

# **Home-Based Business and Government Regulation**

by

**Henry B. R. Beale, Microeconomic Applications, Inc.  
Washington, D.C.**

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*The statements, findings, conclusions, and recommendations found in this study are those of the authors and do not necessarily reflect the views of the Office of Advocacy, the United States Small Business Administration, or the United States Government.*

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# EXECUTIVE SUMMARY

## INTRODUCTION

Government regulations typically have a disproportionately large impact on very small businesses. Studies using various methodologies have found that unit costs of complying with regulations are consistently higher for businesses with fewer than 20 employees than for businesses with over 500 employees that use similar compliance measures. Very little is known about size differences below 20 employees or other aspects of very small businesses that may influence the size and nature of regulatory impacts.

Home-based businesses, which make up roughly half of all U.S. businesses, are of particular interest because of their potential as a wellspring of economic activity. Homes are, in effect, do-it-yourself business incubators, which collectively provide start-ups with an entry point into the business world. Home-based businesses as a group have been characterized, but little more has been done in the way of analysis. A general goal of this study is to advance the understanding of regulatory burdens on home-based businesses, as opposed to non-home-based very small businesses.

## CHARACTERISTICS OF HOME-BASED BUSINESSES

Home-based businesses are the predominant form of small business. Over two-thirds of all sole proprietorships, partnerships, and S corporations are home-based. Home-based businesses are concentrated in relatively few industries. Over 60 percent of home-based businesses are in the service and construction sectors; over 80 percent are in fifteen 2-digit SIC industries; and one quarter are in just six 3-digit SIC industries.

Over 90 percent of home-based businesses are sole proprietorships. Home-based businesses are also quite small. At the time data were last collected (1992):

- In terms of employment:
  - ◆ Over 90 percent of home-based businesses had no employees,
  - ◆ 7.2 percent of all home-based businesses reported fewer than five employees,
  - ◆ Just over 1 percent reported 5 to 19 employees, and
  - ◆ About 0.2 percent reported 20 or more employees.
  
- In terms of income:
  - ◆ Over three quarters (77 percent) had gross receipts of less than \$25,000,
  - ◆ 96 percent had gross receipts of less than \$50,000,
  - ◆ 3.5 percent had gross receipts of \$100,000 or more, and
  - ◆ Less than 1.0 percent had gross receipts of \$500,000 or more.

## **FEDERAL REGULATIONS**

The Internal Revenue Service appears to have the most burdensome regulations of any federal agency for home-based businesses. Thus the IRS is the starting point for this review of federal regulations.

### **Internal Revenue Service**

All businesses are required to file federal income tax returns and related schedules. Businesses with employees must withhold and file related forms for employees. Additional forms are required for deducting depreciation and costs of the home office.

Although older measures of burden are difficult to interpret, and new estimates are still very preliminary, it appears that a self-employed person spends roughly an average of about 50 hours per year – about an hour per week – on activities (familiarization, recordkeeping, and return preparation) related to filing an annual federal business tax return. If a tax preparer is used, direct costs will be around \$500 for the simplest return, ranging up to \$3,500 for partnerships or S corporations, and/or if employees are involved. Available data do not distinguish between home-based and non-home-based businesses.

These average burdens are influenced by several factors: Experience, records that are well organized, and computerization can markedly lower the burden. Conversely, it is the start-up business that has by far the greatest burden, as federal taxes have a steep learning curve.

The IRS provides extensive information designed to assist business filers. Absorbing the information, however, requires a great effort. The publications are voluminous. Information is fragmented, so that the reader must follow cross-references to other publications for a complete picture. Basic publications contain a lot of information that is extraneous for a start-up business. Presentation has a flat, undifferentiated style, making it hard to tell what is important -- or why.

Two elements of the tax code related to home-based businesses fail to recognize the unique characteristics of a home office.

- The tax code treats a home office as a piece of commercial real estate and the resident/owner as a commercial real estate investor. The office must be depreciated over 39 years, and there are adverse tax consequences if the home is sold. Most small businesses, by contrast, can pay and deduct rent.
- The tax code reduces the deductibility of equipment to the extent that it is put to non-business use, regardless of how essential it is to the businesses or whether the other use occurs outside of working hours. Non-home-based businesses are not held to such a standard. Moreover a home-based business faces practical difficulties. Documenting use is burdensome when a family is involved, and any non-business use of the home office in which the equipment is located disqualifies the office for deduction.

The tax code contains other provisions that can (more indirectly) burden home-based businesses disproportionately:

- Self-employed individuals are required to pay self-employment tax in health insurance, even if it is a business benefit. This effectively reduces the value of the deduction by 15.3 percent.
- Home-based businesses are independent contractors, but they may take on characteristics of an employee in order to provide good service to clients. The IRS appears to lean toward classification as an employee, if there is doubt, since this simplifies the collections process.

The general reputation of the IRS creates a fear factor that is exacerbated by the complexity of the tax code and the lack of a sense of definitiveness in assistance materials and instructions. This tends to make businesses – particularly new ones – disinclined to take deductions to which they are entitled, which adds to the burden they already face. Alternatively, the burdens of learning how to comply fully are an incentive for a business to go underground, which serves neither the IRS's interest in revenues or business growth.

