

Focus on Tax Policy

A Standard Home Office Deduction

By Karen Connolly

MST Student

Spring 2010

Introduction

If you are self-employed or you use a portion of your home for business, you might be able to deduct the associated costs. But you must meet tax law requirements to qualify, and if you do qualify, then taking the deduction involves determining how much of the residence is used exclusively for business, what portion of the year it is used, and then deducting a portion of qualified expenses based on that.

Many taxpayers who qualify for the deduction do not claim it because the calculation is too complicated (for example, the IRS instructions are 35 pages long). The result is that many home-based businesses miss out on a deduction to which they are lawfully entitled. A 2006 survey conducted for the National Federation of Independent Business Research Foundation found that 75% of small-employers polled said the home office deduction would apply to their business, but only 15% of those respondents said they had a good understanding of the rules.¹ The key hurdles cited for not taking the deduction are the strict qualifying requirements, complexity of the form and instructions, and fear of being flagged for audit by the IRS.²

Simplifying this deduction is at the top of the tax reform recommendations published by the SBA Office of Advocacy in 2009.³ Current proposals would give taxpayers the option to take a standard home office deduction instead of using the calculation method. The rationale offered for a standard office deduction is that it would simplify the deduction and save time and money for both taxpayers and the IRS.

Several bills have been introduced in Congress to simplify the deduction. H.R. 3615 (111th Congress) proposed a standard deduction of \$1,500 and S. 1349 and H.R. 3056 (111th Congress) relaxed the requirements for clients to be physically present in the home office and allowed for de minimis use of business space for personal use (that is, the exclusive use requirement is relaxed).

¹ Tom Herman, "Fear of the Home-Office Deduction," *The Wall Street Journal On-Line*, 1/16/08, page 2; <http://online.wsj.com/article/SB12004393915626692441.html>.

² Testimony of Scott Scribner on behalf of The National Association for the Self-Employed, "Regulatory Burdens on Small Firms: What Rules Need Reforms?" before the House Committee on Small Business Subcommittee on Regulations, Healthcare and Trade, 07/30/08, page 22; http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_house_hearings&docid=f:42523.pdf.

³ SBA: Office of Advocacy, Letter Re: Recommendations for Tax Reform. 09/29/09, page 1; http://www.sba.gov/advo/laws/comments/tax09_0929.html.

Evaluation of an optional standard home office (HO) deduction against principles of good tax policy

Principle	Application	Rating
<p>Equity and Fairness – Are similarly situated taxpayers taxed similarly? Also consider any different effects based on an individual’s income level and where they live.</p>	<p>In general, a standard HO deduction increases fairness for small businesses. While corporations can fully deduct their operating costs, home-based businesses often cannot.⁴ Adding to this inequity is the fact that many taxpayers who qualify, do not take the deduction because of the complex calculation, record-keeping requirements, and fear of an audit. Similarly situated taxpayers are those who definitely use a home office, but don’t take the deduction for the reasons noted above. A standard HO deduction, particularly along with limited relaxation of the exclusive use rule, would reduce this inequity.</p> <p>Because of the simplicity of a flat deduction amount over the current calculation method, the addition of a standard HO deduction tends to favor less sophisticated taxpayers who do not have access to paid tax assistance to prepare their returns. This also improves fairness.</p> <p>For employees, working at home for the convenience of their employer, a standard HO deduction would continue to be reported as an itemized deduction which favors those who itemize deductions. However, since the existing HO deduction for employees is already reported as an itemized deduction, the addition of a standard HO deduction does not further affect equity/fairness because there is no change to the current treatment. The standard HO deduction would continue to be subject to the 2% AGI limitation which tends to limit the benefit for high-income taxpayers. And for an individual subject to AMT, a HO deduction may be a factor contributing to a taxpayer’s AMT status so many employees may choose to forego the HO deduction altogether, irrespective of a standard deduction alternative.</p> <p>While a standard deduction amount for HO expenses favors those with actual HO expenses less than the standard deduction, there will be others with actual expenses greater than the standard amount who prefer the simplification of a standard deduction. The amount of the standard deduction should be established based on current filing data, with the amount adjusted annually for the effects of inflation.</p>	<p>+</p>

⁴ Nydia Velazquez, House Committee on Small Business, *Broken Promises: The Stalled Agenda for American Small Business*, page 23; <http://www.house.gov/smbiz/democrats/Reports/BrokenPromisesReport.pdf>.

