About That Home Office, How Deductible Is It?

Working Remotely and Your Taxes

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While the immediate effects of the coronavirus are beginning to wane and the economy is reopening, there will almost certainly be lasting changes in the wake of the pandemic. One area at the forefront of these discussions is the future of the workplace.

Following a year in which remote work became a requirement for so many, it is expected that a significant chunk of the workforce will look to continue to spend at least part of the workweek working remotely. In addition, many of the large cities have seen workers migrate out of town and even out of state, in search of more space and more affordable housing.

A recent study by the Conference Board found that more than one out of three employers surveyed expect 40% or more of their team to continue work remotely.

All of these changes will have implications for the economy and society at large, but at the individual level there are also a number of tax issues that must be navigated for those with the ability to work remotely.

Deducting Business Expenses

The Tax Cuts and Jobs Act of 2017 limited or eliminated numerous itemized tax deductions, including the deduction for unreimbursed business expenses. As a result, any expenses you pay out-of-pocket while working from home that aren't reimbursed by your employer are no longer tax-deductible.

Thus any business-related expenses should be paid for by the employer directly or be reimbursed by the company, in order to retain tax-efficiency. If a company reimburses an employee for the purchase of office supplies and equipment, it is generally not considered taxable income to the employee. However, several conditions must be met to avoid taxation.

First, the expense should be "ordinary and necessary." The Internal Revenue Service defines these terms as follows: "*To be deductible, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in your industry. A necessary expense is one that is helpful and appropriate for your trade or business. An expense does not have to be indispensable to be considered necessary*."

Second, your employer should have a written policy for expense reimbursement that defines how claims will be documented and submitted. This is known as an "accountable plan," and without it, reimbursements may be deemed taxable income. Similarly, if the employee does not follow the plan's guidelines for submitting expenses, the reimbursement may be considered taxable income. Often, your employer will provide the equipment directly rather than reimbursing you. Two common examples are work-provided laptops or cellphones. As long as these items are used for business purposes, they are not considered a taxable benefit to employees. Thus if you have shifted to remote work and your employer provides a PC, there are no tax issues.

Further, the IRS formally recognized that particularly with computers and cellphones, some personal use may occur and this is considered a nontaxable fringe benefit. Note that if you purchase the cellphone or computer yourself and are reimbursed, the IRS may look with greater scrutiny at whether the computer or phone was purchased primarily for business use and how often you use it in the course of your job.

Home Office Deduction Rules

The second big change in 2017 was the elimination of the home office deduction for all Form W-2 employees through the year 2025. If you work remotely, but are paid regular W-2 wages, you cannot deduct the use of a home office on your taxes. Self-employed taxpayers, however, can claim the home office deduction provided they pass three tests:

- **Exclusive use test** — the portion of the home used for the home office must be used exclusively for business purposes.
- **Regular use test** — the home office must be used on an ongoing basis.
- **Principal place of business test** — the home office must be the taxpayer's primary place of business.

The exclusive use test is applied quite strictly. If you convert a spare bedroom to an office but allow out-of-town visitors to use it as a guest room for even one night, you will fail the exclusive use test.

The other two tests are less strictly defined and open to interpretation based on the circumstances of your work schedule. For example, you can maintain an office building location and claim the home office deduction, provided you conduct "most" of your business activity from home.

Even then, there are two relatively common exceptions to the principal place of business test. First, if you regularly hold meetings with clients, patients or customers at your home, you can claim a home office deduction, even if it is not your primary place of business.

Second, if the home office is a free-standing structure on the property, like a detached garage or barn, you can claim the deduction, even if it is not your principal place of business.

Figuring a Home Office Deduction

If you qualify based on the above tests, there are two ways to calculate the home office deduction: the regular method and the simplified method. Under the regular method, you simply total up the direct expenses for the space, such as furnishings and supplies, and then add indirect expenses. Indirect expenses are the office space's share of real estate taxes, mortgage interest, insurance and utilities, amongst others.

Typically, you will divide the square footage of the office by the square footage of the home to get the home office's share of indirect expenses. Thus, a 200-square-foot home office in a 2,200-square-foot home would represent 11% of the home and 11% of total indirect expenses like real estate tax would be deductible.

Under the simplified method, you simply multiply the square footage of the home office by $5, up to a max of 300 square feet. Thus, a 200-square-foot office would generate a $1,000 deduction.

While the regular method may produce a higher deduction, there is a greater burden on the taxpayer. The regular method requires precise record-keeping, prorating of itemized deductions between home and home office, and you must calculate depreciation on the home.

The depreciation calculation is beyond the scope of this article and should be done by an accountant. Suffice it to say, the regular method may produce greater tax savings but will also add greater complexity.

Tax Issues for W-2 Employees Shifting to Work From Home

As noted above, the business expense and home office deductions are only available to self-employed taxpayers. For most W-2 employees, working from home in and of itself won't change anything with respect to your income tax.

But if you permanently relocate to a new state, different from your employer's headquarters, you will need to contend with changes to your state tax situation.

In general state tax is withheld from your paycheck by the state where you work. Meanwhile, you file and pay income taxes in the state where you live. For many these states are one and the same. On the other hands, if you live in one state and are employed in another, you may have to file two tax returns.

That doesn't mean you will be double-taxed on the same income. There are two customary treatments for workers living in one state and working in another. One common scenario is that the employer withholds tax from your paycheck in the work state, and the employee files and pays taxes in the home state, receiving a credit for tax withheld in the work state.

On the other hand, a number of states have reciprocal agreements with neighboring states to simplify this further. We are familiar with this here in our home in Washington, D.C. Locally there are reciprocal agreements between Maryland, D.C. and Virginia that allow employees to simply pay and file taxes in their home state, regardless of where their employer is based.

There are 17 states with a reciprocal agreement with at least one other state, concentrated primarily in the Mid-Atlantic and the Upper Midwest. If you work remotely in a state different than your employer's headquarters, and the states do not have a reciprocal agreement, you may have to file and pay tax on income in both states.

Exactly when your income crosses the threshold that requires you to file a nonresident state income tax return differs for each state. In states such as North Carolina, Kansas and Colorado, nonresidents are required to file a state return on any taxable income from in-state sources. In New York, you must file once your in-state income exceeds the state's standard deduction. Other states track the number of days you work in-state. It is critical that you understand the rules for any state where you live or earn income.

Keep Good Records and Talk to a Professional

Much was made during the pandemic of workers fleeing cities and high cost-of-living areas to work remotely from quieter, cheaper, more tax friendly destinations. Even for those staying put, there will almost certainly be a greater portion of the workforce working from home in the future.

As you can see, your taxes can quickly become complicated when transitioning to work from home or relocating out-of-state. It is crucial that you keep good records on how often you worked in each location, along with income and expenses. Given the complexity, we recommend that you consult an accountant if you are considering using the home office deduction or moving to remote work for tax purposes.

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