### **Other Federal Regulations**

Impacts of regulations of other federal agencies on home-based businesses are minimized by several factors:

- Some federal regulations concern government operations and people who participate in programs, rather than businesses.
- Home-based businesses are small enough to benefit from virtually any threshold or flexibility that is built into a regulation.
- Regulations of many agencies target industries – such as manufacturing, finance, or transportation – where there are relatively few home-based businesses.
- Some regulations, including environmental regulations and occupational health regulations, apply to substances that are not used industrially in a home.
- Some regulations, including occupational safety regulations, apply to work sites, and thus do not have a differential impact on a business that is home-based.

## **STATE AND LOCAL TAXES**

### **State Registration**

States tend to use registration as a means of getting businesses into the tax system. Burdens of registering are offset by the information provided. State assistance materials are often clearer and better focused for new businesses than IRS materials.

### **State Income and Withholding Taxes**

Income tax forms in states that were reviewed are closely linked to the corresponding federal tax form. Income tax forms tend to take a measure of income from the federal form and to make such adjustments as are necessary to allow for differences between federal and state tax law. Most of these adjustments are not related to business income, and the rest do not disproportionately burden home-based businesses. Because of their small size and general lack of employees, home-based businesses are less likely than other businesses to incur the burdens of separating in-state and out-of-state income.

Withholding tax forms are generally simple and parallel to the federal forms. They require different numbers than federal withholding, but the recordkeeping and paperwork are similar and subject to efficiencies of being done jointly.

### **Sales, Use, and Excise Taxes**

Sales taxes do not apply to most home-based businesses. When they do, recordkeeping is relatively simple and may be computerized. Some states reduce the burden by collecting local sales taxes along with state sales taxes. Sales taxes do not disproportionately impact home-based businesses.

Use taxes apply to purchases from out of state, on which sales taxes have not been paid. Home-based businesses are usually too localized to incur much use tax liability, and they are too small to be worth the enforcement effort. They appear generally to be ignored in most cases.

Excise taxes usually apply to specific goods or services, and these (e.g., tobacco, liquor, restaurant meals, gasoline, utilities) are generally not provided by home-based businesses.

### **Business Personal Property Taxes**

Business personal property taxes are potentially burdensome, particularly if the requirements are very detailed. They are a fairly inefficient tax, as the revenue potential from small businesses is limited. Most jurisdictions use one or more techniques to minimize the burden or exempt very small businesses altogether:

- The tax may be rescinded at either the state level or local level.
- Statutory thresholds or informal non-enforcement exempt home-based businesses.

- Property may be combined into broad categories with simplified depreciation schedules.
- Local or state governments may take over the computation, requiring the business only to provide and date an inventory of property.

### **Local Fees and Business Taxes**

Local fees and business taxes do not disproportionately burden home-based businesses. Licensing fees usually apply to activities that are not home-based. Most business taxes and registration fees do not differentiate between home-based and non-home-based businesses.

Home occupation taxes are the exception. They can be a significant revenue source. This has provided a beneficial incentive for local jurisdictions to draft ordinances that legalize home-based businesses, so that they can collect the taxes. In most instances in the study, a jurisdiction collects only the equivalent of some other broad-based tax. In a few jurisdictions, however, home occupations are singled out for taxation.

## **STATE AND LOCAL REGULATIONS**

### **State Regulations**

Many state regulations do not apply to the type of businesses that are based in the home. Those that do apply do not have a disproportionate impact. The reasons are similar to those for non-revenue federal agencies. Downloadable state data on regulations and forms provide several interesting sets of regulations that confirm this conclusion.

States license professionals. Licensing regulations are similar from state to state and typically have the same structure within a state. These regulations deal almost entirely with:

- Licensing fees;
- Training of the professional;
- Licensing and the licensing examination;
- Continuing education requirements;
- Standards of practice; and
- Procedures of the licensing board.

Almost none of the regulations deal with the office or any other aspect of the profession that is at all related to whether a business is home-based or not.

Child care is the most consistently and extensively regulated type of home-based business. State regulations typically cover most aspects of operations and facilities. States, however, have multiple classes of licenses, at least one of which is designed specifically for a single care-giver providing care in his/her residence. Regulations for day care homes are tailored to a home-based business. Compared to regulations that apply to non-home-based day care centers, they are shorter and easier to read, they require less formal training for the care-giver, and their provisions tend to be a bit more generic and performance-oriented in nature. State child care regulations are good examples of regulatory flexibility.

Few other regulations that were related to home-based businesses were encountered in the study. Two of the few include:

- Industrial homework regulations, which date from the 1930s, were not designed for home-based businesses as we know them, and pose burdens only if written in an overly broad manner and/or if they prohibit activities; and
- Bed & Breakfast regulations, which do little more than bring together existing codes and other requirements.

