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Don't Try This at Home: The ABCs of Home Office Or Vacation Home Rental Deductions

by Robert W. Wood[*]

As a general rule, under §262,[1] personal, living, and family expenses are not deductible. This rule does not apply where otherwise expressly provided in the Code, such as in the case of interest and taxes. In tandem with §262's general rule, §280A generally disallows deductions for use of a ''dwelling unit'' used as a residence, subject to specific exceptions listed in §280A. Deductions that do not require a business motive, such as qualified residence interest and property taxes, are not limited by §280A.[2]

Section 280A is a complex statute, and the courts have interpreted it strictly.[3] Taxpayers typically seek to deduct home expenses for two types of home business use: home offices and vacation home rentals. Section 280A(c) carves out the only allowable deductions for expenses relating to such uses, and §280A imposes a heavy burden on the taxpayer to establish that such expenses are deductible.

Moreover, taking a home office deduction is widely perceived as a ''red flag'' that may prompt an IRS audit, although it is unclear whether there is a genuine basis for the perception. This article explores some of the basic issues to be aware of when claiming deductions under §280A.

Triggers for §280A

Section 280A's deduction disallowance rule is triggered when one makes personal use of a dwelling unit as a residence for which he/she

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[1] Unless otherwise indicated, all references to ''§'' or ''Section'' are to the Internal Revenue Code (Chapter 26 of the United States Code) and the regulations promulgated thereunder (Chapter 26 of the Code of Federal Regulations).

[2] §280A(b).

[3] *See, e.g.*, *Langer v. Comr.*, 63 T.C.M. 1900 (1992), *aff'd per curiam*, 980 F.2d 1198 (8th Cir. 1993); *Deihl v. Comr.*, T.C. Memo 2005-287; Napoli, ''Home Office Deductions: Recent Decisions Make Up a Mixed Bag for Taxpayers,'' 10 *Rev. Tax'n Individ.* 228, 229 (1986); Burke & Friel, ''Recent Developments in the Income Taxation of Individuals: Expanding the Home Office Deduction Exceptions,'' 9 *Rev. Tax'n Individ.* 380, 384 (1985).

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also claims business expense deductions.[4] A taxpayer subject to these rules can be an individual, partnership, trust, estate, or S corporation, but not a regular C corporation (except in its capacity as a member of a partnership or as a beneficiary of a trust or estate).[5]

For purposes of §280A, a dwelling unit can be a house, apartment, condominium, or any other structure normally understood to be a home.[6] A dwelling unit does not include the portion of a unit used exclusively as a hotel, motel, inn, or similar establishment.[7] Under proposed regulations, a two-pronged test determines whether property may be excluded from the ''dwelling unit'' definition by falling with this hotel exception: (1) the property must be regularly available for occupancy by paying customers; and (2) no person having an interest in the property may have used the unit (or the portion of the unit) as a residence during the taxable year.[8]

Personal Use That Subjects a Taxpayer to §280A's Disallowance Rule

Section 280A is triggered by a taxpayer's ''personal use'' of a dwelling unit as a residence. To trigger §280A, the sum of days of a taxpayer's personal use for the tax year must exceed the greater of 14 days or 10% of the number of days during such year for which the unit is rented at a fair rental.[9] In this context, the term ''personal use'' is deceptively simple. Personal use begins with actual use by the taxpayer entitled to claim deductions attributable to the dwelling unit. Personal use can also apply by extension to any person with an interest in the unit.

Through a series of attribution rules, the taxpayer's personal use includes use by family members; use by an individual pursuant to a reciprocal arrangement that permits the taxpayer to use some other unit with or without a fee; days on which the unit is rented for less than a fair rental; use by other owners in a timesharing arrangement or use by the taxpayer of other units in a rental pool, including an election to average rental pool use; and use attributed as the result of a taxpayer's charitable donation of use of the unit.[10]

There are special attribution rules for personal use by pass-through entities and their owners, such as a partnership, estate, trust, or S corporation. For example, the pass-through entity has a day of personal use for every day that one of its beneficial owners is deemed to personally use the dwelling unit owned by the entity.[11]

Certain exceptions apply to the personal use attribution rules, including use for a fair rental as the lessee's principal residence, and use under a shared equity financing agreement.[12] Other uses are excluded from the definition of personal use, including the period when a unit is held out for rent or during which the taxpayer performs repairs or maintenance.[13] Hence, a taxpayer who wishes to avoid the §280A limits should carefully document both personal and business use of a dwelling unit.