<p>Certainty – Does the rule clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined?</p>	<p>A standard deduction for HO expenses specifies when and how the taxpayer is to take the deduction and it is no different than the current calculation method for taking a HO deduction. A taxpayer completes Form 8829, Expenses for Business Use of Your Home, to determine the allowable expenses and the amount is reported on Schedule C for self-employed taxpayers, as a reduction of tentative profit/(loss), or on Schedule A for employees, as a miscellaneous itemized deduction, subject to the 2% of AGI limitation.⁵</p> <p>The typical wording of the bills proposed in Congress is to amend §280A(c) to allow for a Standard Home Office Deduction Amount, to be the lesser of (i) \$1,500, or (ii) gross income derived from the individual’s trade or business.⁶ Since a flat amount is more certain than the current rules, addition of a standard HO deduction increases certainty.</p>	<p>+</p>
<p>Convenience of payment – Is tax due at a time that is convenient for the payor?</p>	<p>The standard HO deduction would be claimed on the annual return. This is convenient for the taxpayer and represents no change from the current HO rule.</p>	<p>+</p>
<p>Economy in collection – Are the costs to collect the tax at a minimum level for both the government and taxpayers? Also consider the time needed to implement this tax.</p>	<p>The cost to collect would be minimal since this is an addition to the existing HO deduction rules within an established reporting framework.</p> <p>Existing forms, procedures and rules would require modification for the addition of a standard HO deduction but the cost of an addition to existing documents would be minimal compared to implementing entirely new legislation. Other than these modifications, minimal time would be needed to implement the standard HO deduction.</p> <p>If taxpayers abuse the rule, such as claiming the standard HO deduction even if they do not use their home as an office within the Section 280A requirements, additional IRS resources will be used to address the problem. However, the IRS can include questions on Form 8829 to help prevent abuse.</p>	<p>+</p>

⁵ IRS Publication 587, page 18

⁶ H.R. 1509 (111th Congress), Home Office Simplification Act.

<p>Simplicity - Can taxpayers understand the rules and comply with them correctly and in a cost-efficient manner?</p>	<p>The addition of a standard flat amount for a HO deduction is straightforward for understanding the rules and provides a simplified method over the current calculation approach. As referenced earlier, almost half of taxpayers claiming a HO deduction in 2001 made errors.⁷</p> <p>By making the standard deduction optional, taxpayers can choose which method to use, increasing the likelihood they will choose the method they are most confident in calculating correctly.</p> <p>The cost of claiming the HO deduction will decrease for taxpayers because the simplified flat amount allows the option to skip the cumbersome calculation method altogether if desired. A standard HO deduction will not only ease the burden on small business but also improve compliance.⁸</p>	<p>+</p>
<p>Neutrality - The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.</p>	<p>For taxpayers who are eligible but do not claim the deduction, a standard HO deduction would increase the likelihood of taxpayers taking the deduction who are already eligible for it. In May 2008, a National Association for the Self-Employed online poll found that over 60% of home-based businesses that were not currently claiming the HO deduction would do so if a standard deduction option was available.⁹</p> <p>But it is likely that the addition of a standard HO deduction could influence taxpayers to create home offices that don't already have one. However, in order to take the standard HO deduction, the taxpayer must still meet the stringent eligibility requirements. So, taxpayers cannot take the deduction simply because they decide to have a HO. Eligibility will still be driven by the qualifying business use as determined by taxpayer circumstances (or in the case of an employee, for the convenience of the employer.) Rules to prevent abuse of the standard HO deduction would also help to reduce the likelihood of intentional noncompliance. See Minimum Tax Gap below.</p>	<p>+/-</p>

⁷ Statement of Christopher Wagner Deputy Commissioner, Small Business/Self-Employed Division Internal Revenue Service before the House Committee on Small Business Subcommittee on Regulations, Healthcare and Trade, 07/30/08, page 8; http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_house_hearings&docid=f:42523.pdf.