## **Codes**

Building codes apply principally to new construction or to renovations. They regulate design, materials, quality of construction, and systems. Any requirements for existing buildings are fairly basic and/or pertain to genuine hazards (e.g., lead paint). Potential burdens are minor.

Fire codes overlap somewhat with building codes, but they concentrate on public spaces. For home-based businesses that the public might enter, the issues generally are smoke alarms, fire suppression systems (in older buildings, typically fire extinguishers), and adequate egress.

Most health codes reviewed for this study set basic standards that should not pose any exceptional difficulty. Food and its preparation are a special concern of health codes. Since they were clearly written with an industrial facility in mind, there are occasional specific provisions that would be difficult to meet in a home or are otherwise inappropriate for a home-based business. In general, it would be fairly simple to modify such provisions with no real health risk.

## **ZONING**

### **Zoning Requirements**

Local jurisdictions enact zoning codes to separate land uses and maintain the distinctive character of each type of neighborhood. Over the last decade or so, there has been a very broad movement to adopt provisions that would allow home-based businesses in residential zones. Home-based businesses had previously been considered to be commercial operations. As such, they were prohibited in residential areas.

Current zoning codes put many types of restrictions on home-based businesses. These restrictions can be grouped into several categories:

- **Physical Changes and Visibility.** Zoning codes often:
  - ◆ Prohibit exterior physical changes,
  - ◆ Prohibit outside business activities, storage, or displays, and/or
  - ◆ Restrict or prohibit signage or commercial vehicles.
- **Traffic.** Most zoning codes:
  - ◆ Restrict the numbers of visitors to a business,
  - ◆ Restrict the number of employees or prohibit employees altogether, and/or
  - ◆ Restrict business parking or require that additional parking be provided.
- **External Effects.** Most zoning codes:
  - ◆ Restrict or prohibit nuisance impacts (e.g., noise, odors, glare), and/or
  - ◆ Prohibit use or storage of hazardous materials.
- **Business Activities.** Many zoning codes prohibit certain types of businesses in residential areas.

Most zoning restrictions apply to all residential zones on a jurisdiction-wide basis. There are limited means for varying the restrictiveness of zoning regulations from zone to zone:

- Variant definitions of a home-based business can be defined and be allowed in different densities of residential zone, or
- Different types of review and permission can be used for different residential zones.

The most common practice, however, is to have one definition of home occupation, and one definition of day care home, which imposes the same restrictions and requires the same level of review and type of permission throughout the jurisdiction. The treatment of Bed & Breakfasts is more varied, at least with respect to permissibility.

### **Restrictiveness and Flexibility**

Zoning restrictions on home-based businesses seem to be designed for the most vulnerable residential neighborhoods and then applied on a jurisdiction-wide basis. Flexible performance standards that adapt to different characteristics of individual neighborhoods would be more efficient and are preferable. The key to performance standards is to use the existing residential characteristics of the neighborhood as a benchmark. For example:

- Instead of prohibiting exterior physical changes, any remodeling for a home-based business can be required to conform with the neighborhood's residential character and/or architecture.

- Traffic concerns can be addressed by requiring that activities of the home-based business may not significantly reduce availability of parking for residents.
- Acceptable levels of external impacts can be linked to common residential sources (e.g., noise not exceeding that of air conditioner compressors).
- While some types of business (e.g., automotive repair shops) may be hopelessly incompatible with residential neighborhoods, most types of businesses can be restricted through performance standards rather than by absolute prohibition.

### **Quasi-Zoning**

Developments and condominium conversions with homeowner associations are an increasingly important factor in providing new housing. Such developments usually have covenants that are drawn up by the developer, are conditions of purchase of the property, and run with the deed. Prohibition of home-based businesses is often one of the restrictions.

Such covenants have the effect of zoning. Because they are part of contract law or real estate law, however, they are not subordinate to local zoning codes. They can only be changed by members of the homeowner association, and by-law requirements often make such changes difficult. This quasi-zoning is a new challenge for home-based businesses.

### **States, Zoning, and Home-Based Businesses**

The authority to enact zoning codes is an authority delegated to local governments by states. States can enact home occupation legislation that is supportive of home-based businesses. Some states have done this, and some of the state legislation is explicit or forceful:

- Maryland statutes include a definition of “no-impact” home occupation, which is a broadly adopted standard.
- Vermont forcefully states the right of a person to operate a business in his home.
- California statute requires all local jurisdictions to allow day care homes, and it goes so far as to void any contractual agreements to the contrary.

Such legislation has been helpful in the spread of home occupation zoning provisions, but there is a mitigating aspect to it as well. Standards that are meant to apply everywhere tend to be fairly restrictive. Since the easiest thing for a jurisdiction to do is to adopt such a model, local zoning codes may be similarly restrictive.

Maryland also has taken an unprecedented step in limiting quasi-zoning restrictions. The statute essentially requires any homeowner association to allow a “no impact” home occupation upon a simple majority vote of the membership, regardless of by-law requirements on changing covenants.

