Home Office Deductions

What Small Businesses Need to Know.
About the Author:

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Qualifying for a Deduction

To deduct expenses related to the business use of part of your home, you must meet specific requirements. Even then, your deduction may be limited.

Tests for business owners:
1. Your use of the business part of your home must be:
   a) Exclusive (except day care centers and certain storage activities)
   b) Regular
   c) For your trade or business, AND
2. The business part of your home must be one of the following:
   a) Your principal place of business,
   b) A place where you meet or deal with patients, clients, or customers in the normal course of your trade or business, or
   c) A separate structure (not attached to your home) you use in connection with your trade or business.

Additional tests for employees:
If you are an employee and you use a part of your home for business, you may qualify for a deduction for its business use. You must meet the tests for business owners plus:
1. Your business use must be for the convenience of your employer, and
2. You do not rent all or part of your home to your employer and use the rented portion to perform services as an employee.

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Whether your home's business use is for your employer's convenience depends on all the facts and circumstances. However, business use is not considered to be for your employer's convenience merely because it is appropriate and helpful.

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Test 1 - Exclusive Use

To qualify under the exclusive use test, you must use a specific area of your home only for your trade or business. The area used for business can be a room or other separately identifiable space. The space does not need to be marked off by a permanent partition.

You do not meet the requirements of the exclusive use test if you use the area in question both for business and for personal purposes.
Exception for storage of inventory or product samples. When you use part of your home for the storage of inventory or product samples, the exclusive use test does not apply. However, you must meet all the following tests.

✓ You keep the inventory or product samples for use in your trade or business.
✓ Your trade or business is the wholesale or retail selling of products.
✓ Your home is the only fixed location of your trade or business.
✓ You use the storage space on a regular basis.
✓ The space you use is an identifiably separate space suitable for storage.

Test 2 - Regular Use

To qualify under the regular use test, you must use a specific area of your home for business on a continuing basis. You do not meet the test if your business use of the area is only occasional or incidental, even if you do not use that area for any other purpose.

Test 3 - Trade or Business Use

To qualify under the trade or business use test, you must use part of your home in connection with a trade or business. If you use your home for a profit-seeking activity that is not a trade or business (such as managing your personal investments), you cannot take a deduction for its business use.
Test 4a - Principal Place of Business

You can have more than one business location, including your home, for a single trade or business. To qualify to deduct the expenses for the business use of your home, your home must be your principal place of business for that trade or business. To determine your principal place of business, you must consider all the facts and circumstances.

Your home office will qualify as your principal place of business for deducting expenses for its use if you meet the following requirements:

- You use it exclusively and regularly for administrative or management activities of your trade or business.
- You have no other fixed location where you conduct substantial administrative or management activities of your trade or business.

Alternatively, if you do business at more than one location, and your home office does not qualify as your principal place of business based on the previous rules, you determine your principal place of business based on the following factors.

1. The relative importance of the activities performed at each location.
2. If the relative importance factor does not determine your principal place of business, you can also consider the time spent at each location.
Administrative or management activities performed at other locations. The following activities performed by you or others will not disqualify your home office from being your principal place of business.

- You have others conduct your administrative or management activities at locations other than your home. (For example, another company does your billing from its place of business.)
- You conduct administrative or management activities at places that are not fixed locations of your business, such as in a car or a hotel room.
- You occasionally conduct minimal administrative or management activities at a fixed location outside your home.
- You conduct substantial nonadministrative or nonmanagement business activities at a fixed location outside your home. (For example, you meet with or provide services to customers, clients, or patients at a fixed location of the business outside your home.)
- You have suitable space to conduct administrative or management activities outside your home, but choose to use your home office for those activities instead.

More Than One Trade or Business

Whether your home office is the principal place of business must be determined separately for each trade or business activity. One home office may be the principal place of business for more than one activity. However, you will not meet the exclusive use test for any activity unless each activity conducted in that office meets all the tests.
Test 4b - Place To Meet Patients, Clients, or Customers

If you meet or deal with patients, clients, or customers in your home in the normal course of your business, even though you also carry on business at another location, you can deduct your expenses for the part of your home used exclusively and regularly for business if you meet the following tests.

• You physically meet with patients, clients, or customers on your premises.
• Their use of your home is substantial and integral to the conduct of your business.

Using your home for occasional meetings and telephone calls will not qualify you to deduct expenses for the business use of your home.

Doctors, dentists, attorneys, and other professionals who maintain offices in their homes will generally meet this requirement.

