THE OFFICE-IN-HOME DEDUCTION:
THE IMPACT OF RECENT COURT DECISONS

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Section 280A was added to the Internal Revenue Code by the Tax Reform Act of 1976[1] to provide "definitive rules relating to deductions for expenses attributable to the business use of homes."[2] Prior to the enactment of Section 280A, the courts allowed a deduction for an office-in-home if it could be shown to be "appropriate and helpful". This forced taxpayers to substantiate the business element of what is normally a personal item, the maintenance of a home. Thus, nondeductible personal expenses could be converted to deductible business expenses merely because it was appropriate and helpful to conduct some of that business at home. Congress wanted a "less subjective" determination and enacted Section 280A.

SECTION 280A

According to Section 280A(c) of the Internal Revenue Code, a deduction is permitted for expenses incurred with regard to a taxpayer's use of an exclusive portion of a dwelling unit on a regular basis as his principal place of business. In the case of an employee, one other requirement must be met - the office-in-home must be for the convenience of the employer.

Regular Use Test

Section 280A(c) requires that the portion of the dwelling unit be used on a regular basis. For purposes of deciding what constitutes use on a regular basis, the facts and circumstances of each individual case must be analyzed. A portion of the

residence must be used as the principal place of business or a place which is used for business meetings with customers, clients, or patients on a regular basis. Incidental or occasional trade or business use would not be deductible. The portion of expenses allocated to this area is generally allowed as a deduction.

Exclusive Use Test

The exclusive use test is met if the portion of the dwelling unit used to accommodate an office is used exclusively for the purpose of carrying out a trade or business. In this context, "dwelling unit" refers to a house, apartment, condominium, mobile home, or similar property which offers basic living accommodations. Other property and structures which are considered part of the dwelling unit but are not attached to it are also classified as "dwelling units" for the purpose of this deduction. The use of a portion of a dwelling unit for both personal and business purposes does not meet the exclusive use test. Expenses under section 212 relating to income producing activities such as investing are not deductible if the taxpayer is not in the trade or business of making investments.

Principal Place of Business Test

The office-in-home must be the taxpayer's principal place of business. The courts have found it difficult to determine what is meant by principal place of business. Items considered in determining the principal place of business include the following:

(1) The amount of income related to business activities at the different locations;

(2) The time spent at each location;

(3) The facilities available at each location.

Lastly, in the case of employees, the office must be used for the convenience of the employer. The deduction will be disallowed if the employer already furnishes a suitable office.

Gross Income Limitation

The Tax Reform Act of 1986[3] added a further restriction even if all of the above requirements are satisfied. Section 280A(c)(5) limits the total deduction allowed to the total gross income received through use of the unit, reduced by those deductions allowed regardless of whether they are related to the taxpayer's trade or business. Gross income is defined as gross income from the business less expenses which are not related to the office-in-home deduction, such as postage, supplies, etc. In the case where a taxpayer has more than one business activity for which the portion of the dwelling unit is used, all activities must meet all requirements of Section 280A or no deduction is allowed for any activity.

THE FOCAL POINT ISSUE

Nothing in the legislative history of section 280A, the Internal Revenue Code or the regulations furnishes any guidance as to the scope of the "principal place of business" concept. Thus the courts have had great difficulty in arriving at a decision on this issue. In Baie[4] the Tax Court therefore decided

that what Congress had in mind was the "focal point" of a taxpayer's activities. Baie was not allowed to deduct any expenses attributable to her use of a home office or her kitchen because her principal place of business, i.e., the focal point, was her food stand and not her residence.

The dilemma over what constitutes a taxpayer's principal place of business is also evident in the case of Drucker v. Commissioner.[5] Drucker was employed by the Metropolitan Opera Association as a concert violinist and was required to put in many long hours of practice in preparation for performances. However, since individual practice studios were not furnished by his employer, employees had to practice their individual pieces elsewhere. This practice was not required by the employer as a condition of employment, yet was essential for the employee to be able to perform up to the standards of the Metropolitan Opera Association. Drucker was denied a deduction for the room in his apartment that he used exclusively for this purpose.

The Tax Court held that the focal point of the taxpayer's activities was not in the time spent practicing but in performance. While the number of hours spent practicing was much greater in comparison to the number of hours spent performing, this was not a controlling factor. The court placed much more importance on the place of performance, Lincoln Center, than the time Drucker spent in his home studio. According to the court, "the sole reason for the existence of this orchestra is to perform as a group for the public...". Therefore, the place of

performance was deemed to be more valuable, and thus the focal point, because it was where services were performed and income was generated. The time and effort needed to be successful was not taken into consideration. As a result, Drucker's use of the studio in his apartment was considered merely "appropriate and helpful" to the employee.

It was suggested by Judge Tannenwald that there may not be a "principal place of business" in some instances where the taxpayer's activities are carried out at a number of different places.

