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## Taxation--The Office-in-Home Deductions

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serve the grantee as a basis for alleging constructive eviction. The *Brewster* court also indicated (by dicta?) that if the grantee can prove that an outstanding paramount title existed, he can properly allege a constructive eviction. The decision was equitable to the parties involved. In effect, the decision even worked to the benefit of the defendant. If the situation had been allowed to continue as it was, more damages could have occurred to the freehold, possibly making his liability substantially greater. The court saw an inequity and tried to remedy it. Unfortunately case law did not support its position. Keeping in mind the aphorism by Judge Haymond that "hard cases make bad law," it can be said that the result reached by the court was the correct one, but that the use of judicial legislation in reaching that result was unwise. Perhaps the court should have left the solution to this glaring inequity in covenant to the legislature.

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### **Taxation—The Office-in-Home Deduction**

Petitioners Marvin and Marjorie Dietrich filed a joint federal income tax return for the year 1967. Marvin was a first-year resident physician and his duties included teaching as well as patient care. His wife, Marjorie, was a registered nurse and instructor. In the basement of their home they maintained a small office used for preparing and grading lessons, professional reading, paying personal bills, and treating an occasional patient without charge. Neither of the taxpayers was required by his employer to maintain the office. They claimed a deduction on their return for the office-in-home expenses. The Commissioner challenged the deduction arguing that the expenses of an office in an employee's home may not be deducted unless he is required to maintain the office as a condition of his employment. The tax court *held*, petitioners were entitled to the deduction since the "expenses were 'ordinary and necessary' and proximately related to their work." *Marvin L. Dietrich*, 1971 P-H Tax Ct. Mem. ¶71,159 at 718.

Many taxpayers maintain some type of office in their home to perform employment-associated work during the evenings or on weekends. The degree of sophistication of an office-in-home can vary from a simple lamp and table in a corner of the dining room to

a room or rooms complete with library, files, dictating machine, and other office equipment. The expenses of maintaining such an office-in-home are usually deductible. The problems arise in determining who is entitled to such a deduction, how it is treated (*i.e.*, as a deduction *for* or a deduction *from* adjusted gross income), and how the amount of the deduction is to be computed.

### I. PROFESSIONAL AND OTHER SELF-EMPLOYED TAXPAYERS

The concept of adjusted gross income was first introduced into tax law in 1944<sup>1</sup> and was continued in section 62 of the Internal Revenue Code of 1954.<sup>2</sup> Section 62 sets out the deductions allowed elsewhere in the Code which may be used to reduce gross income to arrive at adjusted gross income (*i.e.*, deductions *for* adjusted gross income). Whether or not an allowed deduction falls within section 62 is significant. If it does not, the taxpayer cannot deduct the item if he elects to take the standard deduction.<sup>3</sup>

Expenses in carrying on a trade or business are deductible under section 162(a)<sup>4</sup> if "ordinary and necessary" (not necessarily essential) and if reasonable in amount.<sup>5</sup> For the professional or self-employed taxpayer these deductions fall under section 62(1)<sup>6</sup> and therefore are deductible *for* adjusted gross income. Hence, professionals and other self-employed taxpayers are not only permitted to

<sup>1</sup> Int. Rev. Code of 1939 ch. 1, § 22 (n), 58 Stat. 231. Adjusted gross income is used in the calculation of the standard deduction, the limit on the charitable contributions deduction, the medical expense deduction, and the limit on the child care deduction.

<sup>2</sup> Hereinafter references to the INT. REV. CODE of 1954 will be to the section number alone.

<sup>3</sup> The standard deduction is in lieu of deductions *from* adjusted gross income (*i.e.*, the itemized deductions).

<sup>4</sup> Section 162(a) reads in part:

In General. — There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including —

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses . . . while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

<sup>5</sup> Rev. Rul. 62-180, 1962-2 CUM. BULL. 52.

<sup>6</sup> Section 62(1) allows as deductions *for* adjusted gross income those deductions permitted elsewhere in Chapter 1 of the Code "which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee."

deduct office-in-home expenses; they also gain the benefit whether or not they take the standard deduction.

