# How to Deduct Home Office Expenses under Tax Reform

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In this world of technology and constant connectivity, working remotely has become more common. Either as an employee or as a self-employed person, a home office can provide convenience, flexibility, and a lower overhead. In addition to skipping the daily commute, a tax deduction has been available for working from home in the way of the home office expense. Tax reform did not change the deduction, just the ability for some taxpayers to claim the deduction. Self-employed persons are still able to take the deduction on a Schedule C and are subject to the same strict guidelines for deducting the home office expense as in past years.

For employees, however, the new tax law (TCJA) eliminated the miscellaneous itemized deductions formerly reported on Schedule A of an individual's Form 1040. To make up for significant cuts to deductions, the TCJA doubled the standard deduction available to individuals: $24,000 for married couples filing jointly; $12,000 for single filers; and $18,000 for those qualifying for head of household status in 2018.

## Home Office Deduction Fundamentals

Generally, the only expenses you can deduct for your home are interest and real estate taxes. However, if you use part of your home for business, you can deduct part of your utilities, insurance, and repair costs. You can also deduct depreciation on the portion of your home you use for business.

If you rent a home, condo, or apartment, you can deduct the portion of your rent, utilities, and insurance that relates to the business use of your home. However, you cannot take a deduction for depreciation.

Here is how you can deduct business expenses for using your primary home:

**As your main place of business for any business you run.** If you use a room (usually an office) in your home only for business on a regular basis, you can deduct the expenses related to the room. You also can use your home office as an administrative office and do your work someplace else, as long as you have no other fixed location to do administrative work. For example, doctors (who perform their primary duties in hospitals), salespeople (who spend time in customers' offices), and painters and other tradespeople (who spend most of their time at job sites) can probably take a home office deduction.

**As a place to meet or deal with patients, clients, or customers in the normal course of your business.** You must physically meet with people in your home office and not use the room for personal purposes; making business phone calls from your home is not enough.

**As a place to store inventory you use in your business.** If you regularly use an area of your home to store inventory you sell from your home by mail or delivery, you can deduct expenses for the portion of your home you use to store that inventory. Storing old records from a business you conduct elsewhere does not qualify.

You can also deduct business expenses for using your primary home as a place to store product samples for your trade or business.

**As a day care facility.** You must use your home regularly to provide day care services for children, persons 65 or older, or persons who are physically or mentally incapable of caring for themselves. Your day care facility must be certified or exempt from certification. Generally, if you use your home to provide day care, your deduction is based on the portion of your home that is used, as well as the amount of time in a day the home is used.

You can also deduct the expenses of an unattached, separate building (such as a garage or barn) you use only for business.

## Calculating the Deduction

To calculate your deduction, first gather your home expenses. You can deduct all the expenses that relate directly to the business area of your home. Examples include the cost of repairs to the room and the cost of painting the room. You can also deduct the portion of indirect expenses related to the business-use portion of your home. Indirect expenses include mortgage interest, real estate taxes, insurance, security, utilities, and repairs and maintenance.

Many people calculate the business-use portion by dividing the square footage of the business area by the total square footage of the home. It is also acceptable to base your business percentage on the number of rooms used for business compared to the total number of rooms in your home. Use the method that gives you the higher business-use percentage.

**Example:** You use a room in your home as an office. The room measures 14 x 16 (224 square feet). The room is one of eight rooms in your home. The total square footage of your home is 2,240 square feet. Using the square footage method, you can deduct 10 percent (224/2,240) of your indirect expenses. Using the number of rooms method, you can deduct 12.5 percent (1/8) of your indirect expenses.

If you own your home, you can also depreciate the portion of your home you use for business based on the business-use percentage. Multiply the cost of your home, not including land, by your business-use percentage. You can depreciate the business-use portion of your home over 39 years (31.5 years if you started to use your home for business before May 13, 1993).

Your deductions for the business use of your home cannot be more than the income from your business. If your deductible home expenses are greater than your business income, two things happen. First, you must prioritize the home expenses you can deduct. To start, deduct all of the business percentage of deductible mortgage interest and real estate taxes. Next are home expenses that usually are not deductible and do not affect the basis of your home, such as repairs and utilities. The last expense you deduct is depreciation.