## I. INTRODUCTION

### A. STUDY ISSUES

#### 1. Introduction

Government regulations typically have a disproportionately large impact on very small businesses. Studies using various methodologies have found that unit costs of complying with regulations are consistently higher for businesses with fewer than 20 employees than for businesses with over 500 employees that use similar compliance measures.<sup>1</sup> Very little is known about size differences below 20 employees or other aspects of very small businesses that may influence the size and nature of regulatory impacts.

Home-based businesses, which make up roughly half of all U.S. businesses, are of particular interest because of their potential as a wellspring of economic activity. Homes are, in effect, do-it-yourself business incubators, which collectively provide start-ups with an entry point into the business world. Home-based businesses as a group have been characterized,<sup>2</sup> but little more has been done in the way of analysis. A general goal of this study is to advance the understanding of regulatory burdens on home-based businesses, as opposed to non-home-based very small businesses.

Even among the category of very small businesses, home-based businesses are particularly small and unlikely to have employees.<sup>3</sup> Since many data sources exclude businesses with no employees, findings for very small businesses as a whole may not adequately reflect home-based businesses. Similarly, the types of activities done in a home and the industries that are most suited to home-based businesses often differ from the mix found in non-home-based businesses. Such differences may affect the applicability to home-based businesses of studies of regulatory burdens on small businesses. Moreover, regulatory burdens on home-based businesses may be different simply because of the fact that the business is based in a home.

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<sup>1</sup> Some studies use a macro approach, examining the impacts of broad categories of regulations (e.g., environmental, economic, workplace, and tax regulations) on broad industry groups. See, for example: Henry Beale and Robert Burt, *Cost-Effective Regulation by EPA and Small Business Impacts*, Report to the Office of Advocacy, United States Small Business Administration, 1992. Thomas D. Hopkins, *A Survey of Regulatory Burdens*, Report to the Office of Advocacy, United States Small Business Administration, June 1995. W. Mark Crain and Thomas D. Hopkins, *The Impact of Regulatory Costs on Small Firms*, Report to the Office of Advocacy, United States Small Business Administration, 2001.

<sup>2</sup> Joanne H. Pratt, *Homebased Business: The Hidden Economy*, Report to the Office of Advocacy, United States Small Business Administration, 1999.

<sup>3</sup> The 1992 data analyzed by Pratt indicate that only 9 percent of home-based businesses have employees, compared with 32 percent of very small non-home-based businesses, and of those that do have employees, very small non-home-based businesses average about four times as many employees as home-based businesses.

## 2. Study Objectives

**Regulations at All Levels of Government.** National studies of regulatory burdens (including those sponsored by the SBA's Office of Advocacy) tend to be limited to burdens of federal regulations. Yet home-based businesses also – and in some cases, particularly – bear burdens of state and local government regulation. Thus one study objective is to develop a complete profile of regulatory burdens that may be born by home-based businesses.

**Disproportionate Regulatory Burdens.** For a variety of reasons, home-based businesses may be differently affected than non-home-based businesses with similar size and industry characteristics. This is especially likely to be true where regulations pertaining to home offices are concerned. Thus another objective is to determine which types of regulatory burdens are either disproportionately large or disproportionately small for home-based businesses, compared with other very small businesses.

**Severity of Impacts on Home-Based Businesses.** The relative size of regulatory impacts on home-based businesses is important for assessing the regulatory burdens. At a minimum, it is an objective of the study to categorize burdens on home-based businesses low, medium, high, and prohibitive,<sup>4</sup> and to assign interpretive definitions to such classes.

**Barriers to Expanding Economic Activity.** Two stages in the life cycle of a very small business are particularly critical for contributions to economic activity:

- Start-up of a business may be impeded by regulations, and
- Growth of a solidly established business may be inhibited by regulations.

Regulations whose impacts are sufficiently onerous to drive home-based businesses underground so as to avoid them are also serious. Operating underground or off the books is a barrier to expansion. An objective of this study is to determine which regulatory burdens specifically make it difficult to start home-based businesses, drive them underground, or prevent their growth.

**Policy Development.** An understanding of the source, nature, and general magnitude of the relative regulatory burdens on home-based businesses is essential to any policy initiatives to remove distortions and level the playing field for home-based businesses. Such an initiative may involve adoption of regulatory-flexibility-type measures at the agency level or more sweeping changes in the underlying legislation at the Congressional level. For regulatory burdens at the local level, model codes (e.g., zoning regulations) could be an appropriate mechanism for recommendations. Providing an empirical basis for policy development is a final objective of the study.

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<sup>4</sup> This designation would apply to regulations that categorically prevent home-based businesses.

## B. METHODOLOGY

In as vast and varied an area as home-based business, consistent data of any precision are virtually unavailable. Consequently, the study was qualitative in nature. The approach used was to get information from different perspectives and different sources and to fit these elements together to synthesize a whole picture. Specific perspectives and sources are described below.

### 1. Literature Review

**Studies.** There has not been much research on home-based businesses or other micro-businesses. More research has been done on regulatory burdens (at least at the federal level), much of it sponsored by the SBA's Office of Advocacy. We reviewed reports on these topics to the extent that they were available.

