By James W. Rinier, CPA, and Anthony P. Curatola

Safe Harbor Rules for Deducting Home Office Expenses

When determining the amount to claim for a home office deduction, taxpayers can now choose between the cost method and a new safe harbor method. The new method simplifies the process and reduces the compliance burden, but there are some limitations.

Many taxpayers (and their preparers) view the deductibility of expenses associated with a home office as an IRS challenge waiting to happen or simply an area to avoid. The IRS and Treasury Department recognized that the calculation, allocation, and substantiation of allowable deductions attributable to the use of a portion of a taxpayer's residence for business purposes can be complex and burdensome for small business owners. As a result, the IRS issued Revenue Procedure 2013-13 (IRB 2013-6), which provides a safe harbor for the deduction of those expenses associated with a taxpayer's residence. This safe harbor is effective for taxable years beginning on or after January 1, 2013.

Safe Harbor Rule

The new rule is simple: A taxpayer can claim a home office deduction for the year based on $5 per square foot of his or her home office. Thus, someone with a home office of 200 square feet would claim $1,000 (200 sq. ft. × $5/sq. ft.) as a home office deduction. The safe harbor deduction is limited to $1,500 per year, which means the maximum qualifying square footage is 300. The taxpayer also has the option to elect the safe harbor method one year and elect the actual cost method in other years. The election is made annually on a year-by-year determination and is nonbinding, which means the taxpayer isn't required to get the Commissioner's consent when switching between the cost and safe harbor methods.

Taxpayers electing to file Form 1040, Schedule A (itemized deductions) are afforded another benefit when electing the safe harbor: They can claim the personal itemized deductions associated with their principal residence without apportioning those amounts attributable to the home office. For example, a taxpayer with $5,000 of mortgage interest expense for the tax year is able to claim the entire $5,000 as an itemized deduction and still claim the $5 per square foot under the home office safe harbor method. Under the cost method, the business portion of the itemized deductions is taken into account first.

Similarly, the expenses associated with the business—and not the home office—are still deductible as business expenses to the extent permitted by the Tax Code and Regulations. For example, in addition to the safe harbor deductible amount, the taxpayer would deduct advertising, wages, and travel (to name a few) as business expenses.

Limitations

A taxpayer claiming the safe harbor method is still required to satisfy all the requirements of IRC §280A for determining his or her eligibility to claim the deduction. For example, the business portion must be used on a regular basis exclusively for business purposes.

There are a few other rules one should be aware of when electing the safe harbor method. First, the deductible safe harbor amount is limited to the gross income of the business reduced by the ordinary business expenses. As noted before, the itemized deductions aren't taken into account under this election.

Second, any disallowed amount from a prior year of the safe harbor amount due to the gross income limitation can't be carried forward. The safe harbor amount is a "use it or lose it" amount. This is true even if the taxpayer elects the cost method in the succeeding year. Moreover, if the taxpayer had a carryover from the prior year's election of the cost method, the carryover amount can't be used if the safe harbor method is elected in the current year. The taxpayer will have to wait until the next succeeding taxable year in which he or she elects to use the cost method again in order to use that carryover. Thus, a person needs to exercise careful planning if or when switching between methods.

Third, the allowable square footage is an average monthly calculation for each taxpayer, with the maximum allowable footage of 300 in each month. Therefore, taxpayers who start a business during the year, operate a business seasonally, or increase/decrease their business space need to calculate the average square footage for the year. A taxpayer must have 15 or more days of qualified business use within a month to have it included in the monthly calculation. Section 4.08(4) of Rev. Proc. 2013-13 provides an illustration of a taxpayer who files federal income tax returns on a calendar year basis and begins using 400 square feet of his or her home for qualified business use on July 20 (use in July is less than 15 days) and continues that use until the end of the taxable year. The taxpayer, therefore, has an average monthly allowable square footage of 125 square feet (300 square feet for each month August through December divided by the number of months in the taxable year ((300 + 300 + 300 + 300 + 300)/12)).

Fourth, taxpayers sharing a residence may each elect the safe harbor method for their own businesses—but not if they're part of the same business or using the same space. This is true even if the taxpayers are spouses and regardless of their filing status.

Fifth, if a taxpayer has more than one business operating out of the same residence and elects the safe harbor method for one of the businesses, then it must be elected for all of the businesses. Moreover, the taxpayer is limited to 300 square feet under this method, which can be divided up in any reasonable manner among the businesses. But there is a caveat here: The taxpayer may not allocate more square footage to a qualified business use of a home than is actually used in that qualified business use of the home. Documentation would be advisable here.

Exercise careful planning if or when switching between methods.

Depreciation

When electing the safe harbor method, the taxpayer isn't concerned with depreciation, additional first-year depreciation, or IRC §179 expensing. These items are treated as zero for the year. Taxpayers electing to switch between the safe harbor and actual cost methods need to calculate depreciation for those years when the cost method is used. The optional depreciation tables for MACRS (Modified Accelerated Cost Recovery System) property are provided in the annual IRS Publication 946, *How to Depreciate Property*.

The following is Example 2 appearing in Section 4.08(7) of the revenue procedure: "B, an architect, is a sole proprietor who uses a room in her residence regularly and exclusively to meet with clients in the normal course of her trade or business throughout 2013. B determines that the room is 300 square feet and has a cost basis of $10,000. B placed the room in service in January 2010. For 2010, 2011, and 2012, B depreciates the room as nonresidential real property under the general depreciation system of §168(a), using the straight-line method of depreciation, a 39-year recovery period, and the mid-month convention, but does not use the optional depreciation table. The adjusted depreciable basis of the room as of December 31, 2012, is $9,241.45.

"For 2013, B elects the safe harbor method provided by this revenue procedure. Pursuant to section 4.06 of this revenue procedure, B does not deduct any depreciation for the room on her federal income tax return for 2013, and the depreciation deduction allowable for the room for 2013 is deemed to be zero. Accordingly, B's adjusted depreciable basis in the room as of December 31, 2013, is $9,241.45.

"For 2014, B resumes calculating and substantiating actual expenses for purposes of §280A. Pursuant to section 4.07 of this revenue procedure, B must use the appropriate optional depreciation table for determining the depreciation deduction allowable for the room for 2014 because B used the safe harbor method provided by

continued on page 61

Taxes

continued from page 12

this revenue procedure for a prior taxable year. In 2014, the room has been placed in service by B for five years. The appropriate optional depreciation table provides that the depreciation rate for year five is 2.564%. Accordingly, B deducts depreciation for the room on her federal income tax return for 2014 in the amount of $256.40 ($10,000 × .02564). Consequently, B's adjusted depreciable basis in the room as of December 31, 2014, is reduced to $8,985.05 ($9,241.45 – $256.40)."

The new simplified option for claiming the home office deduction seeks to reduce the compliance burden for both the taxpayer and the IRS. IRS News Release IR-2013-5 describes this as "a common-sense rule to provide taxpayers an easier way to calculate and claim the home office deduction." We'll know for sure after the IRS and Treasury Department finish reviewing the submitted comments that were requested on all aspects of this revenue procedure and further guidance from the IRS is issued. **SF**

James W. Rinier, CPA, is the Vertex Fellow at Drexel University. He can be reached at jwr29@drexel.edu.

Anthony P. Curatola is the Joseph F. Ford Professor of Accounting at Drexel University in Philadelphia, Pa., and a member of IMA's Greater Philadelphia Chapter. You can reach Tony at (215) 895-1453 or curatola@drexel.edu.