

Chapter 7: Office in Home

Exclusive and Regular Use C203

Principal Place of Business C204

Claiming the Home Office Deduction C205

Special Rule for Rental to Employer C212

Corrections were made to this workbook through January of 2013. No subsequent modifications were made.

Claiming a deduction for business use of the home requires that a portion of the home be used for conducting a **trade or business**. The business area of the home must meet one of the following requirements.

- Used exclusively and regularly as the **principal place** of business
- Used exclusively and regularly as the place of **client or customer meetings**
- Used on a regular basis for business-related **storage**¹
- In the case of a separate structure not attached to the home, used in connection with the trade or business

Note. In this chapter, 2011 forms are frequently used rather than draft 2012 IRS forms because many of the draft forms were not available as of the date of publication.

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EXCLUSIVE AND REGULAR USE

“**Exclusive use**” means that the business area of the home is used **only** for business purposes. If the business area of the home is also used for personal purposes, the area does not qualify for any deduction.² However, if the business area of the home is used for **storage**, it is not necessary to meet this exclusivity test if **all** of the following factors apply.

- The taxpayer’s business involves selling products as a wholesaler or retailer.
- Product samples or inventory are kept in the taxpayer’s home.
- The taxpayer’s home is the only permanent business location.
- The storage space is used regularly.
- The space used for storage is suitable for storage purposes and is separately identifiable from other areas of the home.³

“**Regular use**” means that the specific area of the home is used on a consistent basis as opposed to only incidental or occasional use. The determination of whether a taxpayer regularly uses the area for a particular purpose is based on the facts and circumstances of each case.⁴

¹ IRS Pub. 587, *Business Use of Your Home*.

² Treas. Reg. §1.280A-2(g)(1).

³ IRS Pub. 587, *Business Use of Your Home*.

⁴ Treas. Reg. §1.280A-2(h).

PRINCIPAL PLACE OF BUSINESS

While the business-use area of the home can be a separate room, it can also be any separately identifiable space. It does not have to be physically separated or partitioned from space that is personally used.

The taxpayer may have more than one business location. Factors that are considered in determining whether the area in the home is the “**principal place of business**” include the following.

- The relative importance of business activities conducted at each available business location of the taxpayer
- The amount of time the taxpayer spends at each business location⁵

A home office area is the principal place of business if it is the only place used regularly for substantial administrative or management activities. Several different types of functions constitute administrative or management activities. Examples of these include the following.

- Billing customers or clients
- Maintaining books and records
- Ordering supplies
- Establishing appointments with customers or clients⁶

The following activities do **not** prevent the home office from being considered the principal place of business.

- Persons other than the taxpayer conduct the administrative or management activities at other locations outside the home office area.
- The administrative or management activities are conducted in a car or hotel room or other places that are not fixed business locations.
- Minimal administrative or management activities are occasionally conducted at other fixed locations outside the home.
- Significant nonadministrative or nonmanagement activities, such as meeting with clients or customers, are conducted at a fixed location outside the home office.
- The taxpayer has suitable space to conduct administrative or managerial activities outside the home but instead chooses to use the home office area for those activities.⁷

Example 1. Samantha has a financial planning practice near Chicago. A major part of her work involves mutual fund sales for Midshore Mutual Funds, Ltd. which is headquartered in New York. The New York office provides her with support staff that processes the forms and paperwork she sends to them. They also handle Samantha’s bookkeeping and schedule all Samantha’s appointments with clients and prospects.

Samantha has converted her dining room into a home office. This room is used exclusively for her business. She regularly meets with clients at either the client’s home or her home office, whichever is more convenient for the client. Samantha uses a connecting closet exclusively for the storage of files and her business computer. Samantha has a separate area where she keeps her personal computer and does her accounting. She can deduct the cost of the office and closet as a home office business expense. This is true even though Samantha also meets with clients in their homes and Midshore provides managerial and administrative services for her from a location outside the home office.

⁵. IRS Pub. 587, *Business Use of Your Home*.

⁶. Ibid.

⁷. Ibid.