Second, carry forward the expenses you cannot deduct this year because you do not have enough income. You can use this carryforward against future income from your home business.

**Example:** You are employed full-time and operate a second business from your home. You use a room in your basement, which is 15 percent of the home's square footage, on a regular basis exclusively for your second business.

Your income from the second business is $10,000. Your business expenses, other than home office expenses, total $7,000. For the year, you pay the following home-related expenses:

- Real property taxes of $2,000
- Mortgage interest of $8,000
- Utilities and other operating expenses of $1,500
- Repair of the wall in your home office of $1,000

You purchased your home for $120,000, of which $20,000 is allocated to land. Your business income and home office deductions are determined as follows:

Business income: $10,000
Less: other business expenses ($7,000)

Subtotal: $3,000

Less:
Taxes ($2,000 x 15%): ($300)
Interest ($8,000 x 15%): ($1,200)

Subtotal: $1,500

Wall repair ($1,000)

Utilities and other expenses ($1,500 x 15%): ($225)

Subtotal: $275

Depreciation (($100,000 x 15%)/39 years = $385) limited to remaining income ($275)

**Net business income: $0**

Depreciation expenses of $110 ($385 – $275) are not allowed in the current year. You can use the $110 of deductions to reduce your income from the second business in the following year if your income is greater than your deductions.

You calculate your home deductions using Form 8829. The deduction transfers to Schedule C of your Form 1040. The deductible home expenses reduce your self-employment tax and your adjusted gross income.

## Simplified Deduction

Because the calculation of the home office deduction can be complex and oftentimes requires tedious recordkeeping, in 2013 the IRS created a simplified calculation: multiplying $5 by the number of square feet in the home office. The maximum number of square feet you can use in the calculation is 300, so the maximum deduction under the simplified method is $1,500.

When using the simplified calculation, it’s no longer important to have records of the home office expenses to substantiate the deduction, and Form 8829 is not required. However, the general rules for claiming a home office deduction discussed previously must still be met.

If using the simplified calculation for the home office deduction, no depreciation can be claimed. A potential benefit of using the simplified calculation, however, is that the full amount of qualified mortgage interest and real estate taxes can still be claimed as itemized deductions. This is different from the regular home office deduction calculation where an allocation between business and personal portion must be made and only the personal portion is deductible as an itemized deduction.

Generally, it is wise to figure the deduction using both the regular method and the simplified method. Then, choose which one provides the most benefit remembering that the amount of itemized deductions for mortgage interest and real estate taxes are also impacted by the method of choice. You can change your selected method each year.

## Gain Recapture

If you take depreciation on your home office and you later sell your home at a gain, you will have to pay tax on your gain up to the amount of any depreciation you deducted after May 6, 1997. Any remaining gain is eligible for the $250,000 exclusion ($500,000 if you are married filing a joint return) when you sell your home.

Any gain up to the amount of depreciation you take on your home office is taxed at a maximum rate of 25 percent, whether the $250,000 exclusions applies ($500,000 if you are married filing a joint return). On the other hand, if you sell your home for a loss, you should use part of the home for business, because you can deduct losses on business property but not personal-use property.

## Tax Reform Impact

Tax reform wipes out any tax benefit for employees by eliminating 2 percent miscellaneous itemized deductions for taxpayers starting with the 2018 tax year through 2025. However, the TCJA does not impact the home office deduction for self-employed taxpayers.

Although the complexity and documentation requirements, along with potential inclusion of a portion of the gain on the sale of a primary residence, has potentially dissuaded some qualifying taxpayers from claiming the home office deduction in the past, the limit on state and local tax deductions imposed by the TCJA may have some people reconsidering a home office deduction. Because the home office deduction includes a portion of real estate taxes as a Schedule C business expense, moving a portion of the deduction “above the line” will effectively enable taxpayers to exceed the $10,000 limit on state and local taxes.

The mechanics of the home office deduction can seem cumbersome, but it could be well worth the effort, especially considering the implications of tax reform. Although the home office deduction for employees is now obsolete (at least for tax years 2018 through 2025 and unless laws change), the deduction is still available for sole proprietors and pass-through owners, and therefore could become even more popular with business owners.