

HOME OFFICE DEDUCTION

In 1993, the Supreme Court in *Comr v Soliman* upheld an extremely narrow IRS interpretation of what constituted a home office, for purposes of being able to deduct associated costs.

Under pre '97 Act law, an individual could claim business deductions for the costs of a portion of a home used exclusively and regularly

1. as the principal place of business for a trade or business, and
2. as a place of business used to meet with patients, clients, or customers, or
3. as a separate structure not attached to the dwelling unit.



EXAMPLE: The Comr v Soliman case, decided January 12, 1993. During the 1983 tax year, Dr. Soliman, an anesthesiologist, spent 30 to 35 hours per week administering anesthesia and postoperative care in three hospitals, none of which provided him with an office. He also spent two to three hours per day in a room in his home that he used exclusively as an office, where he did not meet patients but did perform a variety of tasks related to his medical practice. His claimed federal income tax deduction for the portion of his household expenses attributable to the home office was disallowed by the IRS Commissioner, who determined that the office was not Soliman's "principal place of business" under 26 U.S.C. 280A(c)(1)(A). The Supreme Court held that Soliman was not entitled to a deduction for home office expenses. The following excerpt from the Court's opinion offers interesting insight into the thinking at that time: "(a) The test used by the Court of Appeals failed to undertake a comparative analysis of the taxpayer's various business locations. If the nature of that business requires the taxpayer to meet or confer with a client or patient or to deliver goods or services to a customer, the place where that contact occurs, though not conclusive, must be given great weight. Moreover, if the nature of the business requires that its services are rendered or its goods are delivered at a facility with unique or special characteristics, this is a further and weighty consideration. Contrary to the Court of Appeals' ruling, the essentiality of the functions performed at home, while relevant, is not controlling, whereas the availability of alternative office space is irrelevant. Second -

and particularly if the foregoing analysis yields no definitive answer - the decision maker should compare the amount of time spent at the home with the time spent in each of the other places where the business is transacted. If the comparative analysis required by the statute reveals that there is no principal place of business, the courts and the Commissioner should not strain to conclude that a home office qualifies by default. Pp. 174-178. (c) Application of these principles demonstrates that Soliman's home office was not his principal place of business. His home office activities, from an objective standpoint, must be regarded as less important to his business than the tasks he performed at the hospitals. The actual treatment of patients at these facilities having special characteristics was the essence of the professional service he provided, and was therefore the most significant event in the professional transaction. Moreover, the hours he spent in the home office, when compared to the time he spent at the hospitals, are insufficient to render the home office the principal place of business in light of all of the circumstances of this case. P. 178-179."

Home Office Rules Relaxed

The Act amends the law to provide that a home office qualifies as the principal place of business if the taxpayer **conducts administrative or management activities** there, and has no other fixed location in which he or she conducts *substantial* administrative or management activities.

A qualified home office deduction will constitute an initial point of business for the automobile deduction.

Business mileage starts at the first point of business of the day. Workers with a home office will have less commute mileage along with greater business mileage and a larger automobile expense deduction.

As under the previous law, the home office must be used exclusively and regularly for business purposes. In addition, if the taxpayer is an employee, the use must be for the employer's convenience. The new rule is effective for taxable years beginning after Dec. 31, 1998.



NOTE: There is a tax trap to be aware of when claiming the **home office deduction**. When the home is sold, the portion of the gain attributable to depreciation of the home

NET OPERATING LOSS CARRY FORWARD

office cannot be excluded from income and will be taxed at a rate of 25%.

The **Net Operating Loss (NOL) carry-back and carry-forward** periods have been changed. Under the new law, the carry-back period is now reduced to 2 years. The carry-forward period is increased to 20 years. This change is effective for tax years beginning after August 5, 1997.

The reduction in the NOL carry-back period does not apply to NOLs for certain "eligible losses". In the case of an individual, "eligible losses" includes losses on property arising from fire, storm, shipwreck, or other casualty, or from theft. For these losses, the three-year carry-back period remains. "Eligible losses" for a small business include disasters declared by the President of the United States.

The 97 Act also does not modify the carry-back period for specified liability losses (10-year carry-back) or for REITs (no carry-back) and excess interest losses (no carry-back) and corporate capital losses.

The increase in the carry-forward period applies with respect to specified liability losses, REITs and excess interest losses.

For example, a NOL for 1997 can be carried back three years to 1994, but NOLs for 1998 can only be carried back to 1996.



PRACTICE: Taxpayer's who paid tax in 1995 and anticipate losses in 1998 may want to, if possible, accelerate the 1998 losses into 1997 so that the losses can be carried back to 1995.

FUNERAL TRUSTS

The trustee of a pre-need (individual purchases services or merchandise from a funeral home or cemetery in advance of death) "qualified" **funeral trust** may elect special income tax treatment of the trust to the extent the trust would be treated as a grantor trust. The funeral trust is subject to an aggregate contribution amount of \$7,000.

For a funeral trust to be "qualified" the following requirements must be met (Code § 685(b) as added by Act §1312(a)):

1. The trust arises as a result of a contract with a person engaged in the business of providing funeral services;
2. The trust's sole purpose is to handle funds for the benefit of the beneficiaries of the trust;

**GIFT AND ESTATE
TAX SAVINGS
THROUGH USE OF
PERSONAL
RESIDENCE
GRANTOR
RETAINED INCOME
TRUST**

3. The only beneficiaries of the trust are those individuals to whom services or property is to be provided at their death under contracts;
4. The only contributions to the trust are for the benefit of the beneficiaries;
5. The trustee makes an election for the special tax treatment; and
6. The trust would be treated under the grantor trust rules.

The Act prescribes taxing of qualified funeral trusts at the entity level with the trustee filing one return that reports the aggregate income from all the trust administered and separately listing income from each purchase. This simplifies the bookkeeping required under pre-'97 law where each taxpayer was required to account for earnings on an individual return.

To save gift and estate taxes, set up a special type of trust. The trust is sometimes termed as "**grantor retained income trust**" or "**GRIT**," and sometimes is called a "**qualified personal residence trust**," or "**QPRT**".

To create a QPRT, you transfer your house or a vacation home to an **irrevocable trust**. The trust terms provide that you are the beneficiary for a period (e.g., five or ten years). During that period you are entitled to use the house held in the trust. At the end of the trust term, the house becomes the property of the beneficiaries you name in the instrument, such as your children or other beneficiaries.

During the trust term, you are responsible for the property taxes and normal expenses of repair to the property. You may act as trustee during this period, so you have full control over the property.

If a husband and wife jointly own a property, each of you may transfer your one-half of the property to a separate QPRT for your benefit. At the end of the trust term, both trusts end and the children become entitled to the trust property.

The tax advantage arises because you are deemed to make a gift of the remainder interest in the house to your children (or other beneficiaries) at the time that you create the trust, and the value of this gift is discounted from its fair market value. The exact amount of the discount depends on your age, the trust's term of years, and the IRS published interest rate for the month of the gift. Attached to this memorandum are sample calculations based on various ages, assumed trust terms and an assumed \$1 million residence.



EXAMPLE: Suppose that you are 60 years old and transfer a house to a QPRT for ten years. You are deemed to make a gift equal to roughly 37% of the property that you transfer. If you have a house worth \$1 million, then you are making a gift of \$370,000.

The advantage of this device may be illustrated by comparing it with doing nothing. In the above example, if you do nothing, at your death you will own a house worth \$1 million and subject to tax at that value. In contrast, if you give away the property using a QPRT, you may transfer the property to the next generation at a "value" of only \$370,000. The transfer also eliminates any appreciation from being included in your estate over the \$1 million value.