⁸ Testimony of Keith Hall, National Tax Advisor, The National Association for the Self-Employed, House Committee on Small Business Subcommittee on Finance and Tax Hearing on "How the Complexity of the Tax Code Hinders Small Businesses." 05/07/09, pages 52 - 58; http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_house_hearings&docid=f:48882.pdf.

⁹ Hall testimony, *supra*..

<p>Economic growth and efficiency – Will the tax unduly impede or reduce the productive capacity of the economy?</p>	<p>The standard HO deduction will enhance economic growth and efficiency because the time and cost used to calculate the deduction under the current method could be used by entrepreneurs to grow their businesses. Every dollar spent on tax professionals is less money reinvested into small businesses.¹⁰ Simplification of complex calculations such as the HO deduction can improve economic efficiency.</p>	<p>+</p>
<p>Transparency and Visibility – Will taxpayers know that the tax exists and how and when it is imposed upon them and others?</p>	<p>Taxpayers will know that the optional standard deduction exists when they prepare their tax returns. The standard deduction will be visible to taxpayers on modified tax forms and instructions. Small business organizations and the U.S. Small Business Administration are also likely to help small business owners know of the new rule.</p>	<p>+</p>
<p>Minimum tax gap – Is the likelihood of intentional and unintentional non-compliance likely to be low?</p>	<p>Providing a simple standard deduction that is a flat amount could increase the likelihood of intentional non-compliance. Individuals who do not have home offices could intentionally take the deduction to which they are not entitled.</p> <p>To deter abuse of the standard deduction, instructions could be modified to explicitly remind taxpayers of the qualifying requirements to take the deduction and/or rules could be added to ensure compliance. For example, taxpayers could be required to answer a set of questions (under penalties of perjury) and attach them to the return in order to take the standard deduction (part of Form 8829). And, the standard deduction amount should be the lesser of \$1,500, or business income, so that some level of income is required to take the deduction.</p> <p>As a positive, the likelihood of unintentional non-compliance would be reduced by providing certainty of the deduction amount for taxpayers who are currently calculating the HO deduction incorrectly.</p>	<p>-/+</p>
<p>Appropriate government revenues – Will the government be able to determine how much tax</p>	<p>The cost of providing a standard HO deduction could be estimated using the current level of returns filed with a HO deduction plus an increase for additional taxpayers who would be expected to take the deduction once simplified.</p> <p>For example, the 2007 IRS Taxpayer Advocate Report indicated</p>	<p>+</p>

¹⁰ Hall testimony, *supra*..

revenue will likely be collected and when?	that while 8 million of the 20 million Schedule C filers in 2003 had a HO, only 2.7 million claimed the deduction. ¹¹ If 60% ¹² of the other 5.3 million eligible filers took a \$1,500 standard deduction, the total deduction amount would be about \$4.8 billion.	
--	--	--

Tax Analysis Summary

A standard home office deduction meets the principles of good tax policy other than minimum tax gap.

Possible Improvements

- To address the tax gap issue, rules could be added to prevent the standard deduction from being abused, and without increasing complexity. For example, adding questions about the home office to Form 8829, could help individuals know if they qualify for the deduction and discourage abuse.
- Relax the exclusive use requirements to allow for de minimis personal use. This would bring greater equity to small businesses operating out of their home relative to businesses that own or rent separate office space.

¹¹ House Committee on Small Business Report, *Seven Ways to Stimulate the Economy by Updating the Internal Revenue Code*, April 2008, page 6; <http://www.house.gov/smbiz/democrats/Reports/small-business-committee-tax-report.pdf>.

¹² Hall testimony, *supra*..