The part of your home you use exclusively and regularly to meet patients, clients, or customers does not have to be your principal place of business.
Test 4c - Separate Structure

You can deduct expenses for a separate free-standing structure, such as a studio, garage, or barn, if you use it exclusively and regularly for your business. The structure does not have to be your principal place of business or a place where you meet patients, clients, or customers.

Figuring the Deduction

After you determine that you meet the tests under Qualifying for a Deduction, you can begin to figure how much you can deduct. You can deduct certain expenses related to the business use of your home, but your deduction is limited by the following.

Business Percentage

To find the business percentage, compare the size of the part of your home that you use for business to your whole house. Use the resulting percentage to figure the business part of the expenses for operating your entire home.

You can use any reasonable method to determine the business percentage. The following are two commonly used methods for figuring the percentage.
1. Divide the area (length multiplied by the width) used for business by the total area of your home.

2. Divide the number of rooms used for business by the total number of rooms in your home. You can use this method if the rooms in your home are all about the same size.

Use lines 1-7 of Form 8829 to figure your business percentage.

**Part-Year Use**

You cannot deduct expenses for the business use of your home incurred during any part of the year you did not use your home for business purposes. For example, if you begin using part of your home for business on July 1, and you meet all the tests from that date until the end of the year, consider only your expenses for the last half of the year in figuring your allowable deduction.

**Deduction Limit**

If your gross income from the business is less than your total business expenses, your deduction for certain expenses for the business use of your home is limited.

Your deduction of otherwise nondeductible expenses, such as insurance, utilities, and depreciation (with depreciation taken last), 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 your home for business (such as mortgage interest or real estate taxes).
2. The business expenses that have nothing to do with your home.

**Carryover of unallowed expenses.** If your deductions are greater than the current year's limit, you can carry over the excess to the next year. They are subject to the deduction limit for that year, whether or not you live in the same home during that year.

**More than one place of business.** If part of the gross income from your trade or business is from the business use of part of your home and part is from a place other than your home, you must determine the part of your gross income from the business use of your home before you figure the deduction limit. In making this determination, consider the time you spend at each location, the business investment in each location, and any other relevant facts and circumstances.
Deducting Expenses
If you qualify to deduct expenses for the business use of your home, you must divide the expenses of operating your home between personal and business use. This section discusses the types of expenses you may have and gives examples and brief explanations of some of the expenses you may be able to deduct.

Types of Expenses

Direct Expenses
Expenses that relate only to the business part of the home (e.g. painting the room where business is conducted). Direct expenses are deductible in full.

Indirect Expenses
Expenses that relate to the entire house (e.g. insurance, utilities, etc.). Indirect expenses must be allocated based on the business use percentage.

Unrelated Expenses
Expenses that relate only to the part of the house not used for business (e.g. painting the master bedroom). Unrelated expenses are not deductible.

Form 8829 has separate columns for direct and indirect expenses.
Examples of Expenses

Certain expenses are deductible whether or not you use your home for business. However, if you qualify to claim business use of the home expenses, you can use the business part of these expenses to figure your business use of the home deduction. These expenses include the following.

- Real estate taxes.
- Deductible mortgage interest.
- Casualty losses.

Other expenses are deductible only if you use your home for business. You can use the business part of these expenses to figure your business use of the home deduction. These expenses generally include (but are not limited to) the following.

- Depreciation.
- Insurance.
- Rent.
- Repairs.
- Security system.
- Utilities and services.
Special considerations:

**Deductible Mortgage Interest** may be limited if your mortgage debt is more than $1,000,000 or if your home equity debt is more than $100,000.

**Casualty Losses** can fall into the category of direct, indirect or unrelated expense and must be categorized based on the property that was damaged or lost. If business property was damaged or lost, it is not subject to the 10% threshold applicable to non-business losses.

**Insurance deductions** are limited if the premium paid provides coverage beyond the end of the tax year. The cost must be allocated and the portion that applies to the next year is deductible in the next year.

**Utilities and Services** are generally deductible based on the percentage of your home used for business. There can be an exception when the business requires unusually high amounts of service, in which case you should consider putting the business portion on separate billing.

**Telephone.** The basic local telephone service charge, including taxes, for the first telephone line into your home is a nondeductible personal expense. However, charges for business long-distance phone calls on that line, as well as the cost of a second line into your home used exclusively for business, are deductible business expenses.
Depreciating Your Home

Depreciation can be a significant portion of your total cost. The rules are complex and covered in a separate article in this series. See Depreciating Your Home.

Day-Care Facility

If you use space in your home on a regular basis for providing day care, you may be able to deduct the business expenses for that part of your home even though you use the same space for nonbusiness purposes. To qualify for this exception to the exclusive use rule, you must meet the following requirements.

