginia anesthesiologist, Nader Soliman, worked with surgeons at several hospitals but made appointments and did billing out of a home office. The government denied him a home-office deduction because Soliman's principal place of work, where he delivered his services, was the hospitals. The question went all the way to the Supreme Court in 1993, which ruled in favor of the IRS. In that case the Supreme Court identified two primary factors for determining whether a home office qualifies as the taxpayer's principal place of business: (a) the relative importance of the activities performed at each business location, and (b) the time spent at each place.

However, the sticky wicket set into motion a new way of thinking about the extent of home-office deductions and helped form the Taxpayer Relief Act, passed by Congress in 1997 and effective in 1999. That overturned the Soliman decision, giving tax write-offs to the doctors and others like him who work outside the office but use it as a base for business. Now if a home office is used *exclusively and regularly for the administrative or management activities* of your business, it also qualifies. Such things as billing operations, keeping your books and records, ordering supplies, or setting up appointments qualify as administrative duties.

The expanded definition of principal place of business will help thousands of taxpayers to claim home office deductions; many of them are small business owners. As many small businesses meet the new principal place of business definition, their owners now will be able to deduct the cost of traveling between home and client offices. Be careful here. The IRS cautions that your home location must be the only place where you can fulfill these responsibilities.

Now come to a situation where the home is used by an employee to perform the duties assigned by his/her employer. If you are an employee, you have additional requirements to meet. You cannot take the home office deductions unless the business use of your home is for the *convenience of your employer*. Also, you cannot take deductions for space you are renting to your employer. Merely use of the home for the employee's convenience or because the employee can get more work done at home will not suffice. There are no hard-and-fast rules when determining whether your home's business use is for your employer's convenience. It depends on all the facts and circumstances. A common case where this tax-deduction requirement applies, for example, is if your company does not provide you space at its location.

An employee who has available a fixed location other than the home office can expect a challenge from the IRS when asserting he or she is conducting home office activities for the convenience of the employer. However, the taxpayer in *Mulne (TCM 1996-320)* was able to secure a home office deduction because her employer required her to prepare reports after

business hours. For security reasons, her downtown Los Angeles office building was closed during the night hours she needed to work. These circumstances might also meet the new convenience of employer requirement, since the taxpayer did not have an employer office available to her at the times she needed to run the reports.

Consider the case of one New Jersey resident. He worked for a company in New York City, but he did all his work from home. New York state tax officials audited him and found that the company was ready, willing and able to provide office space for him in its New York office. So, New York forced the man to pay non-resident New York income taxes, which are higher than taxes in New Jersey. (His only break: a partial credit for the New York taxes on his New Jersey return.) The reason was all of his work from home was for his convenience, not his employer's. There was a solution to the problem. The employee could have requested his boss to write a letter, stating that he could work from home for the convenience of the company and that working from home was a condition of employment, and attached to the return. That could actually decrease his chances of being audited.

The same home office can be the principal place of business for two or more separate business activities. Whether your home office is the principal place of business for more than one business activity must be determined separately for each of your trade and business activities. However, you can't use it for any non-business (personal) activities.

We will discuss the ways to figure out allowable Home Office Tax Deductions and related planning tools in our next Newsletter. Stay tuned!

Important note: This is a summary write up, and as such, it is not intended as a complete explanation of all applicable situations. Many exceptions, definitions, and special rules in the law have been paraphrased, simplified, and/or omitted. Readers should not take specific action based on this summary without first consulting the statute and regulations or seeking advice from a qualified professional.

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