MORE THAN ONE BUSINESS

The same home office can serve as the principal place of business for two or more business endeavors of the taxpayer. The rules for determining whether the home office is the principal place of business are applied separately for each business activity.⁸

Example 2. Use the same facts as **Example 1**, except in addition to her financial planning practice, Samantha also sells handmade purses through her online website as a second profit-seeking business venture. She uses the computer room exclusively for the online business. The computer room equipment is used to fill orders, invoice and correspond with online customers, and maintain business records. Because the computer room is used exclusively and regularly as the principal place of business for the handmade purse business, Samantha can claim a home office deduction for the computer room. Therefore, Samantha will be filing two Schedules C, *Profit or Loss From Business*, and two Forms 8829, *Expenses for Business Use of Your Home*.

SEPARATE STRUCTURE RULE

The taxpayer may have a free-standing structure entirely separate from the home that is used for business purposes. If the separate structure is used exclusively and regularly for business purposes, a deduction can be claimed for its expenses even if it is not the principal place of business.⁹

Example 3. Oscar is an artist living in Topsfield. He sells ornate pottery and glassware at his downtown Boston store. All of Oscar's sales and administrative staff and activity are at the Boston store. Oscar makes the pottery pieces and glassware in a studio equipped with a kiln and glass-blowing equipment. The studio is a separate building located behind his Topsfield residence. Even though the Boston store is the principal place of business, Oscar can still claim a deduction for the expenses of the studio.

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CLAIMING THE HOME OFFICE DEDUCTION

Reporting the deduction is complicated. For example, depending on the taxpayer's status, the deduction is claimed on several different schedules.

- A taxpayer who is an employee claims the deduction on Form 1040, Schedule A, line 21 (unreimbursed employee expenses), and must attach Form 2106, *Employee Business Expenses*.
- A self-employed taxpayer with a nonfarm business claims the deduction on Form 1040, Schedule C, line 30 (expenses for business use of the home), and must attach Form 8829, *Expenses for Business Use of Your Home*.
- A self-employed farmer claims the deduction on Form 1040, Schedule F, line 34 (other expenses), and must use a 41-line worksheet found in IRS Pub. 587, *Business Use of Your Home*. The worksheet is substantially the same as Form 8829.

The home office deduction is calculated as follows.

1. Calculate the **business percentage**. The business percentage determines the amount of household expenses that can be deducted because they are attributable to the business area of the home. The business percentage can be calculated based on comparing the total area (square footage) of the business-use portion of the home with the total area of the entire home.

Example 4. Norris has a 2-story home. The upper level is the same size as the lower level. Norris's retail business is located in the lower level. The residence is in the upper level. Norris's business percentage is 50%.

⁸. Ibid.

⁹. IRC §280A(c)(1)(C).

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Example 5. The entire interior area of Isabella's house is 3,500 square feet. Her home office consists of two rooms measuring 700 square feet. Isabella's business percentage is 20% ($700 \div 3,500$).

2. Home office expenses are **fully deductible** without any limitation if gross business revenue exceeds:
 - a. The regular operating business expenses not related to the home (excluding the 50% self-employment tax deduction), plus
 - b. The business portion of expenses related to the home.

If the home office and other office expenses exceed gross revenue, the deduction for home office expenses is **limited**. When this limitation applies, the taxpayer's business expenses are applied against profits of the business using a special set of ordering rules. To understand how these ordering rules apply, it is useful to categorize the taxpayer's home office expenses into three classes.

Class	Description	Examples
Class 1	The business portion of home expenses that the taxpayer could deduct as itemized expenses on Schedule A even if the taxpayer did not have a business	<ul style="list-style-type: none">• Mortgage interest• Property taxes
Class 2	Expenses attributable to the home office, not including depreciation	<ul style="list-style-type: none">• Insurance• Utilities• Repairs and maintenance• Rent (if the residence is rented and not owned)
Class 3	Depreciation	<ul style="list-style-type: none">• Depreciation on the business portion of the home

Once the taxpayer's home office expenses are categorized into these three classes, the following ordering rules apply in the calculation of the home office deduction.

1. Class 1 expenses are fully deducted from the net income of the business, even if the result is a loss. The deduction limit does not affect class 1 expenses.

Note. If the taxpayer deducts the business portion of mortgage interest and property taxes as part of a home office deduction and also itemizes expenses on Schedule A, the amounts claimed on Schedule A are **reduced** by the amounts claimed as a home office deduction. This prevents the home office portion from being deducted twice.

