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In our last month's Newsletter we discussed preconditions to qualifying for Home Office Deductions. We take up from there to discuss significant Home office tax deductions which allow individuals who meet certain criteria to deduct a portion of mortgage interest or rent, depreciation of the space used as an office, utility bills, home insurance costs, cleaning, repairs, and security costs from their federal income taxes.

Given below are the ways to figure out the allowable deductions and the tools for tax planning.

Business Percentage:

Once a taxpayer *qualifies for Home office Deductions*, he needs to figure the percentage of home used for business and the limit of the deduction. To find the business percentage, compare the size of the part of home that taxpayer uses for business to whole house. Taxpayer can use any reasonable method to determine the business percentage.

Deduction Limit:

Your deduction of otherwise non deductible expenses, such as insurance, utilities, and depreciation (with depreciation taken last), that are allocable to the business, is limited to the gross income from the business use of your home minus the sum of the following:

1) The business part of expenses you could deduct even if you did not use home for business (such as mortgage interest, real estate taxes etc.).
2) The business expenses that relate to the business activity in the home (for example, business phone, supplies, and depreciation on equipment), but not to the use of home itself.

The expenses that are disallowed because of income limitation may be carried forward. They are subject to the deduction limit for that year, whether or not you live in the same home during that year. You can also carry back all business losses for two years.

Example 1: Brian Cohen meets the requirements for deducting expenses for the business use of his home. He uses 25% of his home for business. Brian's income from his business was $8000. The real estate tax and home mortgage amount was $16000. He had $3000 in business expenses not related to the use of his home (phone, supplies, and depreciation on equipment). He had $1200 in expenses for Maintenance, Insurance and utilities. He had $1800 in depreciation expenses for the business use of his home.

In 2005 his business expenses and the expenses for the business use of his home are deducted from his gross income in the following order:

Gross Income from Business	$ 8000
Minus:	
Deductible Mortgage Interest and Real Estate Taxes (25% of $16000)	$ 4000
Business Expenses not related to the business use of Brian's home (100%)	$ 3000
Deduction Limit	$ 1000
Less expenses related to the business use of Brian's home:	
Maintenance, insurance, and utilities (25% of 1200)	$ 300
Depreciation allowed (25% = 1800 allowable, but subject to deduction limit)	$ 700
Other expenses up to the deduction limit	$ 1000
Depreciation Carryover to 2006 ($1800 - $700)	$ 1100

Although Brian had $1800 in depreciation expenses for the business use of his home, he may only deduct $700 of this. The rest, $1100 ($1800-$700) can be carried over to his 2006 taxes.

Example 2: You have a net loss of your home office business this year in the amount of $7500. If you had $25,000 of taxable income that you paid tax on two years ago, you can use the $7,500 loss and reduce your taxable income to $17,500. The result is that you will receive a **REFUND** due to carry back of the loss.

Sale or Exchange of Home:

This involves long-term planning. Taxpayer may be able to exclude gain from the sale of a home that the taxpayer has used for business or to produce rental income. But the taxpayer must meet the ownership and use tests. This means that during the 5-year period ending on the date of sale, s/he met both the following tests.

- S/he owned the home for at least 2 years (ownership test)
- S/he lived in the home as her/his main home for at least 2 years (use test)

Under current law, if you sell a home that was your principal residence for two of the last five years, you can exclude from income as much as $500,000 in gain on a joint return ($250,000 on other returns).

Therefore, if you contemplate selling your home in the future, make sure that you don't qualify and claim a home office for at least 2 of the 5 years prior to the year of sale in order to qualify for the gain exclusion. Even if you do qualify for the exclusion, to the extent you've taken depreciation (for periods after May 6, 1997) on your home office in the past is going to be recaptured. ***For example***, Ron sold his main home in 2005 at $20000 gain. He meets the ownership and use tests to exclude the gain from his income. However, he used one room of the home for business in 2004 and has records showing he claimed $2000 depreciation. He can exclude $18000 ($20000-$2000) of his gain. He has a taxable gain of $2000.

The recaptured depreciation is taxed at 25% (section 1250 gain). But hopefully, you've been deducting depreciation at 28% or better, and you have both the spread and the time value of the money to your net benefit.

Avoid the Audit!

Following are a few examples of items that are generally not deductible as business expenses; taking them is like throwing a red flag in front of IRS and inviting the audit:

- Deducting all or most of the cost of operation of a personal residence. For example, placing a calendar, desk, file cabinet, telephone or other business item in each room does not increase the amount that can be deducted. Taxpayers should also be aware of depreciation recapture rules when assets are sold later.
- Paying children a salary (e.g. for answering telephones, washing cars, etc.)
- Deducting education expenses from salaries paid to children wrongfully claimed as employees.

Although The Internal Revenue Service (IRS) has set strict regulations about who qualifies for the deductions, about 1.6 million people claim the deductions each year. So, if you are self-employed or an employee and meet the IRS guidelines for deducting your home office, you can expect to get a hefty tax break.

Important note: 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.

We appreciate and value your feedback very much. Let us know how we can help make this communication vehicle and the learning resource more valuable to you.

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Sincerely,

Editorial Board, Resource Center
Saboo e-Solutions Pvt. Ltd.
6, Ganesh Chandra Avenue
Kolkata-700013, India
www.sabooe-solutions.com

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