Anthony P. Curatola, Editor

The Home Office: Who Cares About Recapture?

BY A.J. CATALDO, CMA, CPA

The home office deduction is one of the least understood tax deductions. Many taxpayers avoid the deduction, frequently on the advice of their tax accountant or attorney, for fear of an IRS audit or concerns over the recapture of depreciation when their personal residence is later sold. This article provides a brief description of the tax savings components associated with the home office deduction for itemizer taxpayers and provides some net present value computations to quantitatively illustrate the impact of the recapture of depreciation when the taxpayer's personal residence is sold. The impact is modest because the benefits far exceed the cost of the recapture. It should be recognized that the tax savings for nonitemizer taxpayers would be higher. (Nonitemizer taxpayers aren't able to deduct itemized deductions such as real estate taxes or home mortgage interest on their Schedule A, but the business use portion is deductible on their Schedule C).

An Illustrative Example

For this example, assume that:

- The taxpayer is legitimately entitled to deduct the home office. The personal residence is purchased and placed in service on January 1 of the first year and sold on January 1 of the eighth year, when depreciation must be recaptured.
- The home cost $250,000 (40% land), with a 10% down payment and a 30-year loan at 8% interest.
- Real estate taxes are $1,500 per year, homeowner's insurance is $500 per year, and utilities and repairs cost $4,500 per year.
- The combined federal and state income tax (IT) rate is 28%; the self-employment (SE) tax rate is 15.3%.
- A discount rate of 10% is used to illustrate the present value (PV) of the home office deduction.
- Projections are developed for 10%, 20%, 30%, and 40% business use.
- Ignore additional tax deductions from the elimination or reduction of nondeductible commuting (beyond the scope of this article).

Table 1 illustrates the *first-year* tax savings for the itemizer taxpayer at 10%, 20%, 30%, and 40% business use, as follows:

- Otherwise deductible personal expenses (i.e., home mortgage interest and real estate taxes) are

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TABLE 1—First-Year Tax Savings

	Ex. 1	Ex. 2	Ex. 3	Ex. 4
Business Use:	10%	20%	30%	40%
First-Year Expenses:				
Home mortgage interest	$2,244	$4,489	$6,733	$8,978
Real estate taxes	$ 150	$ 300	$ 450	$ 600
Total Shifted from Schedule A to C	$2,394	$4,789	$7,183	$9,578
multiplied by 15.3% SE tax	15.3%	15.3%	15.3%	15.3%
Additional SE tax	$ 366	$ 733	$1,099	$1,465
Depreciation	$ 385	$ 770	$1,155	$1,540
Homeowner's insurance	$ 50	$ 100	$ 150	$ 200
Utilities and repairs	$ 450	$ 900	$1,350	$1,800
Total (Added to Schedule C)	$ 885	$1,770	$2,655	$3,540
multiplied by: 43.3%	43.3%	43.3%	43.3%	43.3%
equals: Additional IT & SE tax	$ 383	$ 766	$1,150	$1,533
plus: Additional SE tax (above)	$ 366	$ 733	$1,099	$1,465
Total tax savings	$ 749	$1,499	$2,249	$2,998

TABLE 2—Benefits of the Home Office Deduction

	Year	Amount	Tax Adjustment*	PV Factor	PV
Business use at 10%					
Annual Tax Savings	1-7	$ 749	100%	4.87	$3,648
Depreciation Recapture†	8	$(2,695)	28%	0.47	$ (355)
Net Present Value					$3,293
Business use at 20%					
Annual Tax Savings	1-7	$ 1,499	100%	4.87	$7,300
Depreciation Recapture†	8	$(5,390)	28%	0.47	$ (709)
Net Present Value					$6,591
Business use at 30%					
Annual Tax Savings	1-7	$ 2,249	100%	4.87	$10,953
Depreciation Recapture†	8	$(8,085)	28%	0.47	$ (1,064)
Net Present Value					$ 9,889
Business use at 40%					
Annual Tax Savings	1-7	$ 2,998	100%	4.87	$14,600
Depreciation Recapture†	8	$(10,780)	28%	0.47	$ (1,419)
Net Present Value					$13,181

*The *Annual Tax Savings* measures are already in *after-tax* dollars.

† $385 x 7 years = $2,695
$770 x 7 years = $5,390
$1,155 x 7 years = $8,085
$1,540 x 7 years = $10,780

shifted from Schedule A to Schedule C, creating additional, *permanent* self-employment tax savings of 15.3%;

- Depreciation expense is deducted on Schedule C for additional combined federal and state income and *permanent* self-employment tax savings; and
- The deductibility of otherwise nondeductible insurance, utilities, and repairs expenses on Schedule C generates additional, *permanent* combined federal and state income and self-employment tax savings.

Table 2 illustrates the benefits from the home office deduction, including the relatively inconsequential present value to be associated with the depreciation recapture. Table 2 is nothing more than an extension of Table 1 (note the comparable measures at the 10%, 20%, 30%, and 40% business use levels).

In all cases, the recapture represents approximately 10% of the present value of the tax savings for the first seven years (e.g., ($355) vs. $3,648 for the 10% business use scenario). Therefore, avoiding business use of personal residence depreciation for fear of having to recapture it later is like saying "I will avoid saving $10 because I may have to pay back $1." If the personal residence is sold at a later date, or never sold, the value (and net present value) of these tax savings would increase further.

Take Advantage of the Deduction

This article used the home office deduction to illustrate the time value of money considerations and *permanent* tax savings associated with the home office deduction. They result from a simple illustrative example, selected and designed to correct misconceptions. Specifically, the issue of depreciation recapture was explored, but this framework may be used to examine a variety of tax planning fact patterns.

Copy or print this very brief article, and discuss these results with your tax accountant. If you've failed to take this deduction in the past but were legally entitled to do so, you may be able to amend your individual tax returns for the prior three years. ■

A.J. Cataldo, CMA, CPA, Ph.D., is a visiting assistant professor of accounting at Northeastern University in Boston, Mass. You can contact him at (857) 233-2791 or ajcataldo@comcast.net.

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