Exceptions to §280A's Disallowance Rule for Certain Business or Rental Use

Section 280A(c) provides a number of exceptions to §280A(a)'s general rule of disallowing a deduction for expenses attributable to the use of a dwelling unit as a residence. Section 280A(c)'s exceptions can apply if the dwelling unit is used:

1. as the taxpayer's principal place of business;[14]
2. as a place for meeting or dealing with patients, clients, or customers in the normal course of business;[15]
3. in connection with the taxpayer's trade or business, if the part used is a separate structure that is not attached to the dwelling unit;[16]
4. as a storage unit for the taxpayer's sales inventory or product samples, but only if the dwelling unit is the sole fixed location of the business;[17]
5. for certain day care services;[18] or

[4] §280A(a).

[5] §280A(a); Prop. Regs. §1.280A-1(a). H.R. Rep. No. 658, 94th Cong., 1st Sess. 856 (1975). *See Smith v. Comr.*, T.C. Memo 1995-410 (applying §280A to S corporation); *Cunningham v. Comr.*, T.C. Memo 1996-141 (applying §280A to S corporation).

[6] §280A(f)(1)(A).

[7] §280A(f)(1)(B). *See also* IRS Pub. 527, Residential Rental Property (Including Rental of Vacation Homes) (2008).

[8] Prop. Regs. §1.280A-1(c)(2).

[9] §280A(d)(1).

[10] *See* §280A(d)(2)(A), (d)(2)(B), (d)(2)(C); Prop. Regs. §1.280A-1(e); Prop. Regs. §1.280A-3(e)(5); Rev. Rul. 89-51, 1989-1 C.B. 89.

[11] Prop. Regs. §1.280A-1(e).

[12] §280A(d)(3).

[13] §280A(d)(2) (flush language).

[14] §280A(c)(1)(A).

[15] §280A(c)(1)(B).

[16] §280A(c)(1)(C).

[17] §280A(c)(2).

[18] §280A(c)(4).

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6. as a rental.[19]

The use of a dwelling unit for all of the foregoing exceptions must be *regular*, except in the case of rental use, where unique rules apply. According to proposed regulations, what constitutes *regular* depends on all the facts and circumstances.[20] Legislative history indicates that incidental or occasional trade or business use is not regular.[21] Thus, regular use probably means frequent and repetitive use.

Besides *regular* use, the first three exempt uses above must constitute *exclusive* use of the space — an issue addressed later in this article.

Gross Income Limitation

When a taxpayer's personal use of a dwelling unit as a residence subjects him to §280A, any allowable home office and vacation home rental expenses may be deducted only up to the amount of a gross income limitation. Under the gross income limitation, costs and expenses properly allocated to a home business or rental activity are disallowed to the extent they exceed the gross income attributable to that activity, reduced by the sum of: (1) deductible nonbusiness home costs such as qualified residence interest and property taxes; and (2) business costs unrelated to the business (or rental) use of the home, such as supplies and employee salaries.[22] Deductions disallowed by the gross income limitation may be carried forward to the next taxable year.[23]

Home expenses in excess of the gross income limitation are subject to a four-tier system of deductions prescribed by the proposed regulations.[24] In applying §280A's gross income limitation, the excess of gross income from the activity over the sum of tier 1 and 2 items is the ceiling for deducting expenses allowable under tiers 3 and 4.

Tier 1 items are deductions that would be allowable even if the taxpayer's residence is not used in a business activity, such as interest, state and local property taxes, casualty and theft losses, bad debts, worthless securities, tax-related expenses, etc. Although not affected by §280A or subject to a gross income limitation, tier 1 items reduce the gross income available for other residential business expenses.

Next, tier 2 items reduce the taxpayer's gross income remaining after tier 1 items are deducted. Tier 2 items include expenses attributable to the excepted business activity, which are not attributable to the taxpayer's use of his residence. Tier 2 items could include supplies, business phone, depreciation on equipment, compensation paid to others, and advertising.

Tier 3 items may be deducted only to the extent of the gross income from the activity, reduced by tier 1 and 2 deductions. Tier 3 deductions consist of items that would have been allowable if the activity had not been conducted in the taxpayer's home, but do not result in an adjustment to basis in property. Tier 3 items generally consist of operating expenses that are deductible if the activity qualifies as a trade or business under §162, or as an investment under §212. Tier 3 items include rent, utilities, maintenance and labor, supplies, insurance, advertising, etc., which relate to the residence.

Items that require a basis adjustment are relegated to tier 4. Tier 4 items are deductible only to the extent of the gross income reduced by all of the tier 1, 2, and 3 items. Tier 4 items consist of depreciation, partial losses with respect to property, partially worthless debts, amortization, and amortizable bond premiums.

