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Standard Home Office Deduction

By Anne Kim, Ryan McConaghy, and Tess Stovall

Small businesses are the engine of American job growth—they employ more than half of all American workers and create the majority of new American jobs. Federal policy should be geared toward smoothing the path for new entrepreneurs to launch themselves and succeed. Yet some aspects of the federal tax code—such as the current home office deduction—are hostile to small business owners. The current deduction is too complex for many small businesses to take advantage of and they are denied an important benefit. A standard home office deduction would both simplify the tax code and provide up to 9 million small business owners who work from home with the help they deserve to succeed.

THE PROBLEM

Current home office tax provisions are too burdensome to use

Many Americans aspire to be their own boss, and many are already doing so—at any given time, as many as 7% of American workers are actively in the process of starting a business, and one in ten Americans is self-employed.¹ Many of these small business owners—nearly 9 million strong—work out of their homes, and home-based small business owners are a growing segment of small businesses.²

The federal tax code is intended to provide these home-based small businesses with a tax break. However, many of these Americans are being denied the help they deserve because of the tax code's complexity.

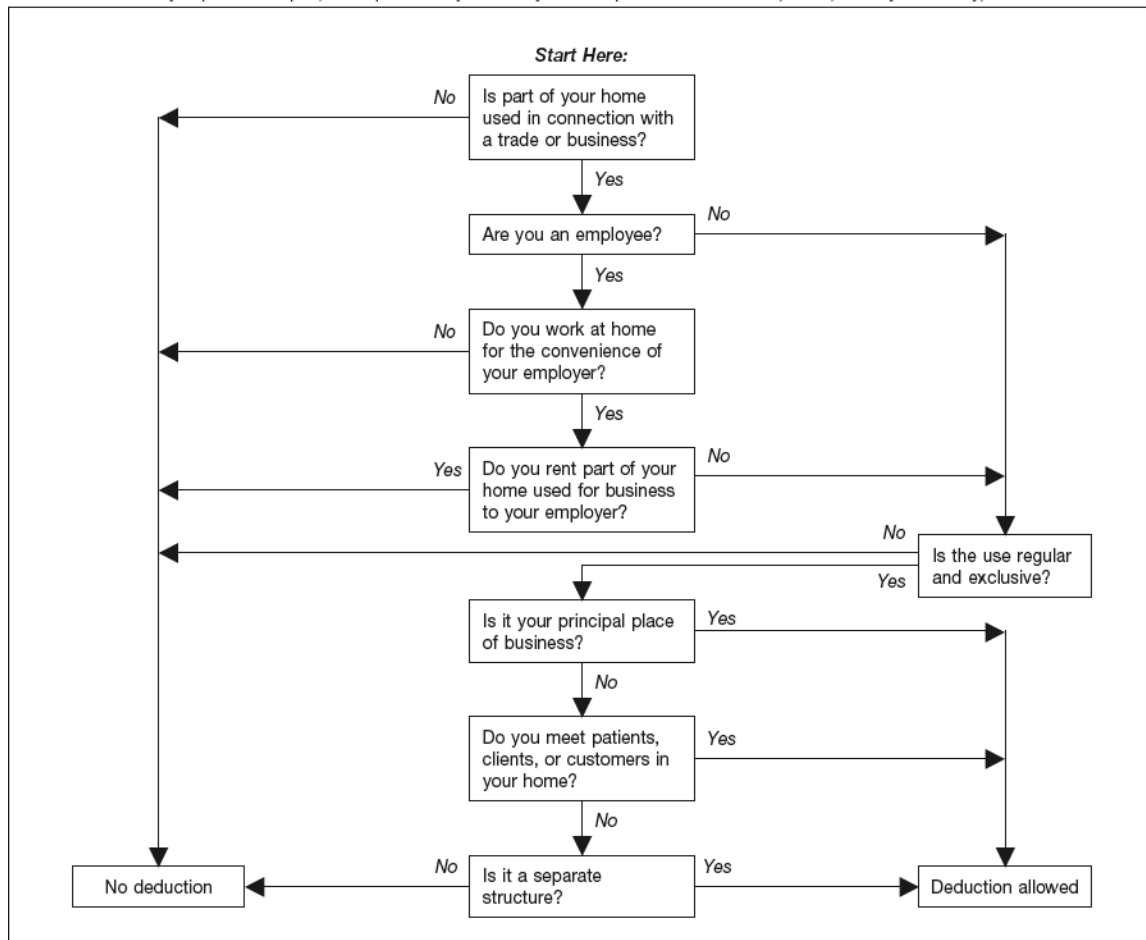
Fewer than one in three home-based small businesses now use the home office deduction.

The current home office deduction has been condemned by the IRS Taxpayer Advocate as “too complex” and “too time-consuming.”³ Fewer than one in

three home-based small business owners take the trouble to figure the deduction,⁴ and the complexity of the deduction is the top tax complaint among self-employed workers.⁵ Among other things, small business owners who want to take the deduction must allocate as business expenses a portion of their mortgage payments, utility bills and other expenses according to a complex formula and set of rules. The following flowchart, which was taken from the 32-page IRS instruction booklet for the home office deduction, helps illustrate this lack of user-friendliness.

Sample instructions for the home office deduction⁶

Figure A. **Can You Deduct Business Use of the Home Expenses?** Do not use this chart if you use your home for the storage of inventory or product samples, or to operate a daycare facility. See *Exceptions to Exclusive Use*, earlier, and *Daycare Facility*, later.



