



# SMALL BUSINESS RESEARCH SUMMARY

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## Home-Based Business and Government Regulation

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Previous research published by the Office of Advocacy has documented the disproportionate impact of federal regulations on small business: businesses with fewer than 20 employees pay 60 percent more per employee to comply with federal regulations than business with 500 or more employees (Crain and Hopkins, 2001). The current report continues this inquiry by investigating the impact of regulations (federal, state, and local) on the smallest of firms, home-based businesses. The home-based business sector is substantial in size: 53 percent of small businesses are based in the home (Pratt, 2000). Some home-based ventures are the incubators of successful ventures that evolve to locations outside the home, while other occupations are well matched to the home environment—bed and breakfasts and infant and toddler day care, small offices, or cottage industries.

### Overall Findings

At the federal level, Internal Revenue Service regulations penalize home-based businesses in their treatment of deductions. At the local level, zoning laws and prohibitions present home-based businesses with a significant entry barrier. The report notes, however, that some states have improved the environment for home-based businesses.

### Highlights

- The tax code treats home offices as commercial buildings. Claiming a home-office deduction is complex; the depreciation is spread over an unrealistically long time; and returning the space to residential use generally entails penalties.
- In order to qualify for a deduction, the tax code requires that a home office be used exclusively for business. Such a requirement ignores the realities of family life and offsets many of the advantages of running a business out of a home.
- Deductibility of other business-related expenses (such as utilities and legitimate maintenance) is contingent on the deductibility of the home office.
- The tax code allows deductions for other equipment only to the extent that they are used in the business, regardless of the necessity to the business. This requirement penalizes home-based businesses for their small scale, creates recordkeeping burdens, and is inconsistent with exclusive business use of an office.
- IRS assistance covers far too many topics that are not relevant to most home-based businesses. Inadequate tailoring to the needs of home-based businesses unnecessarily increases the familiarization and filing burdens on a home-based business.

- Locally, many zoning codes incorporate outright prohibitions, prescriptive requirements, or limits on various aspects of home-based businesses (e.g., number of employees, visitors, parking, exterior changes, or specific industries). Some jurisdictions, however, have adopted more flexible and efficient zoning codes based on a business's performance and its relation to the character of the neighborhood.

- Few local jurisdictions have utilized the different residential zoning categories (pertaining to density and type) as a means of providing more flexibility in home-based business regulation. Jurisdiction-wide restrictions, which appear to have been designed to protect the most vulnerable neighborhoods, are far more common.

### **Scope and Methodology**

The researchers used evidence available in Advocacy's database and thoroughly researched state and local websites. They discussed a number of issues with tax professionals as needed. The report's seven appendixes present extensive data on home-based business regulation, including a comparison of regulation in six states: Arizona, California, Illinois, Iowa, Pennsylvania, and Vermont.

### **References**

Mark Crain and Thomas Hopkins, 2001. *The Impact of Regulatory Costs on Small Firms*. Washington, D.C.: U.S. Small Business Administration, Office of Advocacy. [www.sba.gov/advo/research/rs207tot.pdf](http://www.sba.gov/advo/research/rs207tot.pdf).

Joanne Pratt, 2000. *Home-Based Businesses: The Hidden Economy*. Washington, D.C.: U.S. Small Business Administration, Office of Advocacy. [www.sba.gov/advo/research/rs194tot.pdf](http://www.sba.gov/advo/research/rs194tot.pdf).

### **Ordering Information**

The full text of this report and summaries of other studies performed under contract to the U.S. Small Business Administration's Office of Advocacy are available at [www.sba.gov/advo/research](http://www.sba.gov/advo/research). Printed copies are available for purchase from:

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