

The Home Office Deduction

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Originally Published: August 04, 2006 Modified: March 20, 2007

Establishing a home office can provide significant tax benefits for the sole proprietor. The home office deduction is not an easy calculation and is best left up to a tax professional.

In order to help explain this deduction I will provide example figures (you would need to use your own actual figures) and walk you through the steps. The first step in figuring your benefit is to figure out how much space you will be using in your home exclusively for businesses purposes.

- Office area (desk, printer stand, file cabinets, etc.) is 15' X 15' or 225 sq. feet
- Office closet (storage of office supplies, more filing cabinets, etc.) is 4' X 4' or 16 sq. feet
- Garage (one car slot is 10' X 20', car is used 60% for business) is 120 sq. feet (200 X 60%)

In my example, the total business area of the home is 361 sq. feet (225 + 16 + 120). Assuming that the home is 2,000 sq. feet and there is a two car garage (800 sq. feet), then the total home square footage is 2,800 and the business use percentage is 12.9% (361/2800).

Assuming the cost of the home is \$125,000 and the land is valued at \$25,000 then the assumed basis would be \$100,000. Your business use portion of the basis would be \$12,900 (100,000 X 12.9%). You are allowed to deduct this \$12,900 over 39 years, in the form of depreciation, which amounts to \$331 a year. If your utilities (electric, water, trash, etc.) are \$3,000 per year you can deduct \$387 (3,000 X 12.9%).

If you make any repairs (replace the broken overhead light) or have any maintenance costs (carpet cleaning) specifically for your home office they are fully deductible. If you make repairs or have an improvement for the whole house then you can only deduct the business percentage. In my example I am assuming there are no repairs.

Assuming that your property taxes are \$5,000 you can deduct \$645 as a home office deduction and \$4,355 as an itemized deduction. If your mortgage interest is \$7,000 you can deduct \$903 as a home office deduction and \$6,097 as an itemized deduction.

Insurance is also deductible. All business insurance is completely deductible. The business portion of your homeowners insurance is deductible as part of the home office deduction. We'll assume that is \$2,000 X 12.9% = \$258.

I've compiled the above information into this table:

	Previously Non- deductible Expenses in first full year	Home Office Deductions for first full year	Potential 20 year savings, excluding increases in utility costs, insurance & property taxes
Depreciation	\$331	\$331	\$6,620
Utilities	\$387	\$387	\$7,740
Property Taxes		\$645	\$12,900
Mortgage Interest		\$903	\$18,060
Homeowners Ins.	\$258	\$258	\$5,160
Total additional deductions	\$976	\$2,524	\$50,480
Potential Self-Employment Taxes Saved (15.3% on additional deductions	\$149	\$386	\$7,723
Potential Federal Taxes Saved at 35% on additional deductions less ½ self- employment taxes	\$315		\$6,300
Potential Recapture of Depreciation 25%	(\$83)		(\$1,655)
Potential Total Estimated Tax Savings			\$12,368

As you can see, if you have a qualified home office you can deduct expenses that you are already paying (since you're living in your house). These expenses reduce the profit on your business. A lower profit on your business reduces the amount of self-employment and federal taxes that you pay with respect to that business. In the above example you would save \$386/year in self-employment taxes and \$342/year in federal taxes for a total yearly tax savings of \$701.

If you were to subsequently sell your house, any gain on the sale of your property **up to the amount of depreciation that is allowed or allowable** will be taxable at your regular tax rate up to a maximum long-term capital rate of **25%** as long as you have owned the property for at least one year. Otherwise it's taxed at your regular income tax rates. In this example that would be a potential recapture of \$83/year in taxes.

The potential tax savings indicated above excludes increases in utility costs, homeowners insurance and

property taxes. It also excludes the gain you receive in benefiting from the depreciation deduction now and not paying the tax on it until you sell – in this case 20 years later. This has to do with the time value of money and is beyond the scope of this article.

Having a true home office is a great way to keep your overhead low since you are already paying for the space. If you don't use your home office you will have to buy or rent space elsewhere which is a cost you aren't currently incurring and didn't include above.

Could the home office deduction be a red flag? Possibly, however, considering the fairly low percentage of all returns that are audited, you probably don't have reason for concern unless you claim an outlandishly high deduction.

Whenever the issue of "red flags" come up with my clients, I always point out that if you are legitimately entitled to a deduction, the fear of an audit should not be an issue. It is your legal right to take advantage of every possible deduction that the Internal Revenue Code makes available to you. If you keep good records, and file an accurate return, you have nothing to worry about.

Due to an overwhelming amount of inquiries when this article was first published, I created a spreadsheet (available as a free resource on my website) to help all my readers [estimate the benefit of claiming the home office deduction](#). **This spreadsheet will only provide you with an estimate, not any actual values.** Your actual deduction (benefit) may be greater or less than the amount indicated on this spreadsheet. *You cannot use this spreadsheet to complete any tax forms, liabilities and/or deductions.*

Gina L. Gwozdz is a CPA who has chosen to specialize in taxes. Visit her website at <http://GLGcpa.com> to view more Tax Tip Articles.