

HASHEM and SIMMS, PLLC
CERTIFIED PUBLIC ACCOUNTANTS

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Home Office Deductions

If you are in business for yourself as a sole proprietor, and are interested in moving your business office to your home and you would like to know whether, and to what extent, you can deduct expenses related to part of your home as business expenses.

The general rule is that if you are an individual or an S corporation, no deduction is allowed with respect to the use of a dwelling unit which is used by you as a residence. However, there are several exceptions to this rule. The rule does not apply to any item of deduction to the extent that the item is allocable to a portion of the dwelling unit which is exclusively used on a regular basis in one of the following ways: (1) as the principal place of business for your trade or business (the term principal place of business includes a place of business which is used by the taxpayer for the administration or management activities of any trade or business of the taxpayer if there is no other fixed location of such trade or business which the taxpayer conducts substantial administration or management activities of such trade or business, (2) as a place of business that you use for meeting patients, clients, or customers, or (3) in the case of a separate structure which is not attached to the dwelling unit, in connection with your trade or business.

The application of the principal place of business exception becomes complicated in cases where the business is conducted at more than one location. In such a case, a comparison of the locations must be undertaken to determine which location is the "most important, consequential, or influential," and hence, the principal place of business. This inquiry is essentially a facts-and-circumstances inquiry which is guided by two primary considerations: (i) the relative importance of the activities performed at each business location; and (ii) the time spent at each location.

In determining whether the office in your home is your principal place of business, the "relative importance" test is applied first. The "relative importance" test compares the activities performed at each business location. If this test provides no definitive answer, the "time" test is then applied. The "time" test looks at the amount of time spent on business at home with the time spent on business at other locations.

Your circumstances most likely come under the second exception. This exception exists to the extent an item is allocable to a portion of a dwelling unit used exclusively and on a regular basis as a place of business in which customers meet or deal with you in the normal course of your business. The meetings must be substantial and integral to the conduct of your business. The customers must be physically on the premises; phone calls are not enough.



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There are, however, limitations on the amounts you can deduct each year. Your deduction cannot exceed the gross income derived from the business use of the dwelling less deductions allocable to the business portion of the unit whether or not it was used in a business (real estate taxes and mortgage interest) and deductions allocable to the business but not allocable to the qualifying business use of the unit itself (e.g., expenses for supplies and compensation). Also, the business deductions are allowable in the following order: (1) deductions allocable to the business use without regard to whether the unit is used for business (mortgage interest and real estate taxes), (2) deductions allocable to the business but not allocable to the business use of the unit, and (3) deductions allocable to the business in which the qualifying business use occurs which are allocable to the use of the unit (depreciation, utilities, etc.). For example, if you earned \$45,000 from the qualifying business use of the home and you had expenses of \$10,000 (representing the business percentage of mortgage interest and real estate taxes), \$20,000 (salary expenses), and \$20,000 (depreciation and utilities expenses), only \$45,000 is deductible this year. The remaining \$5,000 (from the deductions allocable to the use of the home itself) is carried over to the next year (subject to next year's income limitation).

Also, the expenses allocable to the portion of the unit used for business purposes may be determined by any reasonable method under the circumstances. The allocation can be made according to the number of rooms or by square footage, for example.

We hope this newsletter has adequately explained for you the rules regarding home office deductions. If you have any questions, please feel free to call us.

Sincerely,

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