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Untaxingly Yours

Working from Home During a Pandemic: Income Tax Implications

By Brian T. Whitlock

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The work and living arrangements of millions of taxpayers have been disrupted during calendar year 2020. The COVID-19 Coronavirus pandemic has forced the closure of places of business, schools, and traditional day care facilities.

Most white-collar taxpayers (including most lawyers, accountants, and tax practitioners) have been forced to incur additional expenses working from home, such as: increased utilities; the cost of installing or upgrading internet connections; purchasing office furniture, monitors, laptops, printers, and other consumer electronics; building additions and/or moving to larger dwellings; or remodeling existing spaces in order to create quiet work spaces. Where children are home all day, neighbors and relatives have created day care alternatives in their homes. Parents have been forced to hire tutors and nannies to keep the children occupied or focused on learning.

In addition to analyzing their own personal situations, tax practitioners will undoubtedly be bombarded with questions from clients, friends, and family. As taxpayers begin to think about year-end tax planning and pull together their tax information for the upcoming filing season a myriad of questions will arise. This column will attempt to look at the potential deductibility of these expenses and what tax practitioners should be discussing with their clients in December of 2020 and January of 2021 regarding the deductibility and recordkeeping requirements related to these additional expenses.[1]

Deducting Expenses When Working from Home

As a general rule, Code Sec. 280A prohibits taxpayers who are individuals and S Corporations from deducting any expenses (other than interest, taxes and casualty losses) that are related to the use of a dwelling unit which is used by the taxpayer as personal residence.

Three additional exceptions exist under Code Sec. 280A(c) for "Certain Business Use" of the home: (1) you maintain an office in your home or use a portion of your home "exclusively" and "regularly," (2) you use a portion of your home to store inventory or product samples, or (3) you use a portion of your home as a "day care facility."

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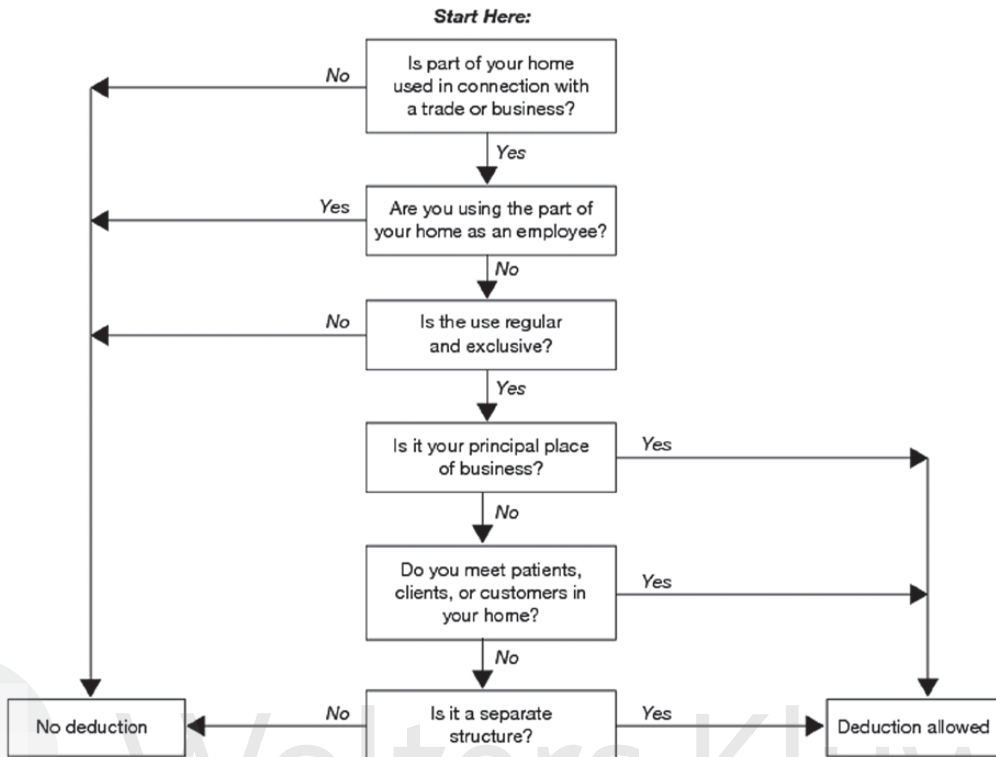
FIGURE A. CAN YOU DEDUCT BUSINESS USE OF THE HOME EXPENSES? DO NOT USE THIS CHART IF YOU USE YOUR HOME FOR THE STORAGE OF INVENTORY OR PRODUCT SAMPLES, OR TO OPERATE A DAYCARE FACILITY. SEE *EXCEPTIONS TO EXCLUSIVE USE*, EARLIER, AND *DAYCARE FACILITY*, LATER



