With easy Internet access, more and more people are choosing to work from home. Having a home office may provide tax savings, but can also create headaches when you decide to sell your home.

Requirements

If you are self-employed, you are allowed to claim a deduction for the business use of your home under any of the following circumstances:

- You use a portion of your home regularly and exclusively (1) as the principal place of business for a trade or business; (2) as a place to meet with clients, patients, or customers in the course of the trade or business; or (3) in connection with your trade or business, if the location is in a separate structure not attached to the home.
- Your home is used for the storage of inventory or product samples used in your trade or business of selling products at retail or wholesale and there is no other fixed location for storage. The regular and exclusive use requirements do not need to be met.
- You operate a day care out of your home. If you do not meet the regular and exclusive use requirements, you can still claim a home office deduction if you are complying with state and local laws in operating your home day care.

Note: "Exclusive use" means a specific area of your home is used only for your trade or business. The term "principal place of business" includes a place that you use for administrative or management activities of any trade or business if there is no other fixed location where you are able to perform those activities.

Determining Business Use

The business-use percentage is most often found by dividing the square footage of the office by the total amount of usable space in the home.

Note: With a day care business, multiply this business-use percentage by the fraction obtained by dividing the number of hours you use the home for business by the total number of hours in the year (8,760 hours, except in leap years).

Calculations

There are two ways to calculate your home office deduction. The simplified method uses a standard deduction. If you maintain a qualifying home office, you may elect to deduct annually $5 per square foot of home office space, up to 300 square feet, for a deduction up to $1,500. If you choose this method, you cannot depreciate a portion of your home; however, you can claim allowable mortgage interest, real estate taxes and casualty losses on the home as itemized deductions on Schedule A. These deductions need not be allocated between personal and business use, as is required under the regular method.

Alternatively, you may calculate your deduction using the actual expense method. Consider direct and indirect expenses when making home office calculations.

Direct expenses are those that pertain exclusively to the home office, such as painting the walls or installing new cabinets, shelving, carpeting, etc.

Indirect expenses are those that pertain to the entire residence, such as rent, mortgage interest, taxes, insurance, repairs, security systems, utilities, casualty losses, and depreciation. Allocate indirect expenses between the business and non-business portions of the home. This is done based on the business use percentage of your home.

Limitations

The amount of expenses you can deduct are subject to specific limitations and ordering rules. The deduction is limited to your net income from your trade or business.

If there is a loss, you are not allowed a deduction and the expenses are carried forward to future years and are allowed when there is net income.

Once net income is reduced by these expenses, you can deduct other home office expenses to the extent you have business income. If business income remains at that point, you can deduct

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depreciation. Any time business income reaches zero, carry the balance of the expenses forward. If you close your business before the carry forward amounts are used, they are lost.

Home sales and excludible gain

When you sell a home that had been the location of your home office, some of your gain may be taxable.

The depreciation the IRS allowed you to claim on your home office is subject to taxation even if it meets the personal-use rules at the time of sale. This depreciation is considered "unrecaptured §1250 gain" and will be taxed at a maximum rate of 25%. The remaining gain is eligible for the §121 exclusion.

Planning considerations

Home office expenses can represent a significant dollar amount in reducing your tax liability. This brochure provides a basic overview of a complicated area of tax law. If you think your situation meets the requirements, talk to your tax advisor for more specific details on how to qualify for this deduction.

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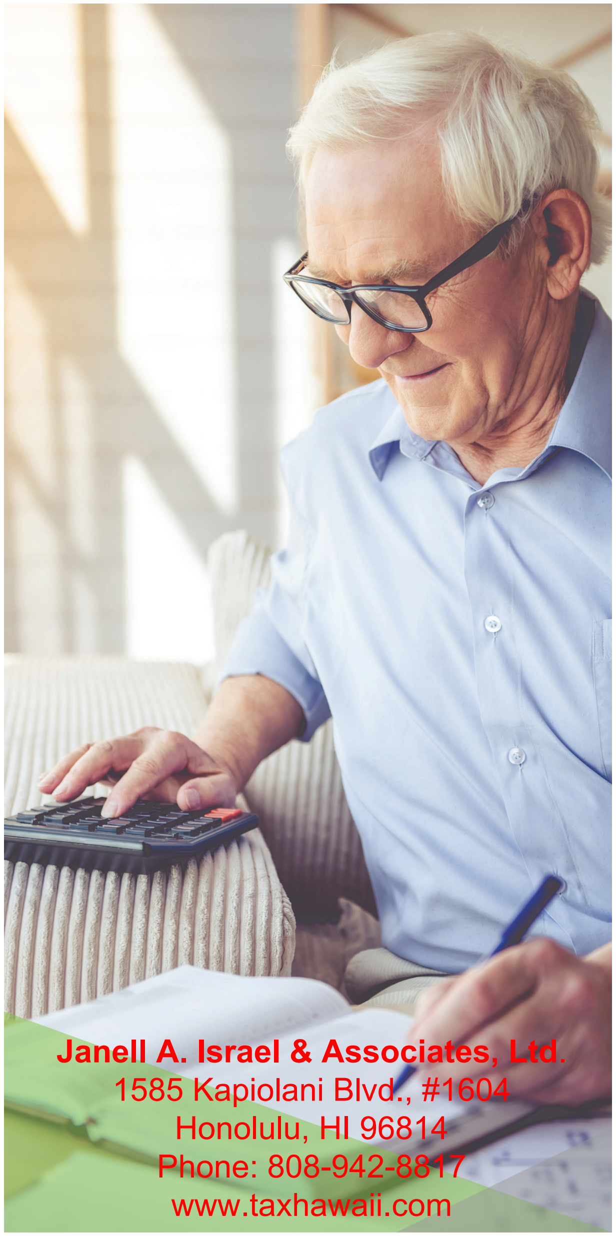

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