**"How To" Literature.** There is an extensive literature on such topics as how to form a small business, home based businesses, and how to deal with the Internal Revenue Service. These often address -- although usually in very general terms -- issues of regulation. We collected and reviewed a sample of this literature.

**The Internet.** Federal governments, state governments, and many counties and cities have web sites, as do many organizations interested in small businesses, the self-employed, home-based businesses, child care, and many other specific aspects of the study. These web sites were useful in a number of respects:

- They provided referrals to other web sites, people, and documents;
- They were the source for most state and local government documents and were quite helpful in searching these documents for relevant information
- They provided extensive information about the organization and functions of federal agencies, state governments, and local governments;
- They were a source of informative articles on various topics; and
- They were themselves an object of study, since they are important sources of information about governments and regulations for home-based businesses.

### 2. Use of Previous Studies

Two of the previous studies sponsored by the SBA's Office of Advocacy were particularly useful at different stages of this study:

- Joanne H. Pratt, *Homebased Businesses: the Hidden Economy*, Report to the Office of Advocacy, United States Small Business Administration, August 1999.

- Management Research and Planning Corporation, *Analysis of State Efforts to Mitigate Regulatory Burdens on Small Businesses*, Report to the Office of Advocacy, United States Small Business Administration, June 2002.

Pratt provided key information on characteristics of home-based businesses. This information, especially the information on industries, contributed greatly to the understanding of the potential for many types of regulations to burden home-based businesses.

MRP provided information on states with bodies (usually legislative or executive-branch committees) that review and comment on regulations for their impacts (including small-business impacts). This information was helpful in targeting states for study, identifying state regulations, and identifying state government interviewees. We included a number of the states identified by MRP, which were not part of the case studies, in the analysis of state tax regulations.

### **3. Interviews**

By design, this study did not include a formal survey, focus groups, or any other method of collecting information from a significant number of people. We principally relied on public documents, web sites, and other published sources of information. We also conducted interviews with a few individuals – most of them members of organizations<sup>5</sup> and state government officials – on each of a wide range of topics.<sup>6</sup> We used interviews to:

- Identify regulatory burdens on home-based businesses, as well as examples;
- Identify jurisdictions that could serve as models (or bad examples);
- Obtain referrals;
- Explore the burden potential of regulations; and
- Obtain explanations, clarification, or other information on specific regulations and their requirements.

### **4. Review of Statutes and Regulations**

Review and analysis of statutes and regulations was a major activity in this study. For federal agencies, we used secondary sources as a screening device. At the state and local level, we performed direct searches on codes and regulations that were related to taxes; licensing; health, safety, and fire codes; rules directly affecting individual home-based business; and zoning and land use. Through these searches we identified statutes and regulations that had a potential

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<sup>5</sup> Of all the organizations contacted, the American Association of Home-Based Businesses was especially helpful.

<sup>6</sup> We took care to keep discussions on any particular topic within OMB's restrictions on information collection.

for burden on home-based businesses. Upon identifying these sections, we extracted and analyzed them in detail.

## **5. Review of Forms and Related Publications**

We collected and reviewed many forms and related instructions. For the most part, these were tax forms, application forms, and registration forms. We also collected and reviewed numerous publications, which generally fell into one (or more) of the following categories:

- IRS Publications providing background information for tax filers;
- Publications (both hard-copy and on-line) designed to help start-up businesses get organized;
- Publications (both hard-copy and web sites) designed to orient new businesses to state and local governments and/or the responsibilities of a business with respect to government requirements, by agency;
- Publications that provided information and/or instructions on specific state and local rules and regulatory requirements.

## **6. Case Studies**

Case studies were the basic technique through which we obtained information on state and local governments. We selected five states and a sample of counties and cities within them. These states were California,<sup>7</sup> the District of Columbia,<sup>8</sup> Illinois,<sup>9</sup> Maryland,<sup>10</sup> and Vermont.<sup>11</sup> These case studies enabled us to analyze the whole picture that included state regulations, local regulations, and the influence of state law on local regulations.

## **C. ON IMPACTS**

### **1. Impacts and Baselines**

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<sup>7</sup> Counties in California included Contra Costa County, Merced County, Nevada County, Orange County, San Diego County, Siskiyou County, and Sonoma County. Cities included Angel Camp, Bakersfield, Chico, Long Beach, Los Angeles, Oakland, Redding, and San Jose.

<sup>8</sup> The District of Columbia, which is not a state, combines state, county, and local functions into one jurisdiction.

<sup>9</sup> Counties in Illinois included Lake County, Sangamon County, and Will County. Cities included Carbondale, Chicago, Elgin, and Peoria.

<sup>10</sup> Counties in Maryland included Frederick County, Howard County, Montgomery County, St. Mary's County, and Talbot County. Cities included Baltimore City, Cumberland, and Gaithersburg.

<sup>11</sup> Towns in Vermont included Burlington, Charlotte, Hartford, Montpelier, St. Johnsbury, and Thetford.

