You requested our advice as to the interplay between the $10,000 limitation on state and local taxes provided in §164(b)(6) and the amounts that are excepted from the general disallowance of expenses in connection with business use of a home under §280A(b).

**Issue:**

Section 164(b)(6) generally limits the amount of state and local taxes that an individual may deduct to $10,000. Section 280A(a) disallows a deduction for expenses incurred relating to the business use of a home unless another subsection of §280A excepts that expense from the disallowance. One such exception, under §280A(b), applies to expenses that would have otherwise been allowable as individual expenses (i.e., expenses unrelated to a trade or business). Given the §164(b)(6) limit, how are state and local taxes calculated as otherwise allowable expenses under §280A(b)?

**Conclusion:**

If a taxpayer’s total individual state and local taxes meet or exceed the $10,000 limitation of §164(b)(6), or if the taxpayer chooses to take the standard deduction
instead of itemizing deductions, none of the taxpayer’s state and local taxes relating to taxpayer’s business use of the home are included as expenses under §280A(b). If a taxpayer’s total individual state and local taxes do not meet or exceed the $10,000 limitation of §164(b)(6), and the taxpayer does not opt to take the standard deduction in lieu of itemized deductions, then the taxpayer can include as expenses under §280A(b) the business portion of the state and local taxes up to the difference between the limitation under §164(b)(6) and the amount of individual state and local taxes that the taxpayer actually deducted under §164.

Law and Analysis:

Section 280A

Section 280A(a) disallows to individuals and S corporations any deduction for expenses related to a dwelling unit used as a taxpayer’s residence during the tax year unless another provision of §280A specifically allows the deduction.

Section 280A(b) excepts from §280A(a) deductions allowable to the taxpayer without regard to the deduction’s connection with the taxpayer’s trade, business, or income-producing activity (i.e., mortgage interest, certain taxes, certain casualty losses that are allowable to individuals under other provisions of the Internal Revenue Code). Section 280A(b) is essentially a parity provision that prevents §280A(a) from limiting home expenses that would otherwise be allowable to individuals who are not using part of their home for trade, business, or other income-producing activity.

Subsections (1) through (4) of §280A(c) except from the disallowance of §280A(a) deductions for certain expenses related to certain business or rental uses of a dwelling unit. However, deductions under §280A(c) are limited under §280A(c)(5) by the following gross income limitation:

\[
\text{Gross income from the trade, business, or rental} - \text{Deductions identified under §280A(b)} - \text{Deductions not incurred in connection with the dwelling unit used as a residence (e.g., advertising, office supplies)} = \text{Gross income from which the taxpayer can deduct §280A(c) expenses}
\]

Deductions identified under §280A(b), as well as expenses that are not incurred in connection with the use of the dwelling unit as a residence (e.g., advertising and office supplies) are not limited under §280A(c)(5).

1 Expenses relating to the taxpayer’s exclusive use of a portion of the taxpayer’s home for business purposes could still be deductible under a different exception to the general disallowance in §280A(a), for example, under §280A(c), but such deductions would be subject to the specific limitations in that exception (e.g., §280A(c)(5)).
If, and only to the extent to which, any amount remains in the calculation, above, a taxpayer may take deductions identified under §280A(c) in the current year. Any expenses not allowed due to the gross income limitation in §280A(c)(5) are carried over to future years. If the taxpayer never has sufficient gross income, the deductions could ultimately be lost.

Section 164

Section 164 generally provides an itemized deduction for certain taxes paid or accrued during the taxable year. Section 164(a) provides a deduction for (1) state and local, and foreign, real property taxes; (2) state and local personal property taxes; (3) state and local, and foreign, income, war profits and excess profits taxes; and (4) the generation skipping transfer (GST) tax imposed on income distributions. Section 164(a) also provides a deduction for state and local, and foreign, taxes not previously described that were paid or accrued within the taxable year in carrying on any trade or business or an activity described in §212 (relating to expenses for the production of income). Section 164(b)(5) allows a taxpayer to elect to deduct state and local general sales taxes in lieu of state and local income taxes. Prior to the “Tax Cuts and Jobs Act,” Public Law 115-97 (the “Act”), enacted on December 22, 2017, although the amount of deductable taxes may have been limited by other sections of the Code, §164 itself did not limit the deduction amount.

Section 164(b)(6) was added to the Code by section 11042 of the Act. Section 164(b)(6) denies a deduction for an individual’s foreign real property taxes paid. It also limits an individual’s itemized deduction to $10,000 ($5,000 in the case of a married individual filing a separate return) for the aggregate of: (1) state and local real and personal property taxes not paid or accrued in carrying on a trade or business or an activity described in §212; (2) state and local income, war profits, and excess profits taxes not paid or accrued in carrying on a trade or business or an activity described in §212; and (3) sales taxes deducted in lieu of income taxes paid or accrued during the taxable year. The limitations under §164(b)(6) apply to taxable years beginning after December 31, 2017, and before January 1, 2026, but they do not apply to any taxes paid or accrued in carrying on a trade or business or other activity described in §212.