2. The class 2 home office expenses are deducted up to the amount of any net income remaining after deducting class 1 expenses. Deduction of class 2 expenses cannot create a loss and any amount not deducted is **carried forward** to the following year. The same limitation applies in the following year for class 2 expenses.
3. Class 3 expenses (depreciation) are deducted up to the amount of any remaining profit. Any depreciation in excess of the limit that cannot be deducted is carried forward to the following year, subject to the same class 3 expense limitation.

Note. The deduction limits prevent home office expenses and/or depreciation from creating or increasing a loss within the current tax year. This prevents the expenses from being used to shelter otherwise taxable income received in the year.

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Example 6. Heidi is the sole proprietor of HLH Interior Designs. Her home office is her principal place of business. Therefore, she qualifies to claim a home office deduction. Heidi provides her tax preparer with the following information for 2011. The amounts for house insurance and utilities relate to Heidi's entire home.

Home Office and Household Expenses for 2011

Square footage of home office	600
Square footage of entire home	2,400
Mortgage interest	\$ 9,000
Property taxes	4,000
House insurance	2,000
Utilities	2,400

Business Data for 2011 Tax Year

Gross income	\$30,000
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Expenses

Advertising	\$ 400	
Business loan interest	200	
Business telephone	600	
Design supplies	1,500	
Legal fees	2,000	
Office expense	700	
Professional license fee	300	
Rental of equipment	400	
Subcontracts	10,000	
Travel	800	
Total expenses	\$16,900	(16,900)
Net income/(loss)		\$13,100

In addition, Heidi's tax preparer obtains the following information.

FMV of home	\$110,000
Cost basis of home and lot	90,000
Cost basis of lot	30,000

The following applies to Heidi's home office deduction as shown on the Schedule C for HLH Interior Design and Form 8829 for her home office deduction.

1. Heidi reports her business income and regular business expenses on Schedule C. Her total regular business operating expenses are **\$16,900**.
2. Form 8829, Part I, shows the calculation of Heidi's business percentage, which is **25% (600 ÷ 2,400 square feet)**.
3. Form 8829, Part II, calculates the business portion of Heidi's mortgage interest and property taxes by multiplying these expenses by her business percentage, which results in **\$3,250 (\$13,000 × 0.25)**. This amount is subtracted from her \$13,100 profit, leaving **\$9,850** of remaining profit. This amount can be used for deducting any class 2 and 3 expenses.

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The remainder of the mortgage interest and property taxes, \$9,750 (\$13,000 – \$3,250), can be deducted on Schedule A.

4. The insurance of \$2,000 and the utilities of \$2,400 are reported on lines 17 and 20, respectively, as indirect expenses in column b because they relate to Heidi's entire house and not just the business portion of the house. Accordingly, the applicable business percentage is applied to these expenses, which results in \$1,100 ($\$4,400 \times 0.25$).

If Heidi had expenses relating strictly to the business portion of the home, the amounts are considered direct expenses and are reported in column a.

Form 8829, Part II, line 26, deducts Heidi's class 2 expenses from the remaining profit, which leaves **\$8,750** ($\$9,850 - ((\$2,000 + \$2,400) \times 0.25)$) of profit.

5. Form 8829, Part III, shows the depreciation calculation for the business portion of Heidi's home. The business percentage is applied to the basis of the building. The value of the land is subtracted because land cannot be depreciated. Heidi's tax preparer refers to the instructions for Form 8829 to find the depreciation percentage for line 40. Because Heidi used the home for the entire duration of 2011, the applicable depreciation percentage is 2.461%. The table from the instructions for line 40 is shown below. The depreciation deduction is calculated as follows.

$$(\$60,000 \times 25\%) \times 0.02461 = \$369$$

Line 40

IF you first used your home for business in the following month in 2011...	THEN enter the following percentage on line 40*...
January	2.461%
February	2.247%
March	2.033%
April	1.819%
May	1.605%
June	1.391%
July	1.177%
August	0.963%
September	0.749%
October	0.535%
November	0.321%
December	0.107%

***Exception.** If the business part of your home is qualified Indian reservation property (as defined in section 168(j)(4)), see Pub. 946, How To Depreciate Property, to figure the depreciation.