The “impact” of a regulation (or any exogenous event) is the change that occurs as a consequence of the regulation that would not have occurred *without* the regulation. Assessing an impact involves defining both a base case and an impact case – typically without and with a regulation. For this study, the focus is home-based businesses.

For regulations that apply to businesses in general, the issue is whether home-based businesses bear a burden that is disproportionate or otherwise different from other businesses. For such regulations, comparable businesses that are not home-based are the appropriate base case – in effect a control group. If the burdens of a regulation on home-based businesses and on non-home-based businesses of comparable size, industry, organization, etc. are essentially the same, there are no impacts that can be attributed specifically to *home-based businesses* as such. That is – from the perspective used for this report – regulatory costs imposed on home-based businesses are considered specific impacts only to the extent that they are attributable (or related) to the business being home-based.

## **2. Home-Based Offices and Off-Site Industry Activities**

One form of home-based business is a business that has an administrative home office (which is its only office) but performs the actual industrial work off site. Examples include home-based businesses in the construction or lumbering industries. Some regulations, particularly those of federal agencies other than the IRS, apply to the industry activity but not to the administrative office (unless, perhaps, it is at the work site) or to a residence.

In such a situation, it is a reasonable presumption that the industry-specific regulation does not affect a home-based business any differently than it effects an otherwise similar non-home-based business. Unless an initial review indicates some reason for expecting differential impacts, it is reasonable to conclude that the regulation does not specifically “impact” or “burden” home-based businesses in the sense that this study is intended to examine.

## **3. Start-Up and Growth**

There are two areas in which impacts on home-based businesses may be qualitatively different from the effects studied in conventional regulatory impact analysis. One is the start up of a home-based business. The other is the growth of a business beyond the friendly confines of the home.

At least in some industries, the home is a natural place to start up a new business. The home is particularly conducive to a small-scale business “on the side” – whether one’s principal occupation is out-of-the-home employment or in-the-home parenting. Small home-based businesses are also a fertile environment for trying out new ideas -- software development and mail-order retail being two examples. The question at this stage is whether regulations -- even if their overall burdens on home-based businesses are not greater than those on non-home-based businesses -- dissuade potential business people from even trying to start a business.

At the other end of the spectrum are “entrepreneurial” home-based businesses. Phillips has characterized these businesses as providing the principal income for the owner, having

employees, and having relatively high sales.<sup>12</sup> These home-based businesses are poised – if the owner so desires – to grow and continue growing so that they eventually move out of the home. Entrepreneurial firms make up a very small percentage of home-based businesses, but they have substantial potential to contribute to the economy. The question here is whether regulatory burdens block this type of maturing and growth out of the home.

The impacts on side businesses and entrepreneurial businesses cannot be assessed with precision, because there is no convenient baseline or control group. One characteristic of home-based businesses is that they are strongly affected by their owners' preferences, and this is a variable that is hard enough to define, much less control for. Nevertheless, assessment of the characteristics of regulatory burdens on home-based business can provide some indication of the potential for additional impact on these two stages of business development.

#### **D. ORGANIZATION OF THE REPORT**

This report is organized into chapters along the lines of issues addressed in the study. The organization of the remainder of the report is as follows:

- Chapter II explores characteristics of home-based businesses.
- Chapter III discusses federal regulations, with special emphasis on the IRS. More extended discussions of other individual federal agencies are in Appendix B.
- Chapter IV discusses impacts of state and local taxes.
- Chapter V assesses state and local regulations (except zoning).
- Chapter VI addresses local zoning.
- Chapter VII presents examples of state rules that reduce burdens on home-based businesses.
- Chapter VIII summarizes the findings and draws conclusions.
- Chapter IX presents recommendations for reduction of regulatory burdens on home-based businesses.
- Reports of the individual case studies are contained in a separate addendum.

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<sup>12</sup> Bruce Phillips, "Home-based Firms, E-commerce, and High-technology Small Firms: Are They Related?" *Economic Development Quarterly*, 16, no. 1 (February 2002), pp. 39-48.

## II. CHARACTERISTICS OF HOME-BASED BUSINESSES

Detailed profiles of home-based businesses have been developed under the SBA Office of Advocacy's sponsorship, by Joanne Pratt.<sup>13</sup> In her latest study Pratt used data from the 1992 Characteristics of Business Owners (CBO) Survey.<sup>14</sup> The CBO Survey represents self-employed owners of businesses that filed Schedule C (proprietorship), Form 1065 (partnership), or Form 1120S (S Corporation) tax returns. Filers of Form 1120 (C Corporations) are not included.

Of the numerous characteristics of businesses examined by Pratt, five appear to be the most relevant for assessment of regulatory impacts on home-based businesses:

- Location of business in a home;
- Industry concentrations of home-based businesses;
- Type of business organization;
- The presence of employees; and
- Size of the business.

### A. HOME-BASED LOCATION

A home-based business is defined as a business that is conducted out of a residence with no other headquarters location. Overall, Pratt found that about two thirds (68 percent) of sole proprietorships, partnerships, and S corporations are home-based. Data on C corporations were available, but the percentage that is home-based presumably is quite small (although not zero).

