

# Maximizing Your Home Office Deduction

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If you're self-employed or run a small business out of your home, you can reduce your income tax bill by claiming a *home office deduction*. This deduction enables you to subtract from your income a portion of expenses attributable to the area of your home that you use for business.

For example, if you run a pet grooming business out of 20 percent of your home and use that other 80 percent as living space, under the right circumstances, you may be able to deduct 20 percent of your mortgage interest, property taxes, homeowner's insurance, homeowner association fees, and utilities (such as electricity, gas, water, sewer, and trash). You might even be able to deduct depreciation on that portion of your home.



Hey, it's only fair. Other businesses get to deduct the cost of maintaining a building or renting office space, so you should get a tax break for the portion of your home you use for conducting business.

Unfortunately, many small-business owners don't claim this deduction because they fear that doing so will raise red flags and increase their odds of becoming a target for a dreaded tax audit. Others avoid claiming it because they're afraid that the calculations or record-keeping would be too complicated. However, the calculations and record-keeping are straightforward, and there's no evidence that claiming the home office deduction increases your odds of being audited. Besides, as long as you're honest about the business use of your home, and you have records to back up the expenses you claim, even if you do get audited, you have nothing to fear.

In addition to being able to claim the home office expense, if you are using your home office as the base for business auto mileage, it is a good idea to establish your home office as your "tax home." This supports your claim for auto expenses any time you travel from your home office to another business location.

**Pro Tip:** You may be able to use expenses associated with a home office to reduce self-employment income and taxable income from your business – but not below zero. If your home office expenses for a particular year are more than your net income from your business, you may be able to carry forward the loss to future years.

### Deciding Whether Your Office Space Qualifies

To qualify for a home office deduction, a portion of your home must be used in one of the following ways:

1. Exclusively and regularly as your principle place of business
2. Exclusively and regularly as a place where you meet and deal with your customers in the normal course of your business
3. A separate structure that's not attached to your home and is used exclusively and regularly in connection with your business
4. On a regular basis, the space is used for storage of inventory or product samples used in your business for selling products at retail or wholesale (note: this usage does not have to be exclusive)
5. For rental use
6. As a daycare facility

Let's translate this into plain English:

- In #1 above, *principle place of business* means that you have no other fixed location where you conduct substantial administrative or management activities of your business. In other words, if you have an outside office where you conduct most of your business and you're bringing work home with you, you do not qualify for this deduction. There is, however, an exclusion to this for an administrative office required by your employer, which is not discussed in detail here. For more info on this, feel free to contact us here at SWC.

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- In #1, #2, and #3 above, “exclusively” means you can’t use the same space for personal and business purposes. The example the Internal Revenue Service (IRS) gives is that if you’re an attorney and use the den of your home to write legal briefs and for personal purposes, your home doesn’t qualify for the home office deduction. On the other hand, if you’re a freelance commercial artist and use a room of your home as your studio, that room qualifies for the home office deduction.
- In #1, #2, and #3 above, “regularly” generally means at least 10 to 12 hours per week.
- In #4, #5, and #6, note that the word “exclusively” is omitted. For example, if you’re running a daycare facility out of your home, and you use your kitchen, dining room, living room, and den during the day as your business space, you can deduct the expenses related to those areas. You just need to calculate the percentage of time that space is used for business.
- Your home office doesn’t have to be an entire room. You can use part of a room so long as it meets the requirements. And in the case of storing inventory, it does not have to meet the “exclusive” requirement –you can store your inventory in your garage and claim a portion of that space!

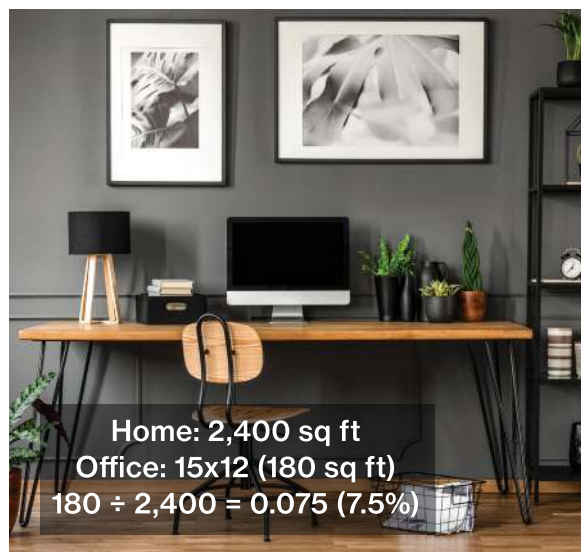
Assuming the space you use for business qualifies for the home office deduction, you can start deducting expenses. If your business is taxed as a sole proprietorship, you’ll use [Form 8829 – Expenses for Business Use of Your Home](#). If your business is taxed as a corporation, you’re not allowed to take the home office deduction, but you can have the corporation reimburse you for home office expenses and then deduct the expense through the corporation’s tax return. If your business is taxed as a partnership, you can deduct home office expenses as unreimbursed partnership expenses.

### Choosing a Method

The IRS provides two methods for calculating the home office deduction – the *regular method* and the *simplified option*. A third method enables you to lease space to your business for up to 14 days per year tax-free and deduct the rent as a business expense. The following sections explain these three options.