## II. THE EMPLOYEE TAXPAYER

The situation is more difficult for the employee taxpayer<sup>7</sup> as in *Dietrich*. The performance of services by an employee constitutes the carrying on of a trade or business within the meaning of section 162,<sup>8</sup> but section 62(2) limits the deductions for adjusted gross income which an employee (who is not an outside salesman) may take to reimbursed expenses, expenses for travel away from home, and transportation expenses. Any other trade or business deductions allowed an employee are deductible from adjusted gross income (itemized deductions) and are of no benefit if the standard deduction is elected.

The source of most taxpayer problems in the office-in-home deduction for employees has come from Revenue Ruling 62-180.<sup>9</sup> That ruling includes three requirements for such a deduction: 1) the employee must be required, "as a condition of his employment," to provide such facilities to perform some of his duties; 2) he must use part of his residence regularly for that purpose; and 3) there must be no other convenient or suitable facilities provided by the employer that could be used instead. The first and third of these requirements have been rejected by both the tax court<sup>10</sup> and the Second Circuit.<sup>11</sup>

*Dietrich*, in rejecting the Commissioner's position that an employee must be required to maintain an office-in-home as a condition of employment before he may deduct the expense, cited with approval *Newi v. Commissioner*.<sup>12</sup> In *Newi* a deduction for a portion of the rental, cleaning, and lighting expenses of an apartment was allowed although the employee was not required by his employer to maintain an office-in-home, and even though his employer's office building was available during the evening. The employee used a

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<sup>7</sup> See Simmons, *Your Home Office May Be Deductible*, 12 L. OFFICE AND MGMT. 77 (1971); Crumbley, *Courts are Changing Current Tax Climate on Office-at-Home Deductions*, 31 J. TAX. 300 (1969). For the test as to whether a person is an employee or independent contractor see 1 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 2.08 (Malone ed. 1969).

<sup>8</sup> Marvyn L. Dietrich, 1971 P-H Tax Ct. Mem. ¶71,159, citing Rev. Rul. 62-180, 1962-2 CUM. BULL. 52.

<sup>9</sup> 1962-2 CUM BULL. 52.

<sup>10</sup> Christopher A. Rafferty, 1971 P-H Tax Ct. Mem. ¶71,203; Marvyn L. Dietrich, 1971 P-H Tax Ct. Mem. ¶71,159; Clarence Peiss, 40 T.C. 78 (1963).

<sup>11</sup> *Newi v. Comm'r*, 432 F.2d 998 (2d Cir. 1970), *aff'g*, 1969 P-H Tax Ct. Mem. ¶69,131.

<sup>12</sup> *Id.*

room in his apartment approximately three hours each night to watch television advertisements and perform various other work in conjunction with his job as a salesman of television time for a network. The circuit court accepted the reasoning of the tax court which had stated:<sup>13</sup>

In our opinion, the [Commissioner] misconceives the nature of the "ordinary and necessary" standard contained in section 162. The Supreme Court has indicated on more than one occasion that the term "necessary" imposes only the minimal requirement that the contested expenditure be "appropriate and helpful" to the taxpayer's business. Moreover, we are unaware of any legal requirement that the expenditure must be "required" before it qualifies as an allowable business expense.

*Newi* leaves only one of the three requirements of Revenue Ruling 62-180 to be met—that part of the taxpayer's residence be used "regularly" to perform his duties as an employee. This is a question of fact and the courts, in both *Dietrich* and *Newi*, found the taxpayers' claim credible on that issue.

Executives and other employees should now be able to get a deduction for their office-in-home expenses as readily as professional and other self-employed taxpayers have in the past. The attitude of the courts is shown by the statement in *Dietrich*—"We can see no reason for imposing a stricter standard upon taxpayers whose trade or business is that of an employee."<sup>14</sup>

### III. NON-BUSINESS EXPENSE

One final method is available to some taxpayers to obtain a deduction for office-in-home expenses. Many expenses not deductible to a particular taxpayer as business expenses under section 162 are deductible under section 212 if incurred for the production of income.<sup>15</sup> Hence, an investor not eligible for the deduction as a prac-

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<sup>13</sup> George H. *Newi*, 1969 P-H Tax Ct. Mem. ¶69,131 at 740 (citations omitted).

