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DEDUCTING THE BUSINESS USE OF YOUR HOME

The federal income tax deduction for the business use of a home has a good dollars and cents upside for those who qualify. Some detailed questions have to be answered correctly to get to that point, however. Not surprisingly, the IRS publication on the subject makes use of a complex flowchart filled with “yes or no” questions to guide taxpayers to a determination of eligibility for the deduction.

Qualifying for the Deduction

To pass the threshold for use of the home business deduction, a taxpayer must satisfy the following two basic sets of requirements. The first set concerns the nature of the business activities, while the second set relates more to the place itself.

First, the use of the business part of the home must be exclusive (with exceptions to be discussed below), regular, and for the business. Second, the business part of the home must be one of the following: the principal place of business—the place where the taxpayer meets or deals with patients, clients, or customers in the normal course of business—or a separate, detached structure used for business.

The exclusive use factor means that the area is used only for business, not for a mixture of business and personal uses. However, the exclusive use requirement need not be met when a part of the home is used for storage of inventory or product samples, or for a day care facility. When the IRS says that the use of the home must be for a trade or business, it does not mean any activity that makes money for the taxpayer. If you use a computer in your den for day trading of stocks or online gambling, do not count on taking the deduction. As for what constitutes a “regular” use for business, that essentially means business conducted on a continuing basis, not occasionally. Even if a taxpayer has a place in the home used exclusively for business, the deduction is not available if the business activity is only sporadic.

As for the requirements relating to the place itself, the area in the home used for business is a “principal place of business” if it is used exclusively and regularly for the administrative or management activities of the business, and there is no other fixed location where substantial activities of that kind are carried out. If some business is transacted at more than one location, determining whether the home location is the principal place of business requires consideration of the relative importance of the activities at each location. If that does not provide an answer, the time spent at each site should be considered. Remember that the deduction is available if either the home is the place for meeting with patients, clients, or customers, or a separate structure on the premises is dedicated for business.

If the taxpayer is an employee using part of a home for business, the deduction is available if all of the requirements described above are met, plus two additional tests. The business use must be for the convenience of the employer (not just appropriate or helpful), and the employee may not rent all or part of the home to the employer while using the rented portion to perform services as an employee.

What Is Deductible?

Deductible expenses for a business use of the home include items such as the business portion of real estate taxes, deductible mortgage interest, rent, casualty losses, utilities, insurance, depreciation, painting, and repairs. This is not likely to be an all or nothing proposition, though. Generally, an expense is fully deductible if it is direct, that is, incurred only for the business part of the home. An indirect expense, incurred for running the home as a whole, is deductible based on the percentage of the home used for business. Any reasonable method for determining that percentage is acceptable, such as dividing the square feet used for business by the total square feet, or dividing the number of rooms devoted to business by the total

number of rooms. If an expense is unrelated to the business part of the home, it is not deductible at all.

If the taxpayer's gross income from the business use of the home is lower than the total business expenses, the deduction for certain expenses will

be limited. But those expenses that cannot be deducted because of such a limitation can be carried forward for the next year's home business expenses.

QUALIFIED PERSONAL RESIDENCE TRUST

Federal estate tax law provides a method by which families can reduce the tax consequences of transferring the family home to the younger generation. The device for accomplishing this is called a qualified personal residence trust (QPRT).

An individual may create a QPRT by transferring his or her residence to a trust (usually for the benefit of family members), while retaining for a particular period of time the right to live in the residence for free. The tax laws treat the transaction as a gift of the remainder interest in the trust, rather than as an outright gift of the residence itself. There is a tax on that gift, but there is no later tax on the value of the whole residence at the time of the grantor's death, as there otherwise could be but for the use of the QPRT. As a rule, the more that a home can be expected to appreciate over the term of a trust, the more beneficial is the use of a QPRT.

A QPRT results in tax savings only if the grantor outlives the period of the retained interest. Even if the grantor does not survive the period established for the trust, the worst that could happen is that the

full value of the residence would be taxed. The result is the same as if there had been no QPRT in the first place.

The QPRT has two generally recognized drawbacks. While the grantor, usually a father or mother of a family, can continue to occupy the residence after the period of retained interest has run, he or she must pay rent to avoid inclusion of the residence in his or her estate. Some individuals may not like the prospect of being their children's rent paying tenants. Second, the QPRT does not provide a "step up" in the cost basis of the residence as there normally would be if a residence is inherited. If a QPRT is used, the gain on the sale of the residence is measured against the price that the grantor paid for the property originally, rather than against the value of the residence at the time of the grantor's death. The result could be higher income tax liability when the residence is sold.

As with most estate planning issues, the advice and guidance of a qualified professional is recommended before establishing a QPRT.

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