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IRS Publication No. 587, *Business Use of Your Home (Including Use by Daycare Providers)*, contains the following flowchart (*see* Figure A) relative to the first exception, maintaining an office in your home.

The most shocking information that jumps out at the reader of the chart is found in the second question "Are you using the part of your home as an employee?" If the answer is "Yes" the flowchart tells us that "No Deduction is permitted." This is correct, the Tax Cuts and Jobs Act of 2017 (TCJA),[2] eliminated IRS Form 1040, Schedule A, *Miscellaneous Itemized Deductions* which previously had been subject to the 2% of Adjusted Gross Income limitation. All unreimbursed employee business expenses became non-deductible effective 2018 and that will continue until 2026. What can employees (and employers) do to ease the burden on this large group of taxpayers?

Accountable Employee Business Expense Reimbursement Plans

Employers should consider establishing an expense reimbursement plan to help employees during the pandemic. Under a reimbursement plan, the employer can authorize the employee to incur various business expenses that will be reimbursed within defined limits. The plan can provide an allowance or monthly dollar limitation for select employees. The employer can reimburse a portion of the employee's business expenses, such as: home office expenses (including depreciation), small tools, equipment, office supplies, and internet access to name a few. If the plan is an accountable plan, and the employee submits detailed expense reports documenting expenses equal to or greater than the employer's monthly limit, then no portion of the amount reimbursed will be taxable to the employee.

Written Accountable Reimbursement Plans

There is no requirement in the law or the regulations that an accountable plan needs to be in writing; however, a written plan document is advisable in order to protect the employer's deduction and avoid misunderstandings by employees. For small businesses, the written expense reimbursement policy should be incorporated into a board

of directors' resolution, and the document should find its way into to business's minute book. The plan should:

1) List only reimbursable expenses which have a business connection;
2) Require reimbursable expenses to be substantiated within a reasonable period; and
3) Require the employee to return any advances not spent to the employer, within a reasonable period of time. *(**Comment**: If the employee fails to substantiate an advance within the required timeline, then the full amount will be taxable to the employee as additional wages)*.

Accountable reimbursement plans are not employee benefit plans subject to the Employee Retirement Income Security Act (ERISA) or other nondiscrimination rules. As a result, reimbursement limitations and categories of qualifying expenditures can vary among employees depending upon their job description and/or level of responsibility. The reimbursements and the expenses should be reported on IRS Form 2106, *Employee Business Expenses*.

Non-Employees and Home Office Deductions

Self Employed persons, independent contractors, statutory employees,[3] and farmers may also claim tax deductions related to the use of their home as an office. In order to qualify the business portion of the home must either be used:

1) "Exclusively" and "regularly" as the taxpayer's principal place of business; or
2) "Exclusively" and "regularly" as a place where the taxpayer meets with clients, patients, or customers; or
3) In a separate structure that is not attached to the home.