Judge Wilbur stated in his dissenting opinion that the principal place of business is not necessarily the place where goods and services are exchanged. Instead, it is where the taxpayer devotes time and effort on a regular basis. He believed that the focal point should be where the most fundamental parts of an activity occur. In Drucker's case, this would be his studio in his apartment because it was necessary in order to establish a quality performance. Wilbur concluded that the time and effort put into the performance should be more important because the end product is simply exhibiting the mastery of a learned activity, one mastered in the studio of Drucker's apartment.

On appeal the Second Circuit Court agreed with Wilbur's reasoning and reversed the Tax Court's decision. The use of a home studio was not purely a matter of personal convenience, comfort, or economy. Since the Tax Court found practicing to be

"necessary" and "essential", it should therefore be considered a "requirement or condition of employment", in other words, for the convenience of the employer.

The issue of what constitutes a principal place of business must be resolved with respect to the facts and circumstances surrounding each individual case, and in Drucker the employee's principal place of business was not that of his employer.

As in Drucker v. Commissioner, the Soliman[6] case again raised the issue of whether the office-in-home was the taxpayer's principal place of business. Soliman was a self-employed anesthesiologist practicing at three different hospitals. Although he spent the majority of his time at the hospitals, he devoted two or three hours each day to making phone calls, sending out bills, reading medical literature, and preparing for patients. He used a room in his apartment exclusively for these purposes. The only "personal" use of his home office was to balance his checkbook which combined his business and personal affairs. The office in his home was necessary since the hospital did not furnish one. Even though Soliman did not see patients in his home office, the court was convinced that his office was his principal place of business, and he was therefore allowed a deduction for the expenses incurred through the use of his home office.

In previous cases, the principal place of business was determined through the use of the focal point test - the place where services were performed and income was generated. However,

in this case, a majority of 11 judges believed that the focal point test was too restrictive. As a result, the court rejected the focal point test to allow an office-in-home to qualify as the principal place of business when a taxpayer's occupation requires essential management and organizational activities aside from those that generate income and the only available office space is in the taxpayer's home. Soliman's activities were considered to be essential to his ability to continue his business as an anesthesiologist and demanded a substantial amount of time - over 30%.

Because Soliman was engaged in two distinct activities related to his business, providing medical care at hospitals and taking care of administrative duties, the time allocated to each activity became less significant. The courts believed that such a comparison would be misleading unless the activities were similar in nature. The distinctness of the activities caused more weight to be placed on the lack of office space at the hospital instead of the comparison of hours spent on each activity.

The Tax Court rejected the focal point test and announced that it "... will no longer follow our opinion in Drucker...in cases in which a taxpayer's home office is essential to his business, he spends substantial time there, and there is no other location available to perform the office functions of the business".[7]

However, Judge Nims argued in his dissenting opinion that

the necessity of performing administrative functions and the lack of furnished office space to perform these duties is not sufficient reasoning to qualify a taxpayer's home office as his principal place of business. He also believed that one cannot detect any reliable basis for determining a taxpayer's principal place of business in the absence of applying the focal point test.

Nims believed that the focal point test was a response to Congress' use of the word "principal" in the statutory phrase "principal place of business". This required the courts to compare places of business activities to determine which ranks higher. He believed that the majority did not seek to make that comparison but only examined the importance of the taxpayer's office in the home. Because they did not examine the time spent in each location, they have essentially substituted the phrase "important place of business" for the phrase Congress enacted.

Judge Ruwe, in his dissent, stated that the majority changed the focal point to the place where administrative duties and billing activities were performed. Deductions being a matter of "legislative grace" should not be allowed for a home office merely because they are "essential" or "substantial".[8] The opinions of the Second and Seventh Circuit should prevail wherein the principal place of business was defined as the place where most of the activity takes place.

The Internal Revenue Service has warned taxpayers in IR 90-55 that it will not follow the Tax Court's opinion and will

continue to challenge the deductibility of those expenses incurred in connection with an office-in-home in which the majority of the taxpayer's work is done outside of the home. The IRS also filed a "motion for reconsideration by the full court" because the Soliman ruling goes against the legislative history of Section 280A.

However, in Pomarantz v. Commissioner[9] the Tax Court denied the home office deduction to a physician who spent most of his time at the hospital which did not provide him with an office. However, he had access to a work area, call room, and physician's lounge. The work area contained phones, desk space, and bookshelves with medical journals and books. The Tax Court acknowledged that the hospital did not provide adequate office space to read, study, perform patient follow up, and maintain records. Nevertheless, the hospital was found to be Pomarantz's principal place of business under the focal point test because he spent an insubstantial amount of time in his office. The Ninth Circuit found that the Tax Court's determination of principal place of business was essentially factual and subject to the clearly erroneous standard. Therefore, the Ninth Circuit would not disturb the Tax Court's factual determination affirming the ruling against the taxpayer.