### B. INDUSTRY CONCENTRATIONS OF HOME-BASED BUSINESSES

#### 1. New Firms at 2-Digit and 3-Digit SIC Detail

The data that Pratt compiled from the CBO Survey<sup>15</sup> can be used to show the industry distribution of home-based businesses in several ways. Pratt's industry detail is basically at the

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<sup>13</sup> Joanne H. Pratt, *Myths and Realities of Working at Home: Characteristics of Homebased Businesses and Telecommuters*. Report to the Office of Advocacy, United States Small Business Administration, 1993.

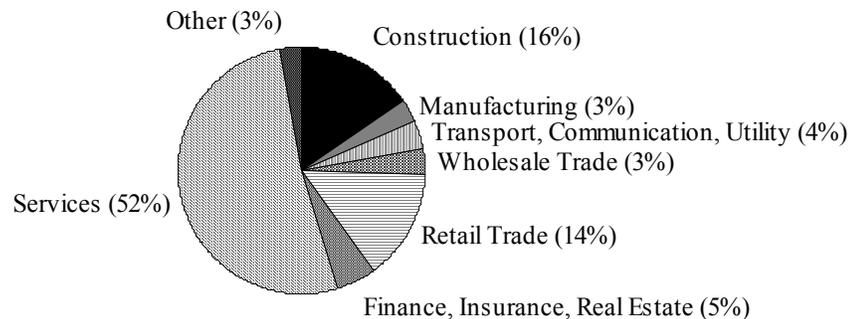
Joanne H. Pratt, "Homebased Businesses: the Hidden Economy," Report to the Office of Advocacy, United States Small Business Administration, August 1999.

<sup>14</sup> As the CBO Survey was not repeated in 1997, these are the latest detailed data on home-based businesses.

<sup>15</sup> Pratt, 1999, Table 4-2. The data in this table are not consistent, as the sum of the home-based businesses in the individual industries is nearly 50 percent higher than the total for "All SICs" in the table. The apparent source of this discrepancy is several individual figures. Based on the percentages in Pratt's table and/or the text (either

2-digit SIC level, although some 3-digit industries are reported and some industries are groups of 2-digit SIC codes. To obtain this level of detail, Pratt used data on new firms, which started business in 1992. The distribution of these home-based businesses is shown in Exhibit 1.

**EXHIBIT 1**  
**DISTRIBUTION OF HOME-BASED BUSINESSES, BY MAJOR SECTOR**



More detailed measures of the distribution of home-based businesses are shown in Exhibit 2.

- The numbers of new home-based businesses in each industry are shown in the first column of Exhibit 2.
- The percentages of all home-based businesses in each industry are shown in the second column of Exhibit 2.
  - ◆ A majority of home-based businesses (52 percent) are in Services,
  - ◆ Construction accounts for 16 percent of home-based businesses,
  - ◆ Retail Trade accounts for 14 percent of home-based businesses, and
  - ◆ No other sector has as much as 6 percent of home-based businesses.
- Home-based businesses as percentages of all proprietorships, partnerships, and S corporations in each industry (i.e., as percentages of all home-based and comparable non-home-based businesses) are shown in the third column of Exhibit 2. By sector, the percent of home-based businesses ranges from
  - ◆ 45 percent (Transportation, Communications, Utilities) to
  - ◆ 78 percent (Forestry, Fishing, and Hunting).
 In individual industries, the percent of home-based businesses ranges from
  - ◆ 1 percent (SIC 58, Eating, Drinking Places) to

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specific comments or failure to comment on enormous concentrations of home-based businesses), it appears that a decimal point was inadvertently moved one place to the right for home-based businesses in SIC 3X, SIC 641, and SIC 835. These three values were divided by 10 as an attempted correction.

- ◆ 92 percent (SIC 152, General Contractors, Residential).