The words "exclusively" and "regularly" are quite specific and limiting. In order to qualify, the space must be either a room or a separately defined space that is used on a consistent basis in support of a profit-seeking activity that is a trade or business; and the space must not be used personally by the taxpayer or other members of the household.

More than One Trade or Business in the Home

The same space in the home may be the principal place of business for two or more taxpayers as well as two or more separate business activities. In the current pandemic, where multiple adults are working from home, it might be necessary to share or alternate the use of the business space. Although the rules, permit multiple or alternating business uses, the same rules would not permit alternating uses which are business and personal. For example, the den which serves as mom's office during the day cannot serve as the homework study hall for adolescent children in the evening.

Calculating the Deduction when in the Home

The tax law permits two methods for calculating the home office deduction: the simplified method and the actual method. Taxpayers are not required to use the same method from year to year.

Under the simplified method, the taxpayer must first calculate the square footage of the home that is used exclusively and regularly for business and multiply the square footage (up to a maximum of 300 square feet) by five ($5) dollars.

Under the actual method, the taxpayer must first calculate the square footage of the home that is used exclusively and regularly for business and then divide that number by the total square footage within the home. Secondly, the taxpayer must calculate the portion of the year that the space was used as the home office.

> **Example #1**: Josh works as an independent contractor. From January 1st through March 17th, Josh was provided with a workspace at each of his client's places of business where he could supervise projects. ***Comment**: During this period, even if he was working from home after hours, he would not be permitted to claim a home office deduction.*[4] On March 18th, Josh's clients closed their offices and Josh was forced to work exclusively from home. Josh worked at the dining room table until April 15th when relocated his teenager and converted the extra bedroom in the basement into his home office. ***Comment**: From March 16th until April 15th, Josh's use of the dining room would not qualify under the exclusive use test.* Beginning April 15th, Josh may claim a home office deduction. If he claims the deduction, he must prorate the expenses and deduct only the portion of his home office expenses that relate to the period running from April 15th until the end of the year (or when he can return to the workspace provided for him at his client's place of business).

Next, the taxpayer must divide expenses into three different categories: direct expenses (only related to the office portion); indirect expenses (expenses related to both the office and non-office portion) such as interest, taxes, utilities, repairs, and insurance; and unrelated expenses (related solely to non-business aspects of the home) such as lawn

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care, and repairs, and maintenance of non-business spaces not serving the business space. Where the dwelling is a rental (rather than an owned) space, the taxpayer may include the rent paid as an indirect expense. IRS Form 8829, *Expenses for Business Use of Your Home*, and the accompanying Worksheet in the instructions to the form are an excellent tool for helping to calculate the Home Office Deduction.

In addition to the out of pocket expenses related to the operation of the home, taxpayers may also claim a depreciation deduction (using the 39-year recovery period for real property) for the business-use percentage of the cost of the home (*i.e.*, the cost of the structure, excluding the cost of the land).

Business Deduction Limitations and Carryovers

Self-employed taxpayers may deduct business expenses related to the use of their home up to the limit of their gross income from their trade or business. Deductions in excess of the gross income generated by the trade or business may be carried forward to the next year in which the taxpayer uses the actual method for calculating the home office deduction.

Non-Business Deductions

It should not be forgotten that the nonbusiness portion of mortgage interest and real estate taxes may still be claimed by the taxpayer on IRS Form 1040 or IRS 1040-SR, Schedule A, *Itemized Deductions* subject to the limitations on itemized deductions.

Exceptions to the "Exclusive Use" Test

Under Code Sec. 280A, there are essentially four exceptions to the "Exclusive Use" test which prohibit deductions related to the taxpayer's personal dwelling:

1) The space is in a separate structure which is not attached to the home;
2) The space is used for the storage of inventory and product samples;
3) The space is rented to third parties[5]; or
4) The space is a day care facility.

Separate Structures Not Attached to the Home

Qualifying as "separate structure" exception might not be as easy as one might suspect. Let's look and an example.

