

# HOME OFFICE EXPENSES OF A SMALL BUSINESS ORGANIZED AS A CORPORATION

Many entrepreneurs and professionals have found it convenient and cost-effective to set up their office or practice in an area of their home. There is no commute or overhead expense, and they don't have to pay someone else office rent. What if the taxpayer's business or practice that is located in the home is incorporated? This article provides an overview of the general rules about office-in-the-home expenses and then discusses the special issue faced by a corporate shareholder-employee.

## General Home Office Expense Rules

Business expenses, such as salary, depreciation, and supplies are deductible without regard to the home office deduction rules and how the business is organized. The expenses at issue are the so-called direct and indirect expenses of a home office.

Direct expenses are those that relate only to the home office, such as the cost of painting the room where the home office is located or repairing the room's leaking ceiling.

Indirect expenses are those that relate to both the personal portion of the home and the business-use portion. Indirect expenses include items such as utilities, real estate taxes, home mortgage interest, rent, homeowners insurance, and repairs benefiting the entire property.

Direct expenses and the business-use portion of indirect expenses relating to a home office within a residence are deductible only if a portion of the home is used regularly (not just occasionally) and exclusively as:

- A principal place of business or
- As a place to meet or deal with customers or clients in the ordinary course of business.

The exclusive use test would fail if the space also doubles as a guest bedroom or your children do their homework there.

If the qualification test is met and the gross income from the business use of a taxpayer's home equals or exceeds total business expenses, all expenses for the business use of the home can be deducted.

If, however, the taxpayer's gross income from that use is less than total business expenses, home office deductions will be limited to the excess of the gross income derived from business use of the home over the sum of:

The deductions allocable to the business use that are allowable whether or not the unit was used, namely mortgage interest and real estate taxes, and the deductions (such as salaries or supplies) allocable to the business activity in which use of the home occurs, but which aren't allocable to the business use of the home.

A qualifying self-employed taxpayer claims home office expenses on Form 8829 (Expenses for Business Use of Your Home) and on Schedule C.

**CAUTION:** Under the Tax Cuts and Jobs Act (TCJA) taxpayers who are employees may no longer deduct home office expenses as Miscellaneous Itemized Deductions on their Schedule A.

## Safe Harbor Method

Instead of deducting a portion of your mortgage interest, property taxes, insurance, utilities, and certain other expenses, you can take a "Safe Harbor" deduction. Only one simple calculation is necessary: \$5 x the number of square feet of the office space. The safe harbor deduction is capped at \$1,500 per year, based on a maximum of 300 square feet.

## Problems of the Closely Held Corporation

If the business operated out of the taxpayer's home is organized as a corporation, direct and indirect expenses of the home office are the entity's expenses, not the owner-employee's expenses.

From a tax standpoint, there are two ways to handle these expenses:

**Payment of rent** -- The corporation can pay its shareholder-employee rent to offset home office expenses and supply him with a 1099-MISC. The rent will be deductible by the corporation, assuming it's a reasonable amount for the space and services actually provided, and will be taxable to the shareholder-employee.

However, the shareholder-employee is not allowed to claim any offsetting deductions to that income. The rules allowing deductions for business use of a dwelling unit do not apply to any expense if attributable to the rental of all or part of a taxpayer's dwelling unit to his employer during any period in which he uses the rented portion to perform services as an employee of the employer. For this purpose, an independent contractor is treated as an employee.

Where a formal lease arrangement exists, the only deductions that are allowable are those that could be claimed in the absence of any business use, namely mortgage interest and real estate taxes.

**Reimbursed employee expenses** -- The shareholder-employee can treat his home office expenses as if he were a regular employee, and then, by written pre-arrangement with the corporation, have it reimburse him for these costs after he substantiates them in full (amount, time, place, and business purpose of each expense).

A home office will be treated as a principal place of business if a portion of the home is used for the administrative or management activities of any trade or business of the taxpayer, and only if there is no other fixed location where the taxpayer conducts substantial administrative or management activities of that trade or business.

In the case of an employee-shareholder, there is an additional burden. The use of the home office must ALSO be for the "convenience of the employer".

To qualify as a home office, the other applicable requirements must also be satisfied. The home office must be used exclusively and regularly for business. In the case of an employee-shareholder, the convenience of the employer test would be met if there is no other business location.

**RESULTS:** Assuming the shareholder-employee of a corporation, could have claimed the expenses as business deductions, the reimbursement for the expenses is fully deductible by the corporation and is a tax-free accountable plan reimbursement to the employee. However, the shareholder-employee can't deduct the business-related portion of his mortgage interest and property tax if the corporation gives him a tax-free

accountable-plan reimbursement for these items. Otherwise, he would be getting a double tax benefit – a deduction and tax-free reimbursement for the same expense.

**If we can assist you with tax and business planning, please give us a call.**