#### *The Regular Method*

With the regular method, you calculate the percentage of your home used as a business. For example, if your home is 2,400 square feet, and your office is 15-by-12 (180 square feet), the percentage of your home used for business is 180 divided by 2,400, which equals 0.075 or 7.5 percent of your home.



If the rooms of your home are all roughly the same size, you can calculate the percentage by dividing the number of rooms you use for business by the total number of rooms. For example, if your home has 10 rooms all about equal in size and you use one of them for business, 1 divided by 10 equals 10 percent.

If you're running a daycare from your home and use space both for living and business purposes, multiply the percentage space you use for business by the percentage of time it's used for business. For example, suppose your home is 2,500 square feet, and you use half of it during the course of the business day, but the business day is only 10 hours five days a week. The percentage of your home space used for business is 50 percent, but the percentage time that space is used is 50 hours divided by 168 hours in a week, which equals about 0.30 or 30 percent. Multiply 0.50 by 0.30, and you get 0.15, which is 15 percent.

The next step is to use that percentage to calculate *indirect expenses* – expenses related to the entire home, as opposed to expenses related only to your office space. For example, if your electricity bill was \$4,000 for the year, multiply the percentage of your home by \$4,000 to determine your deduction. If your office space is 7.5 percent of your home, your deduction for electricity would be \$4,000 times 0.075 = \$300. Repeat that calculation for all expenses that apply to your entire home, including the following:

- Homeowner's insurance
- Mortgage interest
- Property taxes
- Homeowner's association fees
- Cleaning services
- Maintenance, repairs, or improvements for the entire home (such as a new roof or siding, furnace or air conditioning maintenance or replacement, a security system, and so on)
- Utilities (gas, electric, water, sewer, trash)
- Depreciation of the home, which is the only complicated calculation. Start with your basis in the home (what you paid for it plus the cost of any improvements), subtract the cost of the land, and divide by 39 (the number of years over which the property will be depreciated). The first year you place the office in service, instead of dividing by 39, you multiply by a percentage specified in a table provided on the instructions for filling out form 8829. For example, if you first started using the home for business in June, you'd multiply the basis of your home by 0.01391, which is 1.391 percent.

The final step is to add in any *direct expenses* – 100 percent of any expense related exclusively to the office space. For example, if you replace the carpet in the office or have the office painted, you can deduct the entire expense. (You're not allowed to deduct expenses for the parts of your home not used for business, for example, lawn care or painting a room not used for business.)

**Note:** When you use the regular method, you claim depreciation as a home office expense; when you sell your home, the sale may result in a capital gain due to *depreciation recapture*, and you

will be responsible for paying taxes on that gain. For example, if over the course of 15 years, you claimed \$10,000 in depreciation for your home office and you sell the home for a profit of more than \$10,000, that amount is treated as a taxable gain even if your total profit on the sale of the home is less than the allowable \$250,000 tax-free residential sale exclusion.

### ***The Simplified Option***

With the simplified option, you claim a flat rate of \$5 per square foot for up to 300 square feet of qualifying home office space (regardless of what percentage it occupies in your home and regardless of your actual expenses). If you itemize, you can deduct mortgage interest and property tax on Schedule A (Form 1040 – Itemized Deductions). You lose the depreciation deduction, but when you sell your home, you won't be subject to depreciation recapture for the years you use this method.

The simplified option is easier than the traditional method, but you're likely to end up with less of a deduction. The only way to know is to run the numbers and calculate the deduction both ways.

### ***The Renting Your Home Approach***

Another way to use your home as a business deduction is to have your business rent your home for up to 14 days per year and deduct the rent as a business expense, assuming the business has a separate and distinct corporate identity. In other words, this method is an option if your business is organized as a C corporation or S corporation, but it is not an option if your business is structured as a sole proprietorship or single-member limited liability company (LLC).

If you use this method, note the following:

- You must charge a fair market rental rate for your home, which you can determine by checking rental rates for similar properties in your area.
- You must document business use of your residence, which you can do by keeping a record of shareholder meetings, business planning meetings, budgeting meetings, staff meetings, or other business on the dates the property was used.
- The corporation must file a Form 1099-MISC to report the income, and you must report the rental income on Schedule E (Supplemental Income and Loss), Form 1040, but you can then zero out the rental income by reporting “other deductions.”

### **An Additional Perk**

Claiming the home office deduction can also boost your car and truck deductions by minimizing or even eliminating nondeductible commuting miles for your business. For example, suppose you're a real estate agent with a desk at your broker's office. If you don't have a home office, your trip from home to the office is a nondeductible commute. However, if you have a home office, and you start your workday in that office, your “commute” is your trip to the home

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office, and your trip from home to your desk at the broker is a deductible trip from one business location to another.

We refer to this as the “doorknob touch rule.” When you touch the doorknob of the first location you work at during a day, the business mileage from that point becomes deductible. Therefore, if you touch the door knob of the home office first, perform work there and then leave to the brokers office, for example, mileage to the brokers office and any other business locations then becomes deductible, including the mileage to return to the home office at the end of the day.

As covered earlier, it is important to establish your home office as your “tax home” for the purposes of qualifying auto expenses.



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