6. Heidi's total home office deduction of **\$4,719** is calculated on Form 8829. This is shown on line 35, and is also entered on Heidi's Schedule C, line 30. After the applicable home office deduction, Heidi's business net income is **\$8,381**, which is shown on Schedule C, line 31. This amount is entered on her Form 1040, line 12.

Heidi's Schedule C and Form 8829 follow.

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For Example 6

SCHEDULE C (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Profit or Loss From Business (Sole Proprietorship)

► For information on Schedule C and its instructions, go to www.irs.gov/schedulec
► Attach to Form 1040, 1040NR, or 1041; partnerships generally must file Form 1065.

OMB No. 1545-0074

2011

Attachment
Sequence No. **09**

Name of proprietor Heidi L. Hahn		Social security number (SSN) 987-65-4321
A Principal business or profession, including product or service (see instructions) Interior Design		B Enter code from instructions ► 5 4 1 4 0 0
C Business name. If no separate business name, leave blank. HLH Interior Designs		D Employer ID number (EIN), (see instr.) 3 8 9 8 7 6 5 4 3
E Business address (including suite or room no.) ► 456 Newton Street City, town or post office, state, and ZIP code Waterbury, CT 06704		
F Accounting method: (1) <input checked="" type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual (3) <input type="checkbox"/> Other (specify) ►		
G Did you "materially participate" in the operation of this business during 2011? If "No," see instructions for limit on losses <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No		
H If you started or acquired this business during 2011, check here <input type="checkbox"/>		
I Did you make any payments in 2011 that would require you to file Form(s) 1099? (see instructions) <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No		
J If "Yes," did you or will you file all required Forms 1099? <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No		

Part I Income

1a Merchant card and third party payments. For 2011, enter -0-	1a	0
b Gross receipts or sales not entered on line 1a (see instructions)	1b	30,000
c Income reported to you on Form W-2 if the "Statutory Employee" box on that form was checked. Caution. See instr. before completing this line	1c	
d Total gross receipts. Add lines 1a through 1c	1d	30,000
2 Returns and allowances plus any other adjustments (see instructions)	2	
3 Subtract line 2 from line 1d	3	30,000
4 Cost of goods sold (from line 42)	4	
5 Gross profit. Subtract line 4 from line 3	5	30,000
6 Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)	6	
7 Gross income. Add lines 5 and 6	7	30,000

Part II Expenses

Enter expenses for business use of your home only on line 30.

8 Advertising	8	400	18 Office expense (see instructions)	18	700
9 Car and truck expenses (see instructions)	9		19 Pension and profit-sharing plans	19	
10 Commissions and fees	10		20 Rent or lease (see instructions):		
11 Contract labor (see instructions)	11	10,000	a Vehicles, machinery, and equipment	20a	
12 Depletion	12		b Other business property	20b	400
13 Depreciation and section 179 expense deduction (not included in Part III) (see instructions)	13		21 Repairs and maintenance	21	
14 Employee benefit programs (other than on line 19)	14		22 Supplies (not included in Part III)	22	1,500
15 Insurance (other than health)	15		23 Taxes and licenses	23	300
16 Interest:			24 Travel, meals, and entertainment:		
a Mortgage (paid to banks, etc.)	16a		a Travel	24a	800
b Other	16b	200	b Deductible meals and entertainment (see instructions)	24b	
17 Legal and professional services	17	2,000	25 Utilities	25	600
28 Total expenses before expenses for business use of home. Add lines 8 through 27a	28	16,900	26 Wages (less employment credits)	26	
29 Tentative profit or (loss). Subtract line 28 from line 7	29	13,100	27a Other expenses (from line 48)	27a	
30 Expenses for business use of your home. Attach Form 8829 . Do not report such expenses elsewhere	30	4,719	b Reserved for future use	27b	
31 Net profit or (loss). Subtract line 30 from line 29.	31	8,381			

• If a profit, enter on both **Form 1040, line 12** (or **Form 1040NR, line 13**) and on **Schedule SE, line 2**.
 If you entered an amount on line 1c, see instr. Estates and trusts, enter on **Form 1041, line 3**.
 • If a loss, you **must** go to line 32.