MORE THAN ONE PRINCIPAL PLACE OF BUSINESS

While Drucker was considered an employee whose employer did not provide practice studios and Soliman was self-employed, Hamacher[10] dealt with a professional actor engaged in two

separate businesses. He worked independently as a contract actor for the Alliance Theater and also worked as an employee of the theater, serving as administrator of the acting school at the theater. Although most of his contract work was for the Alliance Theater, he also worked as an actor doing radio and television commercials. This work was separate and independent from the Alliance Theater. The theater provided an office for Hamacher which was available to him during business and nonbusiness hours. This office was also used by other employees in his absence. Hamacher used an office in his home for conducting activities related to both businesses. These activities included receiving calls regarding acting roles, preparing for auditions, and rehearsing parts for commercials. He also used his office for "creative thinking" since he was so often interrupted by questions and telephone calls at his theater office. His other activities included developing the schools' curriculum, selecting plays for the theater, and administrative duties in connection with the Alliance Theater acting school. Hamacher spent 20% of his time in his home office, 40% in his theater office, and 40% acting on stage.

Prior to 1981, home office deductions were only allowed in cases where the taxpayer was using his residence as the principal place of business of his main business activity. In 1981, however, Congress amended this rule by permitting a deduction for taxpayers with more than one trade or business.[11] This allowed a taxpayer to use an office-in-home as the principal place of

business for more than one business if the regular and exclusive use tests were met for all businesses. Therefore, the fact that Hamacher used his home office in conducting two business activities did not by itself violate the exclusive use requirement or destroy the applicability of Section 280A(c)(1).

Hamacher's use of his home office in connection with his profession as administrator of the acting school was not deductible because it was not considered to be for the convenience of his employer. He was not required to do any work at home and also was furnished with an office at the acting school. Therefore, his home office was considered to be for his own personal convenience and comfort.

Section 280A offers limited guidance on the issue of when an office is considered to be used for the convenience of the employer. Generally, this is true when an employee must have the office as a condition of employment. Many people find it helpful to take work home with them, but that does not automatically establish that the home office is for the convenience of the employer.

Since Hamacher used his home office for two separate business activities and his activity as an employee did not satisfy the requirements necessary to be considered for the convenience of his employer, no expenses attributable to his home office were deductible in connection with either activity.

IMPLICATIONS AND CONCLUSIONS

The office-in-home deduction continues to be contested in

the courts. However, three conditions generally must be present before one should consider taking the deduction:

(1) The home office must be used for activities which are essential to the operation of the business. The Tax Court has put more emphasis on the place where administrative and organizational activities are performed and less on the place where income is generated.

(2) Substantial time must be spent in the home office. The concept of substantial time, however, will differ with the facts and circumstances of each case, and it will be difficult to rely on any certain figure as a bench mark for the deduction.

(3) No other suitable office must be available in which to conduct business activities. If an employer provides an office for the employee's use, the home office is generally not considered for the convenience of the employer and the deduction will be disallowed.

Since the Internal Revenue Service disagrees with the courts' position, there is a substantial risk that the deduction will be disallowed. The taxpayer may even be subject to the so-called "accuracy penalty." The Revenue Reconciliation Act of 1989[12] added new Code Section 6662 effective for tax returns due after December 31, 1989. According to Section 6662(b)(1) and (c) a taxpayer's understatement of income tax may cause a penalty to be imposed if the understatement is due to negligence or disregard of the rules or regulations. Under this penalty, 20% of the portion of the underpayment will be added to the total

amount of tax owed.

Presumably the taxpayer could claim an exception under Section 6664(c) if the home office deduction was taken in good faith and it was reasonable to do so. However, this exception requires disclosure either by attaching Form 8275 or writing the line and page number where the disclosure is made on the top left-hand corner of the front page of the tax return.[13] This disclosure is necessary to avoid the negligence penalty, but it is questionable whether a taxpayer could be charged with negligence when he relies on Soliman, a court decision with an eleven judge majority.

FOOTNOTES

1. Public Law 94-455, 1976 Tax Reform Act, 90 Stat. 1520.

2. Senate Report 94-1236 (1976), 1976-3 C.B. (Vol.3) 807, 839.

3. Public Law 99-514, 1986 Tax Reform Act, 100 Stat. 2085.

4. Baie, 74 T.C. 105 (1980).

5. Drucker v. Commissioner, 715 F2d 67, 52 AFTR2d 83-5804, (2d Cir. 1983), rev'g 79 T.C. 605.

6. Soliman, 94 T.C. No. 3 (1990).

7. Ibid., p. 29.

8. Ibid., p. 40.

9. Pomarantz v. Commissioner, 867 F2d 495, 62 AFTR2d 88-5882, (9th Cir. 1988), aff'g P. 86,461 PH Memo TC.

10. Hamacher, 94 T.C. No. 21 (1990).

11. Public Law 97-119, 1981 Black Lung Benefits Revenue Act, 95 Stat. 1635.

12. Public Law 101-239, 1989 Revenue Reconciliation Act, 103 Stat. 2106.

13. Notice 90-20, Internal Revenue Bulletin, March 5, 1990, p. 17-20.