Millions of small business owners may be missing an important benefit.

Roughly 9 million small business owners operate their businesses out of their homes.⁷ If only one in three home-based small businesses is taking advantage of the current deduction, that means more than 6 million small business owners could be missing out on an important tax benefit.

THE SOLUTION

A standard home office deduction

Congress should offer small business owners the option of a standard home office deduction to make it easier for home-based entrepreneurs to sustain their businesses. The standard home office deduction would be equal to the lesser of \$2,500 or the annual gross income from the taxpayer's home business.

Home-based small businesses are the engine of small business job growth.

Home-based businesses are growing in number, thanks to the advent of the Internet, which enables small business owners to reach customers halfway around the world with the click of a mouse.

Nearly half of all small-businesses are home-based, including a majority of businesses owned by women.⁸ The majority of small businesses also start at home, including three-fourths of businesses run by solo entrepreneurs.⁹ Home-based businesses contribute \$314 billion to the U.S. economy,¹⁰ and they are also potentially an ideal option for mothers with young children who want to ease back into the workforce while retaining flexibility and control over their lives. Both the Small Business Administration and the National Federation of Independent Business support a standard home office deduction as one of the most important changes that can be made to the tax code to help out small business owners.¹¹

Supporting small business supports new American jobs.

Small businesses employ slightly more than half of the American workforce and create half of the nation's gross domestic product.¹² In 2004, small businesses accounted for all of the new jobs created in America—they generated nearly 1.9 million net new jobs while bigger companies actually shed workers.¹³ In the first quarter of 2007, before all sectors began to show declines, small business accounted for 74% of net new jobs. From 1994 to 2004, small businesses were responsible for 60 to 80 percent of net new jobs and provided two out of every three workers with their first job.¹⁴ Small businesses are also the lifeblood of the rural economy—nine out of ten businesses in rural America are small businesses.¹⁵

The new tax break would help simplify the tax code.

The complexity of the current home office deduction is a relic of an earlier time, when home-based businesses were a rarity, not the norm. Offering the option of a standard home office deduction would eliminate pages of red tape and hours of needless frustration for small business owners. And it would dramati-

cally reduce the number of compliance errors. It would also make the tax code fairer by making it much easier for small business owners to get the tax break they are intended to receive.

The proposal is affordable.

A standard home office deduction would cost \$3.6 billion per year, \$20.3 billion over five years and \$46.3 billion over 10 years. All of these costs would go to jobs-producing small businesses and entrepreneurs.¹⁶

THE ROLLOUT

Ideas for launching and rolling out the standard home office deduction

- **Hold a press conference** with small business owners who work out of their homes.
- **Reproduce a chart** showing the complicated tax system on the books today.

CRITIQUES & RESPONSES

A standard home office deduction

It's too expensive.

A standard home office deduction would cost \$3.6 billion per year. This is a small price to pay to keep small businesses—the engine of American job growth and innovation—growing.

Encouraging the growth of small businesses will also help grow and sustain the middle class. Owning your own business is a big part of the American dream for many people, and the federal government should be doing more, not less, to help people reach those aspirations of success.

Increasing the home office deduction will encourage tax fraud.

If anything, it would do the opposite by creating the option of a single, standardized deduction. The current law involves numerous complex calculations and accounting, which creates much more temptation for some people to “fudge” the numbers.

APPENDIX

Details of the standard home office deduction

This proposal would give small business owners the option of taking a standard home office deduction equal to the lesser of \$2,500 or the annual gross income from the taxpayer's home business in lieu of calculating the deduction under current law. Small business owners who would benefit more from the current credit would retain the option not to use the standard home office deduction.

This proposal would greatly simplify the tax code for small business owners while giving more home-based businesses an opportunity to take advantage of the intended tax break.

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■ ENDNOTES

1 Small Business Administration, "The Small Business Economy for Data Year 2006: A Report to the President," December 2007, available at http://www.sba.gov/advo/research/sb_econ2007.pdf.

2 Small Business Administration, "The Small Business Economy for Data Year 2006," December 2007, available at http://www.sba.gov/advo/research/sb_econ2007.pdf. Approximately 49% of the 16.7 million respondents in the Small Business Administration's survey of small business owners had home-based businesses.

3 U.S. Internal Revenue Service, "National Taxpayer Advocate's 2007 Annual Report to Congress," January 2008, available at <http://www.irs.gov/advocate/article/0,,id=177301,00.html>.

4 Small Business Administration, The Small Business Advocate, Vol. 27, No. 4, April 2008, available at <http://www.sba.gov/ADVO/april08.pdf>.

5 National Association of the Self-Employed, "Business Tax Questions Leave Micro-Businesses Searching for Answers from the IRS," 2008.

6 IRS Publication 587, "Business Use of Your Home (Including Use by Day Care Providers)," available at <http://www.irs.gov/pub/irs-pdf/p587.pdf>.

7 Small Business Administration, "The Small Business Economy for Data Year 2006," December 2007, available at http://www.sba.gov/advo/research/sb_econ2007.pdf. Approximately 49% of the 16.7 million respondents in the Small Business Administration's survey of small business owners had home-based businesses.

8 Ibid.

9 Small Business Administration, "Expected Costs for Startup Ventures," November 2003, available at <http://www.sba.gov/ADVO/research/rs232tot.pdf>.

10 Ibid.

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