The Tax Rules for Home Businesses and Working From Home

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Maybe, due to the pandemic, you've started a home business this year or have been working from home as an employee. If so, you'll want to understand the tax rules so you know what you can and can't write off on your 2020 tax return.

Personally, I swapped my W-2 for a 1099-MISC years ago, when I started my business as an independent contractor working out of a home-based office.

It works for me but does require diligent record-keeping to avoid running afoul of the Internal Revenue Service (IRS) and to ensure I grab all the tax breaks I'm entitled to receive.

Here's the tax lowdown for the self-employed working from home(https://www.nextavenue.org/coronavirus-work-from-home) and for employees working from home:

Taxes and Home Offices

"A lot of people are afraid that a home office deduction is inviting an audit," said Mark Luscombe, principal federal tax analyst at Wolters Kluwer Tax & Accounting in Chicago. "My view on that is if you are entitled to the deduction you should claim it, as long as you follow the rules."

If you are self-employed working out of a home office, here's the basic rule: the office area must be used for work entirely and on a regular basis, either as your main place of business or a place to meet with clients. That doesn't mean the whole room must be used exclusively for work; just that at least part of it is.

Deductible expenses can include a pro-rated portion of your mortgage or rent, homeowner's or renter's insurance, home repairs and utility bills, based on the square footage of your home and office.

In essence, if the square footage of your home office equals, say, 10% of your home's total, you can claim 10% of those expenses. (The IRS also has a "simplified" rule for deducting a home office (https://www.irs.gov/businesses/small-businesses-self-employed/simplified-option-for-home-office-deduction) which lets you write off $5 per square foot of your home office — up to $1,500, based on a maximum of 300 square feet.)

"The tricky part is the 'exclusively used' requirement," said Luscombe. "You can't have the kids watching TV in the home office in the evening. That's the rule."

There is, however, a slightly different and more relaxed rule if you converted your garage or another structure on your property into a home office, Luscombe added.

What's Deductible

You can also deduct the cost of your home-office equipment and supplies. The tax law lets you fully write off in one year any purchases like a new computer and office furniture. Self-employed people can write-off business expenses such as professional fees, training and education, licensing and certification.

Training and education expenses are only deductible, however, if they maintain or improve skills needed in your present work, according to the IRS. Oddly, if you went back to school in 2020 to shift careers, this deduction is not permitted.

Independent contractors and small business owners who've set up their businesses as partnerships, limited liability corporations, S corporations (https://www.nextavenue.org/four-types-businesses-and-which-one-may-be-best-you) or sole proprietorships, may also be entitled to a tax deduction of 20% on qualified business income, if they earn less than certain amounts.

In general, total taxable income in 2020, must be under $163,300 for single filers or $326,600 for joint filers. In 2021, the threshold increases to $164,900 for single filers and $329,800 for joint filers.

If you're over the limit, complex IRS rules determine whether your business income qualifies for a full or partial deduction.

When it's time to file your 2020 tax return, in order to claim home-office expenses you'll need to complete Form 8229(https://www.irs.gov/forms-pubs/about-form-8829) , "Expenses for Business Use of Your Home" and then note the expenses on Schedule C of Form 1040. You can read all the home-office rules in IRS Publication 587(https://www.irs.gov/forms-pubs/about-publication-587) .

Tax Rules for Employees Working From Home

People telecommuting (https://www.nextavenue.org/future-of-work) from home due to the COVID-19 pandemic who are full-time employees (the W-2 set) *cannot* claim the home office deduction – even if they set aside a part of their home as an office.

Instead, "taxpayers can request reimbursement from their employers for home-office expenses such as office supplies and equipment, and those repayments are not taxable to the employee if there is adequate documentation" said Eileen Sherr, American Institute of CPAs (AICPA) director for tax policy & advocacy and state tax expert.

Where it gets confusing is when you're an employee working from home in a different state than where your employer's office is located. That might be the case for you this year if you decamped to a temporary place or a second home in another state in the mountains or by the sea when your employer mandated remote work.

An October AICPA survey of 2,053 U.S. adults found that 47% of those working remotely weren't aware that each state has its own tax laws related to remote working; 71% didn't know that working remotely in other states can impact the amount of state taxes they owed and 54% were unaware that the number of days worked out of the state from where their physical workplace is located may also impact the amount of state taxes owed.

Some states expect you to pay partial state income tax based on the number of days you worked there — though your home state may allow you a tax credit for whatever amount you owe the other state, Sheer said.

According to the AICPA, 13 states and the Washington, D.C. have agreed not to tax workers who moved there temporarily because of the pandemic: Alabama, Georgia, Illinois, Indiana, Maryland, Massachusetts, Minnesota, Mississippi, Nebraska, New Jersey, Pennsylvania, Rhode Island and South Carolina.

"You need to file in the state where you are a resident," Sherr said. "Then claim a credit for taxes paid in other states on your return. Hopefully, you will get the money back."

My advice: Don't wing this one. Confer with your tax preparer if you have questions about how and where to file state taxes; 2020 has been perplexing enough without having to get tripped up by unforeseen tax bills.

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