Recordkeeping

You do not have to use a particular method of recordkeeping, but you must keep records that provide the information needed to figure your deductions for the business use of your home. You should keep canceled checks, receipts, and other evidence of expenses you paid.

Your records must show the following information.

- The part of your home you use for business.
- That you use the part in (1) exclusively and regularly for business as either your principal place of business or as the place where you meet or deal with clients or customers in the normal course of your business.
- The depreciation and expenses for the business part.
You must keep your records for as long as they are important for any tax law. This is usually the later of the following dates.

- 3 years from the return due date or the date filed.
- 2 years from the date the tax was paid.

Keep records to prove your home's depreciable basis. This includes records of your original purchase price, any improvements to your home, and any depreciation you are allowed because you maintained an office in your home.

Where To Deduct

Deduction of Self-Employed Persons

If you are self-employed and file Schedule C (Form 1040), attach Form 8829 to your return. If you file Schedule F (Form 1040), report your entire deduction for business use of the home, up to the limit discussed earlier (line 32 if you used the worksheet) on line 34 of Schedule F. Write "Business Use of Home" on the dotted line beside the entry.

Deductible Mortgage Interest and Real Estate Taxes. If you file Schedule C (Form 1040), enter all your deductible mortgage interest on line 10 of Form 8829 and real estate taxes on line 11 of Form 8829. Step through the form and carry the personal portion to Schedule A. If the interest you deduct on Schedule A for your home mortgage is limited, enter the excess on line 16 of Form 8829.
If you file Schedule F (Form 1040), include the business part of your deductible home mortgage interest and real estate taxes with your total business use of the home expenses on line 34. Enter the nonbusiness part of the deductible mortgage interest on Schedule A, lines 10 and 11.

**Casualty Losses.** If you are using Form 8829, refer to the specific instructions for lines 9 and 27 and enter the amount from line 33 on line 27 of Form 4684, Section B. Write "See Form 8829" above line 27.

If you file Schedule F (Form 1040), enter the business part of casualty losses (line 31 if you use the worksheet) on line 27 of Form 4684, Section B. Write "See attached statement" above line 27.

**Other Expenses.** Report the other home expenses that would not be allowable if you did not use your home for business (insurance, maintenance, utilities, depreciation, etc.), on the appropriate lines of your Form 8829. If you rent rather than own your home, include the rent you paid on line 20. If any of these expenses exceed the deduction limit, carry them over to next year. They will be subject to next year's deduction limit.
If you file Schedule F (Form 1040), include your other home expenses that would not be allowable if you did not use your home for business (insurance, maintenance, utilities, depreciation, etc.), with your total business use of the home expenses on line 34 of Schedule F. If any of these expenses exceed the deduction limit, carry them over to the next year. They will be subject to next year's deduction limit.

**Business Expenses Not for the Use of Your Home.** Deduct in full your business expenses that are not for the use of your home itself (dues, salaries, supplies, certain telephone expenses, etc.) on the appropriate lines of Schedule C (Form 1040) or Schedule F (Form 1040). Because these expenses are not for the use of your home, they are not subject to the deduction limit for business use of the home expenses.

**Deductions of Employees**

As an employee, you must itemize deductions on Schedule A (Form 1040) to claim expenses for the business use of your home and any other employee business expenses. This generally applies to all employees, including outside salespersons, except for statutory employees who use Schedule C (Form 1040).

If you have employee expenses for which you were not reimbursed, report them on line 20 of Schedule A. You will provide specific support for the deduction by completing and attaching Form 2106 or Form 2106-EZ.
Deductible mortgage interest and real estate taxes. Although you generally can deduct expenses for the business use of your home on line 20 of Schedule A (Form 1040), do not include any deductible home mortgage interest or real estate taxes on that line. Instead, deduct both the business and nonbusiness parts of the interest on line 10 or 11 of Schedule A and the real estate taxes on line 6 of Schedule A.

If the home mortgage interest you can deduct on lines 10 or 11 is limited by the home mortgage interest rules, you cannot deduct the excess as an employee business expense on line 20 of Schedule A, even though you use part of your home for business.

Casualty losses. Enter the business part of casualty losses (line 31 of the worksheet) on line 27 of Form 4684, Section B. Write "See attached statement" above line 27.

Other expenses. If you file Form 2106 or Form 2106-EZ, report on line 4 the following expenses.

- The business part of your otherwise nondeductible expenses (utilities, maintenance, insurance, depreciation, etc.) that do not exceed the deduction limit.
- The employee business expenses not related to the use of your home, such as advertising.
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