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INSIGHT

The Home Office Tax Deduction

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The home office deduction allows certain taxpayers to deduct expenses attributable to the business use of their homes. In response to public health concerns surrounding the Coronavirus Disease 2019 (COVID-19) pandemic, many workers transitioned to remote work or work-from-home arrangements, increasing interest in this deduction. However, employees who have moved from onsite work to working from home as a result of the pandemic are not able to claim this benefit for the work they do for their employers.

This Insight summarizes the home office deduction eligibility, calculation methods, and costs.

Eligibility

Expenses related to a taxpayer's home generally are not tax deductible. However, some taxpayers may deduct expenses attributable to the *exclusive* and regular business use of a portion of their home (26 U.S.C. §280A).

There are three main categories of business use of a home office that qualify for the deduction:

1. The home office is used as the taxpayer's principal place of business. For taxpayers who conduct most of their business outside the home, a home office used as the primary location of administrative or management activities (e.g., billing) qualifies.
2. The home office is used to meet or serve patients, clients, or customers.
3. A separate structure not attached to the home is used for business (e.g., workshop).

The exclusive use condition requires that an area of the home be used only for business and never for personal uses, by the taxpayer or anyone in the taxpayer's family. For example, a room would generally fail the exclusive use test if the taxpayer's child uses it to do homework, even if the taxpayer only uses it for business. There are limited exceptions to the exclusive use condition for wholesale or retail sellers and licensed day care operators.

Can Employees Claim a Home Office Deduction?

Employees are currently ineligible to claim the home office deduction for work they do for their employers. Before 2018, in some cases employees could deduct the business use of their home as a miscellaneous itemized deduction. (This benefit was unavailable to taxpayers who claimed the standard

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deduction.) Under this provision, the home office had to be for the convenience of the *employer* (not the employee's preference). In addition, the amount that could be deducted had to exceed 2% of adjusted gross income (AGI), a floor applicable to miscellaneous itemized deductions generally. P.L. 115-97 (often called the "Tax Cuts and Jobs Act") suspended all miscellaneous itemized deductions for tax years 2018 through 2025. Under current law, certain employees who itemize their deductions may be able to claim this benefit beginning in 2026.

At least one legislative proposal in the 117th Congress would extend the deduction to employees for home office expenses during the COVID-19 pandemic.

Calculating the Deduction

There are two methods for determining the amount of the deduction: the actual expense method and the simplified method.

Actual Expense Method

The actual expense method requires a taxpayer to keep detailed records in order to calculate the deduction amount (and to substantiate their claim, if requested to do so). Generally, deductibility varies by the portion of business use and whether the taxpayer itemizes deductions for individual income taxes.

Deductible expenses are either direct or indirect. Direct expenses are due only to the business use of the home, such as a wall repair in the home office. The full amount of direct expenses can be deducted.

Whereas home office repairs are generally deductible, permanent improvements cannot be deducted. The IRS considers repairs to be actions that keep a house in good working order, whereas permanent improvements permanently increase the value. Repainting a home office would most likely be a repair, whereas building a wall to create a room for business would most likely be a permanent improvement.

Indirect expenses are expenses for the whole home that also benefit the business. These include utilities such as electricity, as well as certain personal itemized deductions, such as mortgage interest. The taxpayer must allocate these expenses between personal and business use and can only deduct the business portion. The IRS allows any reasonable method to determine the percentage used for business. One common method is dividing the area used for business by the area of the whole home.

The home office deduction cannot exceed the gross income of a business in a given year. The amount of the deduction that would exceed gross income may generally be carried over to the following year.

Simplified Expense Method

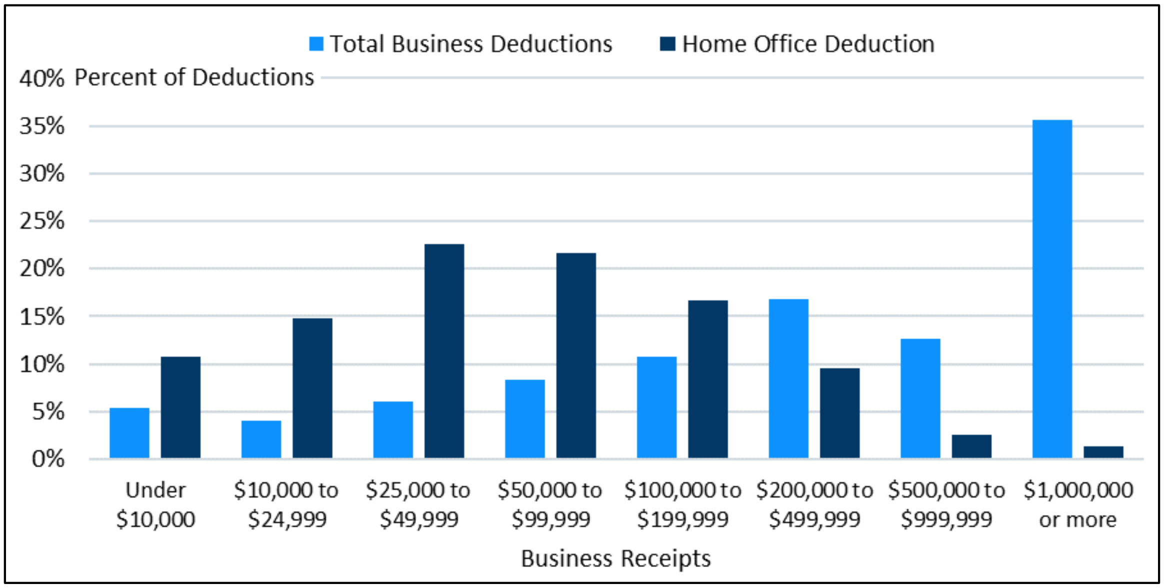
The IRS recognized that the documentation and calculation requirements of the standard method were burdensome for some small businesses. In 2013, it created an optional safe harbor to determine the amount of deductible expenses for business use of a residence (Rev. Proc. 2013-13). The simplified method deduction is $5 times the physical area used exclusively for business, up to a maximum of 300 square feet. The maximum deduction is $1,500 or the gross income of the business, whichever is less. Excess home office expenses under the simplified method cannot be carried over to the following year.

Cost and Equity

In tax year 2018, $10.6 billion was deducted by nonfarm sole proprietorships for home office expenses. (A sole proprietorship is an unincorporated business owned by the taxpayer only.) This is 0.9% of the $1.2 trillion of all sole proprietor business deductions.

The benefits of the home office deduction are more likely to go to businesses with lower business receipts (see **Figure 1**). In tax year 2018, about 70% of the home office deduction dollars went to businesses with annual receipts of less than $100,000. Those same businesses received 24% of all business deductions. The largest sole proprietorships, with receipts of $1 million or more, claimed 36% of all business deductions but 1% of home office deductions.

Figure 1. Distribution of Dollars Deducted in Total and Under the Home Office Deductions Among Sole Proprietors, by Business Receipts, 2018



Source: Figure created by CRS using data from Table 2, IRS Statistics of Income Bulletin, "Sole Proprietorship Returns, Tax Year 2018," Spring 2021, available at https://www.irs.gov/pub/irs-soi/soi-a-insp-id2104.pdf.

Author Information

Anthony A. Cilluffo
Analyst in Public Finance

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