Example #2: Reynalory worked identically to Josh in Example #1. However, when she was forced to work from home, she converted her "she shed" which was separate structure located in the backyard into her home office.

The Tax Court in *Scott*[6] looked at a similar fact pattern. Even though the shed was not physically attached to the home, the Court nonetheless found that it was "part of the dwelling unit" by virtue of the fact that it was located on the same lot, and all of the expenses for the property including real estate taxes, utility services, interest and insurance were all part of common bills. Creating a separate space under this definition might require partitioning of the land and the separate metering of utility services.

Home Office Used for Storage Use for Inventory and Product Samples

The second exception to the exclusive use rule appears to be clear cut. Space which is used for the storage of inventory and product samples generally becomes unusable for other purposes since the personal property will likely fully occupy the space. This exception however has four tests:[7]

1) The taxpayer must sell products at wholesale or retail as their trade or business;
2) The products must actually be kept in the dwelling on a regular basis;
3) The dwelling must be the only fixed location for the business; and
4) The space must be separately identifiable.

Schedule C Filers

Sole Proprietors, self-employed persons, independent contractors and statutory employees who are required to file IRS Form 1040 or 1040-SR, Schedule C, *Profit or Loss from Business*, should report their deduction on line 30 and use IRS Form 8829 to support the calculation of the deduction unless they are using the simplified method.

Owners of Rental Real Estate

Taxpayers who do not "materially participate"[8] in a rental activity are deemed to be passive investors. Passive investors in rental real estate may not claim a home office deduction.

Taxpayers who are engaged in the "trade or business"[9] of renting real estate may deduct all ordinary and necessary business expenses. Rental activities may rise to the level of a trade or business where the owner materially participates in the rental activity.

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Wholly owned rental activities are reported on Schedule E, *Supplemental Income and Loss*, page 1, Part 1. Rental activities conducted in concert with others (inside of partnerships and limited liability companies) are generally reported on Schedule E, page 2 line 28. If the taxpayer is engaged as a "Qualified Real Estate Professional" as defined in Code Sec. 469, then he or she may be better served to claim any applicable home office deductions on Schedule C where it will reduce self-employment income. If the taxpayer has no Schedule C income, but their rental activity nonetheless rises to the level of being a trade or business, then the deduction may be claimed on Schedule E either page 1, or as part of Schedule E, page 2. Consider using IRS Form 8829 as a worksheet to support the calculation of the calculation of the Home Office deduction.

Although theoretically, a taxpayer may be engaged in rental activities which are deemed to be a trade or business, neither the instructions to Schedule E nor IRS Publication 587 refer to home office deductions for the owners of rental real estate. In *Scott*,[10] a taxpayer successfully claimed home office deductions associated with its ownership and management of five rental properties.

Farmers

Taxpayers who are required to file IRS Form 1040 or 1040-SR, Schedule F to report farming activities may also claim a home office deduction. The IRS instructions to Schedule F suggest that the deductions should be claimed on lines 32a through 32f as ordinary and necessary farm expenses. Taxpayers are specifically advised not to use IRS Form 8829 but rather to rely on the worksheets contained in IRS Publication 587 in order to compute the allowable deduction if they are not using the "simplified method."

Partners and Members

Partners and members of limited liability that are actively engaged in a trade or business may deduct home office expenses on their individual Form 1040, *U.S. Individual Income Tax Return*. If the expense is of the type the partner is expected to pay without reimbursement, the partner can deduct the expense on Schedule E, *Supplemental Income and Loss*, as "unreimbursed partner expense" (UPE). Per the instructions to Schedule E, UPE should be reported on Schedule E, page 2, line 28 as a separate line, along with the name of the partnership, the Employer Identification number, a description of the amount, and the notation "UPE." Form 8829 can be used to determine the appropriate deduction, but the form itself does not need to be filed.