Trade or Business Requirement

All of the exceptions for certain business uses of a taxpayer's dwelling unit,[25] except rental use, require that the items to be deducted relate to a trade or business of the taxpayer. The term ''trade or business'' is not defined, although it is used frequently throughout the Code. The taxpayer need not hold himself out to others as engaged in the selling of goods and services, but the trade or business activity must be undertaken with a profit motive, and must be regular and continuous.[26]

Exclusive Use

A taxpayer's use of the business part of his residence must be ''exclusively'' for excepted business purposes if he relies on any of the first three ''business use'' exceptions: principal place of business;[27] meeting with clients;[28] or separate structure.[29] The exceptions may apply even if the taxpayer uses his residence for more than one trade or business, although in that case, each use must qualify independently. Under the proposed regulations, a room is used ''exclusively'' for an excepted business purpose only if there is no use of that portion of the unit at any time

[19] §280A(c)(3).
[20] Prop. Regs. §1.280A-2(h).
[21] S. Rep. No. 938, 94th Cong., 2d Sess. 148 (1976).
[22] §280A(c)(5).
[23] §280A(c)(5).
[24] *See* Prop. Regs. §1.280A-2(i).

[25] §280A(c).
[26] *Comr. v. Groetzinger*, 480 U.S. 23 (1987).
[27] §280A(c)(1)(A).
[28] §280A(c)(1)(B).
[29] §280A(c)(1)(C).

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during the taxable year other than for business purposes.[30] For purposes of applying the exclusive business use rule, necessary repair or maintenance does not count as use by the taxpayer.[31]

In addition, an employee may claim one of the exclusive uses only if it is for the convenience of his employer.[32] The phrase ''for the convenience of the employer'' is not defined by statute or regulations. The convenience of the employer standard, however, has been satisfied where the employee is required to maintain a home office as a condition of employment, where the home office was necessary for the functioning of the employer's business, or to allow the employee to perform his duties properly.

For example, in *Drucker v. Comr.*,[33] a musician employed by the New York Metropolitan Opera practiced at least 30 hours each week in a home studio. Notably, the employer provided no practice space. The Second Circuit held that the musician's use of the home studio was a business necessity and therefore for the convenience of his employer.

However, when home office or business use is not exclusive, §280A's disallowance rule will prevent certain business deductions. For example, *Deihl v. Comr.*[34] involved two related S corporations, Mayor and KareMor, owned by the taxpayers (a married couple). Mayor manufactured a patented multivitamin product. KareMor was a multilevel marketing organization created to help market the multivitamin product.

The S corporations (Mayor and KareMor) maintained their principal offices at a location other than the taxpayers' personal residence. Yet the taxpayers often used their personal residence to host parties attended by distributors of the multivitamin product. The taxpayers renovated their personal residence to create a ''showplace'' or ''trophy'' home.

The Tax Court considered whether it was appropriate for the taxpayers to deduct business and depreciation expenses for that renovation on their 1996-1998 tax returns. The IRS argued that §280A prevented such deductions. The taxpayers argued that §280A should not apply because (1) it addresses the ''use of a dwelling'' as a facility; and (2) the taxpayers used their house as a ''trophy house,'' making the renovation expenses akin to money spent for a billboard or other media related to the Mayor and KareMor businesses.

The Tax Court held in favor of the IRS, noting that §280A applies to disallow deductions during any taxable year for a dwelling unit used as a residence. The Tax Court commented that §280A(f)(1)(A) defines a dwelling unit to include a house and all structures or other property appurtenant to the dwelling unit. In this case, the taxpayers slept, ate, and had free access to all areas of their ''trophy house.'' And they did it for a sufficient time period during the taxable year to make it a ''residence.''

No portion of the taxpayers' residence was used exclusively for business, and none of §280A(c)'s enumerated exceptions for certain business or rental uses applied. Hence, neither the taxpayers nor their S corporations could take business or depreciation deductions for the renovation expenses.

Qualifying Uses That Must Be Regular, But Need Not Be Exclusive

The following two exceptions to §280A's general disallowance rule allow expenses to be deducted for uses of a dwelling unit that are *regular*, but not necessary *exclusive*:

1. Use as a storage unit for the taxpayer's inventory or product samples, but only if the dwelling unit is the sole fixed location of the business;[35] or
2. Use in the taxpayer's business of providing day care for children, senior citizens, or certain handicapped individuals.[36]

Deduction for Rental Expenses

Section 280A allows a taxpayer to deduct rental expenses attributable to a vacation home or other dwelling unit that he personally uses as a residence during the tax year for more than the greater of 14 days or 10% of the days that the home or unit is rented at a fair rental.[37] Such rental expenses are subject to the gross income limitation.

