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The simplified home office deduction

Beginning in the 2013 tax year, the IRS gave taxpayers a choice when it comes to the home office deduction. To avoid the necessity of detailed recordkeeping, a new "safe harbor" deduction was created for home offices. The simplified deduction was set at $5 per square foot of the home office space, up to a limit of $1,500 (300 square feet).

The existence of the new safe harbor and relief from recordkeeping does not change the other requirements for taking the home office deduction. The office must be used regularly and exclusively for business. The office should either be the principal place of business or used for administrative or management activities when the taxpayer has no other office for handling those chores. An office kept for the convenience of the employer, such as a salesman who lives away from company headquarters might have, also will qualify.

In many cases, the actual expenses for the home office will be greater than the safe harbor. These may include, for example, a share of utilities and insurance costs. For example, the IRS reported that for the 2010 tax year, the average home office deduction was $2,600, so many people will find the safe harbor limit too low. The taxpayer may choose the traditional route of actual expenses instead of the safe harbor. What's more, that choice may be made for each tax year, without regard to the choices made in earlier years. Thus, the taxpayer may alternate between methods, choosing the one most favorable each year.

With the traditional method of calculating the deduction, a proportionate depreciation deduction is permitted for the office space. The amount of the depreciation is recaptured and taxed as income when the house is later sold. The safe harbor alternative does not generate depreciation recapture.

The deduction for the home office may not exceed the net income of the business. If the business is showing a loss for the year, the loss may be carried forward when the traditional method of calculating the deduction is used. However, the carryover is not permitted with the safe harbor approach. What's more, any carryover loss created from the actual home office expense calculations may not be deducted in years in which the safe harbor is elected.

Although the simplified deduction was intended to make life easier for taxpayers, the reality is that many taxpayers will have to figure the deduction both ways to decide which is the better way to go.

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