The IRS takes the position that these expenses are not deductible on an individual return unless the partnership agreement (operating agreement) expressly states that the partner (member) is required to pay the expense personally.[11] Tax practitioners should review partnership (operating) agreements and insist that such language requiring each partner or member to pay for home office and other partnership expenses without reimbursement.

Recordkeeping

Numerous Tax Court cases can be found involving taxpayers that have unsuccessfully attempted to claim home office deductions. A close reading of these cases suggests that the failures of these taxpayers appear to be the result of poor recordkeeping, rather than whether home offices are "per se" deductible expenses.[12] It is not enough to merely keep copies of receipts for rent, interest, taxes, utilities, purchases of furniture, electronics and supplies. Photographs showing the separate nature of the workspace, logs recording patient, client, and customer visits are all useful aids in showing that the space is exclusively and regularly used to support the trade or business.

Daycare Operators

As mentioned earlier, the fourth exception to the exclusive use test is exists where the taxpayer uses of any portion of the dwelling on a regular basis in the taxpayer's trade or business of providing day care services for children under the age of 13, adults over the age of 65, or individuals who are physically or mentally incapable of caring from themselves.

Similar to the "Separate Structure" exception, compliance with this exception is much more difficult than it might first appear. The proposed Treasury regulations under Code Sec. 280A[13] require that in order to constitute a trade or business the day care operator must be acting in accordance with applicable State law relating to the licensing, certification, registration, or approval of day care centers or group homes.[14]

If the neighbor or relative can meet the State requirements of licensing, certification, registration, and approval, then they may deduct a portion of their expenses for maintaining their home against the income that they earn in their trade or business as a day care provider. A day care provider computes the business use deduction by multiplying the total costs incurred during the year that are allocable to the use of the home by two fractions:

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1) The total square footage of the dwelling that is available for day care on a daily basis divided by the total square footage of the dwelling, and
2) The total hours in the year that the day care business is operated (including set-up and clean-up), divided by the total number of hours in the year.

Tutors, Nannies, and Caregivers

The child and dependent care credit available under Code Sec. 21 is generally equal to a percentage of the taxpayer(s) employment-related dependent care expenses. Taxpayers may claim a tax credit[15] for up to $3,000 of expenses for one qualifying individual (a dependent child under the age of 13) and up to $6,000 for two or more qualifying individuals and IRS Form 2441, *Child and Dependent Care Expenses*. Code Sec. 21(d) limits the expenses to the earned income of the taxpayer or the lower paid spouse, if both are working.[16] Employment related expenses must be reduced by any amount that is excluded from the taxpayer's gross income under a Code Sec. 129, *Dependent Care Assistance Program*.[17]

Payments made to a spouse, a dependent of the taxpayer, a child of the taxpayer under the age of 19, or to the parent of the qualifying child do not qualify for the credit.[18] However, payments made to family members that are not dependents of the taxpayer may qualify, even if the relatives reside in the taxpayer's home.[19]

Future Work Spaces and Living Arrangements

The pandemic has already had a significant impact on the design of work relationships and offices. As businesses attempt to lure people back into offices, they may be forced to rethink open office architecture and group workspaces. The impact on commercial real estate value may be significant.

As individual taxpayers look to the future, this past years' experience will not only influence the future design of taxpayers' living spaces, but it may ultimately cause them to rethink their choice on whether to live in dense urban settings or suburban and rural areas. The impact on residential real estate value may shift as well.

ENDNOTES

1 This column will not discuss all aspect of Code Sec. 280A or the rules for deducting expenses related to rental properties (either primary or vacation residences) which are also personally used by the taxpayer as dwellings.