<sup>14</sup> 1971 P-H Tax Ct. Mem. ¶71,159 at 717.

<sup>15</sup> Section 212 reads:

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year —

(1) for the production or collection of income;  
(2) for the management, conservation, or maintenance of property held for the production of income; or  
(3) in connection with the determination, collection, or refund of any tax.

ting professional, self-employed individual, or employee might still be eligible under this section for such a deduction. Note, however, that this would ordinarily be an itemized deduction. If the expense qualifies both under section 162 and section 212, the one under which it is deducted is important only with respect to the adjusted gross income figure.

#### IV. COMPUTATION OF THE DEDUCTION

After the taxpayer has determined that he qualifies for an office-in-home deduction, the question remains how much can be deducted as ordinary and necessary expense attributable to that portion of the personal residence used for an "office." Many taxpayers will fall short in this aspect of their claim because of a failure to substantiate the deduction with adequate records and documentation.

Revenue Ruling 62-180<sup>16</sup> sets forth guidelines for determining the amount of the deduction. Pro rata portions of items such as rent, utilities, taxes, certain repairs, insurance, telephone, interest on a mortgage, and depreciation<sup>17</sup> are deductible. A ratio must be used to determine that part of the expenses for the entire home attributable to the "office." Number of rooms, square feet, or any other reasonable method may be used.

Beyond this, if the taxpayer fails to show that the "office" space is used exclusively for business purposes, Revenue Ruling 62-180 requires an additional allocation based on time. This second ratio greatly reduces the deduction — it is the proportion of the number of hours the room is actually used for business purposes to the total time available for all uses. For example, taxpayer, an executive, rents a four-room apartment for \$200 per month and uses one of the rooms only fifteen hours a week. For ten of these hours it is used as an office-in-home and the other five to watch television for his personal enjoyment. The rooms are of equal size so the space allocation of the "office" is 25 percent, but the time allocation is only 6 percent (10 hours/168 hours in a week). The pro rata deduction for rent would be \$3 per month ( $\$200 \times 25\% \times 6\%$ ), but if the taxpayer simply moves the television into another room and uses the "office" exclusively for business purposes, his deduction would be \$50 per month ( $\$200 \times 25\%$ ).

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<sup>16</sup> 1962-2 CUM. BULL. 52.

<sup>17</sup> See Treas. Reg. § 1.167(g)-1 (1964) for tax basis of personal residence subsequently converted to use for trade or business or for the production of income.

The use of 168 hours as the total time available per week is illogical. Most rooms in reality are used only a small portion of the day. Nonetheless the 168-hour formula has been sustained in *Hoggard v. United States*<sup>18</sup> and *Martha E. Henderson*.<sup>19</sup> As long as this type of allocation is approved, the amount of the deduction allowed for office-in-home expenses will be minimal unless the space is used exclusively for business purposes. A formula such as a ratio of "business" use time to total use time seems more realistic.

#### V. CONCLUSION

The maintenance of a regularly used office-in-home is generally deductible as an "ordinary and necessary" expense. As a result of recent court decisions the restrictive view of Revenue Ruling 62-180 is no longer a barrier for an employee seeking the deduction. He needs to show only that he uses the "office" regularly. Employees are to be treated on a par with self-employed taxpayers.

Some thought and planning may result in a deduction perhaps not previously taken, or if taken, not maximized. The taxpayer should keep adequate records substantiating his expenditures and be aware of the drastically reduced deduction caused by the application of the time-use allocation when the office-in-home is not used exclusively for business purposes.

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<sup>18</sup> 20 Am. Fed. Tax R.2d 5805 (D. Va. 1967).

<sup>19</sup> 1968 P-H Tax Ct. Mem. ¶68,022.