When a taxpayer's personal use is *not* in excess of the greater of 14 days or 10% of the number of days during such year for which such unit is rented at fair rental, deductions attributable to the rental are not subject to the gross income limitation of §280A. In that case, otherwise allowable deductions may exceed rental income from the property.[38]

Under a special exception, if a taxpayer rents out a residence for fewer than 15 days during the taxable year, rental expense deductions are wholly disal-

[30] Prop. Regs. §1.280A-2(g)(1).

[31] Prop. Regs. §1.280A-2(g)(1).

[32] §280A(c)(1) (flush language).

[33] 715 F.2d 67 (2d Cir. 1983).

[34] T.C. Memo 2005-287.

[35] §280A(c)(2).

[36] §280A(c)(4).

[37] §280A(d)(1).

[38] *See* IRS Pub. 527, Residential Rental Properties (Including Rental of Vacation Homes) (2008).

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lowed.[39] Correspondingly, however, income from such *de minimis* rental use is excluded from gross income.[40]

If a taxpayer rents a residence for more than 14 days during the year, the rental expense deductions are subject both to a gross income limitation and an expense allocation formula requiring an allocation between business and personal use.[41] In fact, personal use of a dwelling unit for even one day during the taxable year requires a taxpayer to allocate rental expenses between personal and business.[42] The rental expense allocation requirement applies even if a taxpayer's personal use is insufficient to characterize the dwelling unit as a residence.[43]

Expenses allocated to the rental activity may be deductible, but are subject to the gross income limitation if the taxpayer's personal use is sufficient to characterize the dwelling unit as a residence.[44] Nevertheless, the rental expense allocation formula does not apply to deductions that are allowed without regard to the rental of a dwelling unit, such as qualified home mortgage interest and real estate taxes.[45]

Interaction of §280A with Other Code Provisions

Section 280A is detailed and is a handful all by itself. In addition, questions sometimes arise as to how §280A interacts with other Internal Revenue Code provisions. Consider the following examples:

The §183 ''hobby loss rule'' limits the deductions of certain individuals and other taxpayers from activities that are not engaged in for profit. The Tax Court has held that when §280A applies to a dwelling unit for a tax year, §183 does not apply to the unit for that tax year.[46]

Section 469 generally defers passive activity losses and credits until the taxpayer disposes of his entire interest in a passive activity in a taxable transaction. Section 280A can apply in the same taxable year as §469, but §469 does not apply to any activity in any taxable year in which the §280A gross income limitation applies to the activity.[47]

Section 465 limits a taxpayer's deduction for losses from an activity to the amount that the taxpayer has ''at risk'' in the activity. Section 280A can apply in the same taxable year as §465.[48]

Section 67 imposes a floor for miscellaneous itemized deductions.[49] Except for §280A tier 1 items (such as interest, taxes, and casualty losses), which are specifically excluded from the definition of miscellaneous itemized deductions in §67, items allowable under §280A still may be disallowed under §67.[50]

Conclusion

Taxpayers routinely run afoul of §280A, with understandable confusion over its disallowance rule, and with the exceptions for expenses related to a taxpayer's residence. Many a taxpayer has been tripped up by improper attempts to deduct expenses connected to the business use or rental of his residence. Even sophisticated people can be flummoxed. Indeed, the process of nominating President Obama's pick for a high-level Treasury Department post reportedly has been delayed due to potentially improper home office deductions on that nominee's personal tax returns.[51]

Taxpayers who intend to deduct business expenses connected to a home office or vacation home rental should be careful to adhere strictly to §280A's requirements. Furthermore, to bolster the propriety of such deductions, taxpayers should be scrupulous. One should endeavor to keep timely and accurate records showing detailed information regarding the business or rental use of his residence.

There is no reason for §280A to be the pariah that some advisers consider it to be. Admittedly, however, the phrase ''don't try this at home'' suits its dynamics nicely.

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[39] §280A(g)(1).

[40] §280A(g)(2).

[41] §280A(c)(5), (e).

[42] §280A(e)(1).

[43] §280A(e), (d)(1); Prop. Regs. §1.280A-3(a).

[44] §280A(c)(5), (d).

[45] §§280A(e)(2), 163(h), 164; Prop. Regs. §1.280A-3(c)(3).

[46] *Ruggiero v. Comr.*, T.C. Memo 1997-423 (IRS could not disallow expenses allowable under §280A based on the hobby loss rule).

[47] §469(j)(10).

[48] *See* §§280A, 465.

[49] §67(a).

[50] §67(b)(1)-(3); Pusker, ''Home Office Deductions: Some Good News,'' 18 *J. Real Est. Tax'n* 24, 31 (1990).

[51] Vaughan, ''Tax Inquiry Delays Pick by Obama at Treasury,'' *Wall. St. J.*, Sept. 11, 2009, at A4.

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