2 Tax Cuts and Jobs Act of 2017 (TCJA), P.L. 115-97.

3 A statutory employee is an independent contractor that is treated as an employee sole for tax withholding purposes. The IRS currently classifies four groups as statutory employees: (1) a driver that distributes food and beverages or picks up dry cleaning and is paid a commission; (2) a full-time life insurance agent who sells primarily for one life insurance company; (3) an individual who works at home assembling goods on a piecemeal basis; and (4) full-time sales person soliciting resale business. A tax preparer can identify a statutory employee where box 13 on Form W-2 is checked by the employer. All business-related expenses can be reported using the same rules as a self-employed person on Schedule C (IRS Form 1040 or IRS Form 1040-SR).

4 In the Taxpayer Relief Act of 1997 (P.L. 105-34) Congress amended Code Sec. 280A and relaxed principal place of business rules. Under the prior rules, the home office was required to be the taxpayer's principal place of business. *N.E. Soliman*, SCt, 91-1 USTC ¶50,291, 113 SCt 701, 935 F2d 52 (1991). The Taxpayer Relief Act expanded the definition of home of to permit the deduction if the taxpayer there is no other fixed location of such trade or business where the taxpayer can conduct administrative and management activities and the space in the home is regularly use by the taxpayer to meet with patients, clients or customer in the normal course of its trade or business.

5 The rental of personal residences and vacation homes to third parties generally permits taxpayers to deduct expenses so long as their personal usage does not exceed the lesser of 10% of the available days or 30 days. A detailed discussion is beyond the scope of this particular column.

6 *Charles A. Scott and Jan F. Scott*, 84 TC 683, Dec. 42,024 (1985).

7 *See*, Code Sec. 280A(c)(2) and Reg. §1.280A-2(e).

8 A discussion of the definition of a "material participation" under Code Sec. 469 (the Passive Loss Rules) and other relevant provisions is beyond the scope of this particular column, but nonetheless relevant to the determination of whether the taxpayer's real estate activities rise to the level of being a passive activity.

9 A discussion of the definition of a "trade or business" under Code Sec. 1411 (the Net Investment Income Tax) and other relevant provisions is beyond the scope of this particular column, but nonetheless relevant to the determination of whether the taxpayer's real estate activities rise to the level of constituting a trade or business.

10 *Charles A. Scott and Jan F. Scott*, 84 TC 683, Dec. 42,024 (1985).

11 *See*, *McLauchlan*, CA-5, 2014-1 USTC ¶50,203, 558 Fed Appx 374 (2014); *see also* TAMs 9316003 and 9330004.

12 *P.J. Simonelli*, 114 TCM 362, Dec. 61,024(M), TC Memo. 2017-188 (affirmed U.S. Ct of Appeals, Ninth Cir., January 23, 2020); *T.W. Brombach*, Dec. 59,195(M), 104 TCM 307, TC Memo. 2012-265 (2012); *Carmickle*, T.C. Summary Opinion 2012-60 (June 26, 2012); and *Hartman*, T.C. Summary Opinion 2010-164 (October 28, 2010).

13 Proposed Reg. §1.280A-2(f)(3) (published in the Federal Register on August 7, 1980, with amendments published in the Federal Register on July 21, 1983).

14 The website *www.daycare.com/states.html* contains a listing of the State Licensing Requirements for all 50 states plus the District of Columbia. Some states such as Illinois (my home state) exempt individuals from the licensing requirements if they serve three or fewer children under the age of 13, including their own, or children from a single household or only children related to the provider.

15 The amount of the credit decreases as the taxpayer's wages increase. A 20% rate will likely apply to typical white-collar couples with dependent children, since their adjusted gross income will likely be in excess of $43,000.

16 *See also*, Reg. §1.21-2(b)(1) (T.D. 9354, 2007-2 CB 759).

17 A Dependent Care Assistance Program is a written nondiscriminatory plan maintained by an employer. The maximum amount that may be excluded from an employee's gross income under such a program is $5,000 per year.

18 Reg. §1.21-2 (T.D. 9354, 2007-2 CB 759).

19 *E.L. Langlois*, 56 TCM 36, Dec. 45,032(M), TC Memo. 1988-415 (1988).

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