

## Home Office

This whitepaper is based on our understanding of the changes made by the Tax Act that became law on December 22, 2017.

In order to qualify for deduction of home office costs, a part of the home must be used regularly and exclusively for:

- The principal place of business for a trade or business, or
- A place of business used by patients, clients, or customers to meet or deal with the taxpayer in the normal course of business, or
- In connection with the trade or business if it is a separate, non-attached structure, or
- Used for storage of inventory or product samples (if the home is the only fixed location of the trade or business). The structure does not have to be the principal place of business or a place where you meet patients, clients, or customers.

Daycare purposes:

- A daycare facility in the taxpayer's home will normally not meet the exclusive use test. However, the home office is allowed if the taxpayer is in the business of providing day care for children, aged or mentally or physically disabled persons and
- Has a valid business license (or exempted from) or approval as a daycare center or home under state law.

## S Corporation Shareholders

Many shareholders in S corporations incur home office expenses. Congress and the IRS have never specified how S corporation shareholders can accomplish this. Some accountants incorrectly take a deduction on Form 1040, Schedule E, page 2 for "Unreimbursed shareholder expenses", but that provision only applies to partners in a partnership, and the IRS would disallow the expenses, and often the preparer would be penalized. Taking the deduction as an employee business expense is no longer allowed in 2018 under the 2017 Tax Cuts and Jobs Act.

Paying rent to the shareholder is not acceptable because most office in home expenses are not deductible when the office is rented to the taxpayer's employer under Internal Revenue Code Section 280A(a) which states: "Except as otherwise provided in this section, in the case of a taxpayer who is an individual or an S corporation, no deduction otherwise allowable under this chapter shall be allowed with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence." The deduction for allocable mortgage interest, property tax and casualty losses is still allowed, but no deduction is allowed for utilities, repairs, depreciation or other home office related expenses.

Rather than claiming an office-in-the-home deduction as a miscellaneous itemized deduction, an S Corporation shareholder-employee could have the corporation reimburse the expenses properly allocable to the business use of the home under accountable plan provisions. Reimbursement of business expenses is provided for under Internal Revenue Code Section 132 under the accountable plan rules. Pursuant to regulations applicable to Section 132, out-of-pocket business expenses should be documented and reimbursed on a current, monthly basis. We believe that a clear establishment of square footage used exclusively and regularly for the home office as a percentage of total square footage should be determined, and that the taxpayer turn in these expenses no less often than quarterly

for reimbursement, preferably monthly under the accountable plan rules requiring timely submission and reimbursement. We also believe the S corporation's Board of Directors should approve this policy in its formal board meetings and not in the minutes of the corporation.

As an employee the home office must be for the convenience of the employer. This means the home office is required as a condition of employment, it is necessary for the business to function or it is necessary for you to properly perform your duties as an employee. If there is no other place of business, such as a rented office or storefront, the home office should qualify, or if there is no other suitable place available for sales calls, client meetings and phone calls and client service at an existing facility the home office should also qualify. The deduction for expenses allocable to the business use of the home is limited to the net income derived from the business activity.

We believe any out-of-pocket expenses should qualify (including rent), other than mortgage principal payments and those expenses that are specifically allocable to other areas of the home. In particular this would also provide the S corporation shareholder with a tax-free reimbursement for such things as shelving, lighting and improvements to the specific office area and move the deduction to the S corporation return where it belongs. We do not believe that a reimbursement may be made for depreciation because it is not an out of pocket shareholder expense, but we can find no specific court cases commenting either way.

The home office reimbursement will reduce any normal residential tax deductions for mortgage interest and property tax on Schedule A. No recapture would apply upon the sale of the home since the taxpayer never deducted depreciation.

### **Partner/Member in a 1065 Entity**

A Member in a 1065 entity that works from home should consider meeting the same home office rules that other taxpayers need to meet, and then they should consider the following to enable home office and the related allocable property tax deductions.

- Generally, a partner may not directly deduct the expenses of the partnership on his or her individual returns, even if the expenses were incurred by the partner in furtherance of partnership business. An exception applies, however, when there is an agreement among partners, or a routine practice equal to an agreement, that requires a partner to use his or her own funds to pay a partnership expense.
- The instructions to Part Two of Schedule E state that the taxpayer may deduct "unreimbursed ordinary and necessary expenses of the partnership if you were required to pay these expenses under the partnership agreement." We understand that auditors aggressively pursue the disallowance of this deduction and recommend the use of an accountable plan to get the expenses to Form 1065 and avoid the problem completely.
- The Tax Court ratified the deductibility of unreimbursed expenses when the partner was required to pay them, they were valid business expenses, and the partner could not seek reimbursement.
- **Note-this is a special rule for LLC or partnership owners only.** S Corporation and C Corporation shareholders are legally separate entities and do not receive this special treatment.
- These deductions also reduce SE income.
- The instructions state to separately list these items on Line 27, not netting them against other partnership income.
- The instructions say that the title of the partnership entered in Line A should be "UPE".
- The court now states that, in order for a partner to deduct unreimbursed partnership expenses, the partnership agreement must:

- In writing require that the partners pay expenses personally,
- In writing state that no reimbursement will be made,
- Be specific as to expenses.

**Example of partnership agreement for unreimbursed partnership expenses:**

The partners hereby agree that for reasons of business consistency individual partners may wish to emphasize certain aspects of the partnership's business more than the partners as a whole wish to emphasize these same matters. Because of this difference of opinion in matters of business importance to the partnership, the individual partners agree that they are required to pay these expenses personally, and to not seek reimbursement from the partnership, as summarized below.

“In situations where the partnership is not in agreement as to amounts to be paid directly by the partnership, individual partners are required to pay these expenses personally (such as automobile expenses, travel & entertainment, and home office expenses) and to not expect or seek reimbursement from the partnership for these items.”

We composed this on January 21, 2018, and expect the IRS may well issue regulations in the coming months that could modify the information below. It is important that you seek advice regarding your particular situation including any subsequent changes.