32 If you have a loss, check the box that describes your investment in this activity (see instructions).
 • If you checked 32a, enter the loss on both **Form 1040, line 12**, (or **Form 1040NR, line 13**) and on **Schedule SE, line 2**. If you entered an amount on line 1c, see the instructions for line 31. Estates and trusts, enter on **Form 1041, line 3**.
 • If you checked 32b, you **must** attach **Form 6198**. Your loss may be limited.

32a ☐ All investment is at risk.
 32b ☐ Some investment is not at risk.

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 11334P

Schedule C (Form 1040) 2011

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For Example 6

Form **8829**
Department of the Treasury
Internal Revenue Service (99)

Expenses for Business Use of Your Home

► File only with Schedule C (Form 1040). Use a separate Form 8829 for each home you used for business during the year.
► See separate instructions.

OMB No. 1545-0074

2011
Attachment
Sequence No. **176**

Name(s) of proprietor(s)

Heidi L. Hahn

Your social security number

987-65-4321

Part I Part of Your Home Used for Business

1	Area used regularly and exclusively for business, regularly for daycare, or for storage of inventory or product samples (see instructions)	1	600
2	Total area of home	2	2400
3	Divide line 1 by line 2. Enter the result as a percentage	3	25 %
For daycare facilities not used exclusively for business, go to line 4. All others go to line 7.			
4	Multiply days used for daycare during year by hours used per day	4	hr.
5	Total hours available for use during the year (365 days x 24 hours) (see instructions)	5	8,760 hr.
6	Divide line 4 by line 5. Enter the result as a decimal amount	6	.
7	Business percentage. For daycare facilities not used exclusively for business, multiply line 6 by line 3 (enter the result as a percentage). All others, enter the amount from line 3	7	25 %

Part II Figure Your Allowable Deduction

8	Enter the amount from Schedule C, line 29, plus any gain derived from the business use of your home and shown on Schedule D or Form 4797, minus any loss from the trade or business not derived from the business use of your home and shown on Schedule D or Form 4797. See instructions	8	13,100
See instructions for columns (a) and (b) before completing lines 9-21.			
	(a) Direct expenses	(b) Indirect expenses	
9	Casualty losses (see instructions)		
10	Deductible mortgage interest (see instructions)	9,000	
11	Real estate taxes (see instructions)	4,000	
12	Add lines 9, 10, and 11	13,000	
13	Multiply line 12, column (b) by line 7	3,250	
14	Add line 12, column (a) and line 13		3,250
15	Subtract line 14 from line 8. If zero or less, enter -0-		9,850
16	Excess mortgage interest (see instructions)		
17	Insurance	2,000	
18	Rent		
19	Repairs and maintenance		
20	Utilities	2,400	
21	Other expenses (see instructions)		
22	Add lines 16 through 21	4,400	
23	Multiply line 22, column (b) by line 7	1,100	
24	Carryover of operating expenses from 2010 Form 8829, line 42		
25	Add line 22 column (a), line 23, and line 24		1,100
26	Allowable operating expenses. Enter the smaller of line 15 or line 25		1,100
27	Limit on excess casualty losses and depreciation. Subtract line 26 from line 15		8,750
28	Excess casualty losses (see instructions)		
29	Depreciation of your home from line 41 below	369	
30	Carryover of excess casualty losses and depreciation from 2010 Form 8829, line 43		
31	Add lines 28 through 30		369
32	Allowable excess casualty losses and depreciation. Enter the smaller of line 27 or line 31		369
33	Add lines 14, 26, and 32		4,719
34	Casualty loss portion, if any, from lines 14 and 32. Carry amount to Form 4684 (see instructions)		
35	Allowable expenses for business use of your home. Subtract line 34 from line 33. Enter here and on Schedule C, line 30. If your home was used for more than one business, see instructions		4,719

Part III Depreciation of Your Home

36	Enter the smaller of your home's adjusted basis or its fair market value (see instructions)	36	90,000
37	Value of land included on line 36	37	30,000
38	Basis of building. Subtract line 37 from line 36	38	60,000
39	Business basis of building. Multiply line 38 by line 7	39	15,000
40	Depreciation percentage (see instructions)	40	2.461 %
41	Depreciation allowable (see instructions). Multiply line 39 by line 40. Enter here and on line 29 above	41	369

