Chapter 2: Small Business Issues

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Please note. Corrections for all of the chapters are available at www.TaxSchool.illinois.edu. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

SIMPLIFIED OPTION FOR CLAIMING HOME OFFICE DEDUCTION1

In January 2013, the IRS announced a new method for claiming home office expenses. This new method is expected to save taxpayers 1.6 million hours of recordkeeping annually.2

Previously, the only method of deducting qualified home office expenses required determining the applicable business percentage. This can be calculated by comparing the total square footage of the home office with the square footage of the entire home. The business percentage is then applied to the applicable household expenses to determine the expenses attributable to the business area of the home.

Under the new method, taxpayers may deduct $5 per square foot of home office space, up to a maximum of $1,500 per year. One of the key benefits of the method is that taxpayers are not required to substantiate the expenses incurred for their home.

This simplified method is also referred to as a safe harbor method by the IRS. The use of this method is an election available to taxpayers with qualifying home offices.

Note. The new simplified method is for determining the amount of the deduction. It does not change the requirements that must be met for a home office to be considered a qualified home office. For more information on these requirements, see the 2012 University of Illinois Federal Tax Workbook, Volume C, Chapter 7: Office in Home.

For tax years starting on or after January 1, 2013, taxpayers may elect to use the safe harbor method to determine the amount of deductible expenses for their home offices. For 2013, taxpayers may choose to deduct $5 per square foot of home office space instead of using actual expenses. The $5 rate may be adjusted in the future if the IRS deems that the rate is no longer appropriate.

The election to use the safe harbor method must be made on a timely filed original return using Schedule C. See the following page for a draft version of the bottom portion of page 1 of 2013 Schedule C. The election is made simply by using this method. However, once made, the election is irrevocable for the tax year.

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AVGAGE SQUARE FOOTAGE CALCULATION

The maximum number of square feet that may be used for this calculation is 300. For purposes of determining the allowable square footage, a taxpayer with a qualified business use of a home for a portion of the tax year or a taxpayer who changes the square footage for a qualified business use during the tax year must determine the average of the monthly allowable square footage for the year. In determining the average monthly allowable square footage, no more than 300 square feet may be taken into account for any month. For the purposes of this calculation, if the taxpayer uses the home office for at least 15 days, it is counted as being used for the entire month.

Example 1. Trista starts a business as a wedding planner on June 1, 2013. She uses 108 square feet of her home as a qualified home office. In 2013, she did not track her applicable home expenses, so she computes her home office deduction using the optional safe harbor method, as follows.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th>1</th>
<th>2</th>
<th>3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Square Feet Used</td>
<td>Applicable Months</td>
<td>Total</td>
<td></td>
<td></td>
</tr>
<tr>
<td>January–May 0</td>
<td>5</td>
<td>0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>June–December 108</td>
<td>7</td>
<td>756</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total use over 12 months</td>
<td>756</td>
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<td>756</td>
<td></td>
</tr>
<tr>
<td>Average monthly square foot usage</td>
<td>63</td>
<td>$5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Home office deduction</td>
<td>$315</td>
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</table>

DEPRECIATION ISSUES RELATED TO THE SAFE HARBOR METHOD

Taxpayers who use the safe harbor method cannot deduct any depreciation for the qualified home office for that tax year. The depreciation deduction allowable for that portion of the home for that tax year is deemed to be zero.

If a taxpayer uses the safe harbor method for one year and uses the actual expense method for any subsequent year, the taxpayer must calculate the depreciation deduction allowable in the subsequent year by using the appropriate optional depreciation table applicable for the property. This is true regardless of whether the taxpayer used an optional depreciation table for the property in the year it was placed in service. The optional depreciation tables for MACRS property are provided in IRS Pub. 946, How To Depreciate Property. The appropriate optional depreciation table is based on the depreciation system, depreciation method, recovery period, and convention applicable to the property at the time it was placed in service.

The allowable depreciation deduction is calculated in the subsequent year by multiplying the remaining adjusted depreciable basis of the home office by the annual depreciation rate specified in the appropriate optional depreciation table. The applicable year to use in the table is the year that corresponds with the current tax year based on the placed-in-service date of the property.
Example 2. Use the same facts as Example 1. In 2014, Trista tracks the expenses and determines that using the actual expense method will be more beneficial. To calculate the depreciation portion of the 2014 deduction, she first determines her remaining adjusted basis of the home office portion of the home. In 2013, when she placed the home office in service, the portion of the home’s basis allocable to the home office was $10,000. Under the safe harbor method, the allowed or allowable depreciation for 2013 is $0. Therefore, her remaining adjusted basis at the beginning of 2014 is still $10,000.

The appropriate optional depreciation table in IRS Pub. 946 is A-7a, which follows. It shows that the depreciation rate for year two is 2.564%. Accordingly, Trista’s 2014 depreciation deduction for the home office is $256 ($10,000 × .02564). Her adjusted depreciable basis at the end of 2014 is $9,744 ($10,000 – $256).

Table A-7a. Nonresidential Real Property
Mid-Month Convention
Straight Line—39 Years

<table>
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<tr>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
<th>11</th>
<th>12</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2.461%</td>
<td>2.247%</td>
<td>2.033%</td>
<td>1.819%</td>
<td>1.605%</td>
<td>1.391%</td>
<td>1.177%</td>
<td>0.963%</td>
<td>0.749%</td>
<td>0.535%</td>
<td>0.321%</td>
<td>0.107%</td>
</tr>
<tr>
<td>2–39</td>
<td>0.107</td>
<td>0.321</td>
<td>0.535</td>
<td>0.749</td>
<td>1.031</td>
<td>1.391</td>
<td>1.605</td>
<td>1.819</td>
<td>2.033</td>
<td>2.247</td>
<td>2.461</td>
<td></td>
</tr>
<tr>
<td>40</td>
<td>2.564</td>
<td>2.564</td>
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<td>2.564</td>
</tr>
</tbody>
</table>

Note. Taxpayers who sell their homes after claiming depreciation for a home office may have to pay taxes on the depreciation portion of any gain realized. However, if they have used the safe harbor method of calculating their home office deductions for the entire time that they had a home office, there is no allowed or allowable depreciation to recapture.

QUESTIONS AND ANSWERS

Question 1. Once a taxpayer elects to use the safe harbor method, may they use the actual method in future years?4

Answer 1. Yes. The election is made on a year-by-year basis.

Question 2. May employers use the safe harbor method to reimburse employees for qualified employee home offices?5

Answer 2. No. The IRS will not allow employers to use this method for reimbursing employees.

Question 3. Does using the safe harbor method reduce the amount of itemized deductions allowed on Schedule A, Itemized Deductions?6

Answer 3. No. Mortgage interest and real estate taxes are deductible on Schedule A in full without any adjustment for having used the safe harbor method to determine the deduction for the business use of the home.

Note. This may be one of the most taxpayer-friendly provisions under the new method. In addition to the home office business deduction, taxpayers are allowed to deduct 100% of their otherwise allowable mortgage interest and real estate taxes.

3. IRC §121(d)(6).