Because the limitation under §164(b)(6) is calculated by combining the taxpayer’s state and local taxes, a taxpayer using a portion of the taxpayer’s residence for an income-producing purpose must first calculate the percentage of the business use of the home and then apply that percentage to the total amount of state and local taxes paid in connection with the ownership of that home to determine the portion of the state and local taxes attributable to the business use of the home and the portion attributable to the individual use of the home. Once that determination is made, the taxpayer combines the individual use portion with the taxpayer’s other individual state and local taxes paid (income taxes or sales taxes, personal property taxes, war profits, excess profits taxes, and other real property taxes) to determine the taxpayer’s total individual state and local taxes. If that amount meets or exceeds the $10,000 limitation under
§164(b)(6), then the taxpayer does not have any additional taxes that would be deductible under §164(b)(6). In that case, the entire business portion of the state and local taxes would be considered a §280A(c) expense subject to the gross income limitation under §280A(c)(5). Similarly, if a taxpayer opts to take the standard deduction in lieu of itemizing deductions, then the taxpayer is not entitled to any deduction under §164(b)(6), and the entire business portion of the state and local taxes would be considered a §280A(c) expense subject to the gross income limitation under §280A(c)(5).

In the case of a taxpayer whose individual state and local taxes do not meet or exceed the $10,000 limitation under §164(b)(6), if that taxpayer had state and local taxes attributable to the income-producing activity, the taxpayer could deduct as a §280A(b) expense the amount of state and local taxes attributable to the business, up to the difference between the $10,000 limitation under §164(b)(6) and the taxpayer's total individual taxes under §164. The rest of the state and local taxes attributable to the business would be expenses under §280A(c) and would be subject to the gross income limitation under §280A(c)(5).

For purposes of illustration:

**Example 1:** Taxpayer has a home that he rents for 1/3 of the year. Taxpayer's real estate taxes on the home are $12,000. Taxpayer also pays $5,000 in state and local income taxes. The real estate taxes are allocated $8,000 to the individual use of the home and $4,000 to the rental use of the home. Taxpayer's total individual state and local taxes paid equal $13,000 (i.e., $8,000 individual real estate taxes plus $5,000 state and local income taxes). Under §164(b)(6), Taxpayer's individual itemized deduction for state and local taxes is limited to $10,000. Because Taxpayer's actual individual state and local taxes exceeds to the $10,000 limit under §164(b)(6), Taxpayer's $4,000 of real estate taxes attributable to the rental are expenses under §280A(c) and are subject to the gross income limitation under §280A(c)(5). None of Taxpayer's real estate taxes attributable to the rental use of the Taxpayer's home are expenses under §280A(b).

**Example 2:** The facts are the same as Example 1, except that Taxpayer rents the home for 2/3 of the year. In this example, the real estate taxes are allocated $4,000 to the individual use of the home and $8,000 to the rental use of the home. Taxpayer also paid $12,000 in mortgage interest on the home but had no other itemized deductions. Therefore, Taxpayer's total individual state and local taxes equal $9,000 ($4,000 individual real estate taxes plus $5,000 state and local income taxes) and Taxpayer's total individual itemized deductions equal $13,000 ($9,000 in state and local taxes plus $4,000 in mortgage interest (1/3 of the total mortgage interest paid)). Taxpayer's itemized deductions exceed the standard deduction amount of $12,000, so Taxpayer chooses to itemize his deductions. Taxpayer's total individual state and local taxes do not meet or exceed the $10,000 limitation in §164(b)(6). If Taxpayer had not rented his home, Taxpayer would have been able to deduct an additional $1,000 of the real estate
taxes, which are currently attributable to the business use of the home, as individual state and local taxes under §164(b)(6). As such, Taxpayer can include as a §280A(b) expense the $1,000 (the difference between the $10,000 limitation under §164(b)(6) and $9,000 (Taxpayer's total individual state and local taxes)), and such amount will not be subject to the gross income limitation of §280A(c)(5). The rest of Taxpayer's real estate taxes attributable to the rental use of the home ($7,000) are §280A(c) expenses and are subject to the gross income limitation under §280A(c)(5).

Example 3: The facts are the same as Example 2, except that Taxpayer did not pay any mortgage interest on the home. As such, Taxpayer had a total of $9,000 in individual itemized deductions and opted to take the standard deduction of $12,000 under §63(c) instead of itemizing his deductions. Because Taxpayer opted to take the standard deduction in lieu of itemized deductions, there is no amount of state and local taxes that would have otherwise been allowable to Taxpayer under § 164 but for the rental use of the home. As such, all of the real estate taxes attributable to the rental use of the home are §280A(c) expenses and are subject to the gross income limitation of §280A(c)(5).

Other Itemized Deductions Available To Individuals:

The methodology, above, also applies when applying the rules in §280A to other itemized deductions available to individuals (i.e., mortgage interest and casualty losses).

If you have any questions, please contact Bridget Tombul at (202) 317-7011 or Megan McLaughlin at (202) 317-7007.