Part IV Carryover of Unallowed Expenses to 2012

42	Operating expenses. Subtract line 26 from line 25. If less than zero, enter -0-	42	
43	Excess casualty losses and depreciation. Subtract line 32 from line 31. If less than zero, enter -0-	43	

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 13232M

Form **8829** (2011)

SPECIAL RULE FOR HOME DAYCARE FACILITIES

As explained earlier, if the taxpayer has a “mixed-use” area (both personal and business use), the exclusive-use requirement is not met. However, a special exception exists for home daycare facilities if the taxpayer uses part of the home for both personal and business purposes. For such mixed-use areas of the home, the taxpayer operating a home daycare facility is permitted to calculate the **business percentage** by:

- Calculating an initial business percentage under the rules explained earlier, and
- Determining the percentage of time that the mixed-use area is used as a daycare facility.¹⁰

A room that is available for the daycare business each day and **regularly** used in the daycare business is considered to be used for business throughout each business day. Occasional personal use of the room is allowed. However, **occasional business use** does not qualify the room as a business-use area. Records showing specific hours of use are not required.

This special rule is only available if the taxpayer’s home daycare facility meets the following criteria.

- The taxpayer’s business must be a daycare for children, individuals over 65, or persons unable to care for themselves.
- The taxpayer must be licensed as a daycare provider under state law **or** must have applied for the appropriate state daycare license **or** be exempt from licensing under state law. A taxpayer whose license application has been rejected or whose license has been revoked does not meet this criterion.¹¹

Example 7. Use the same facts as **Example 6**, except Heidi uses the same area of her home to operate a fully licensed daycare facility for children. Heidi must calculate her business percentage. Heidi uses the daycare portion of her home for 10 hours per day, five days per week. The daycare business operates 49 weeks per year. When the daycare is not operating, the daycare area of the home is used for personal purposes and is therefore a mixed-use area. Heidi calculates her business percentage in the following manner.

$$\begin{aligned}\text{Business portion of the home} &= \frac{600 \text{ square feet}}{2,400 \text{ square feet}} \\ &= 25\%\end{aligned}$$

$$\begin{aligned}\text{Daycare portion of year} &= \frac{\text{Hours of daycare use during the year}}{\text{Total number of hours in the year}} \\ &= \frac{10 \times 5 \times 49}{24 \times 365} \\ &= \frac{2,450}{8,760} \\ &= 27.97\%\end{aligned}$$

Accordingly, Heidi can deduct 27.97% of the direct expenses attributable to the mixed-use daycare area of the home. For indirect expenses (those expenses attributable to the entire home), Heidi can deduct $25\% \times 27.97\% = 6.99\%$.

Note. For more information regarding the home office deduction, see IRS Pub. 587, *Business Use of Your Home*.

¹⁰ IRS Pub. 587, *Business Use of Your Home*.

¹¹ Treas. Reg. §§1.280A-2(f)(2) and (3).

SPECIAL RULE FOR RENTAL TO EMPLOYER

If the taxpayer rents a home office to an employer and uses that home office space in the course of employment, there is a **limitation** on the items that are deductible.¹² The following table outlines some of the items that can and cannot be deducted.

Deductible Items	Nondeductible Items
Mortgage interest	Other trade or business expenses that are normally allowed
Property taxes	Business casualty losses
Personal casualty losses for the rental portion	Depreciation on the home office space

Example 8. George, an employee of Stonybrook Administrative Services, Inc., rents office space in his home to Stonybrook. He uses this office space to perform his services as a Stonybrook employee. Using the appropriate business percentage, George calculates the following expenses that are directly attributable to the office space rented to Stonybrook.

Mortgage interest	\$2,200
Property taxes	650
Heat	260
Water	112
Electricity	420
Office space depreciation	560

Because George rents the office space to his employer, his deduction is limited to the mortgage interest and property taxes attributable to the office space. The rest of the expenses that are usually deductible for a home office, such as the utilities and depreciation, cannot be deducted. George must also report the rental income received from Stonybrook.

¹² IRC §280A(c)(6).