**EXHIBIT 2**  
**INDUSTRY DISTRIBUTIONS OF HOME-BASED BUSINESSES**

<u>Industry Group</u>	<u>SIC Code</u>	<u>New Home-Based Proprietorships, Partnerships and S-Corporations<sup>a</sup></u>			
		<u>Number (1,000s)</u>	<u>Percent of H-B Total</u>	<u>Percent of P,P&amp;S</u>	<u>Percent of All Industry</u>
<u>Agricultural Services</u>					
Landscape Services	78	12	1.0%	63%	20%
Other Agricultural Services	07, ex 078	10	0.8%	37%	27%
Total Agricultural Services		22	1.8%	48%	23%
<u>Forestry, Fishing &amp; Hunting</u>					
	08, 09	7	0.6%	78%	161% <sup>b</sup>
<u>Mining, Oil &amp; Gas</u>					
	10, 12, 13 & 14	5	0.4%	56%	17%
<u>Construction</u>					
General Contractors, Residential	152	24	1.9%	92%	21%
General Contractors, Other	15, ex 152	14	1.1%	67%	26%
Carpentry	175	45	3.6%	66%	93%
Other Construction	16, 17, ex 175	111	8.9%	70%	31%
Total Construction		194	15.6%	71%	34%
<u>Manufacturing</u>					
Logging	241	6	0.5%	60%	46%
Other Manufacturing	2X, ex 241	11	0.9%	58%	6%
Other Manufacturing <sup>c</sup>	3X	16	1.3%	73%	9%
Total Manufacturing		33	2.6%	65%	9%
<u>Transportation, Communications, Utilities</u>					
Motor Freight Transportation	42	29	2.3%	44%	26%
Transportation Services	47	3	0.2%	17%	6%
Other Transportation, etc.	41, 44, 45, 46, 48, 49	17	1.4%	65%	16%
Total Transportation, etc.		49	3.9%	45%	19%
<u>Wholesale Trade</u>					
Wholesale Trade, Durable Goods	50	32	2.6%	84%	10%
Wholesale Trade, Non-Durable Goods	51	9	0.7%	53%	5%
Total Wholesale Trade		41	3.3%	75%	8%
<u>Retail Trade</u>					
Building Materials & Misc. Retail	52, 59	147	11.8%	79%	35%
General Merchandise, Apparel, Furniture	53, 56, 57	16	1.3%	55%	6%
Food Stores	54	10	0.8%	56%	6%
Automotive Dealers except Gasoline	55, ex 554	6	0.5%	35%	6%
Eating, Drinking Places	58	0	0.0%	1%	0%
Total Retail Trade		179	14.4%	63%	12%

<sup>a</sup> SOURCE: Joanne H. Pratt, "Homebased Business: The Hidden Economy," 1999, Table 4-2. These firms *started* business in 1992.

SOURCE for All Industry: "1992 Census of Business," except for SIC 07, SIC 08, and SIC 09, which are based on "County Business Patterns" data.

<sup>b</sup> More new businesses (in 1992) than total businesses with employees; indicates rapid growth of home-based businesses in industry.

<sup>c</sup> Number of home-based firms is given as 159 in the original. This apparent error (by a factor of 10) was corrected based on Pratt's percentages and the text.

**EXHIBIT 2 (continued)**  
**INDUSTRY DISTRIBUTIONS OF HOME-BASED BUSINESSES**

<u>Industry Group</u>	<u>SIC Code</u>	<u>New Home-Based Proprietorships, Partnerships and S-Corporations<sup>a</sup></u>			
		<u>Number (1,000s)</u>	<u>Percent of H-B Total</u>	<u>Percent of P,P&amp;S</u>	<u>Percent of All Industry</u>
<u>Finance, Insurance, Real Estate</u>					
Insurance Agents <sup>d</sup>	641	11	0.9%	52%	9%
Real Estate Operators	651	13	1.0%	76%	13%
Real Estate Agents	653	33	2.7%	43%	31%
Other Finance, Insurance, Real Estate	6X, ex 641, 651, 653	10	0.8%	67%	4%
Total Finance, Insurance, Real Estate		67	5.4%	52%	11%
<u>Services</u>					
Hotels, Rooming Houses	70	0	0.0%	29%	0%
Beauty Shops	723	17	1.4%	31%	21%
Other Personal Services	72, ex 723	107	8.6%	84%	94%
Services to Dwellings and Buildings	734	43	3.5%	59%	75%
Miscellaneous Business Services	738	37	3.0%	55%	49%
Other Business Services	73, ex 734 & 738	69	5.6%	85%	40%
Auto Repair	75	20	1.6%	43%	12%
Misc. Repair, Motion Pic., Amusement	76, 78, 79	59	4.7%	63%	32%
Doctor Offices	801	1	0.1%	11%	0%
Dentist Offices	802	0	0.0%	4%	0%
Other Health Services	80, ex 801 & 802	63	5.1%	75%	40%
Legal Services	81	10	0.8%	56%	7%
Child Day Care <sup>e</sup>	835	71	5.7%	86%	138% <sup>b</sup>
Other Education, Social Services, Museums	82, 83, 84, ex 835	24	1.9%	43%	21%
Management Services	874	85	6.8%	77%	118% <sup>b</sup>
Engineering, Accounting, Research, Mgmt.	87, ex 874	39	3.1%	63%	24%
Total Services		645	51.9%	67%	33%
ALL INDUSTRIES		1,242	100.0%	68%	22%

<sup>d</sup> Number of home-based firms is given as 111 in the original. This apparent error (by a factor of 10) was corrected based on Pratt's percentages and the text.

<sup>e</sup> Number of home-based firms is given as 708 in the original. This apparent error (by a factor of 10) was corrected based on the text.

- Home-based businesses as percent of all businesses – or an approximation<sup>16</sup> thereof – are shown in the fourth column of data in Exhibit 2. This comparison indicates that:
  - ◆ Overall, new home-based businesses (CBO data) make up just under a quarter (22 percent) of all establishments (Economic Census data),
  - ◆ In some sectors the percentage is far higher – especially
    - Services (35 percent), and
    - Construction (34 percent), and
  - ◆ At the industry level, there are more new home-based businesses (CBO data) than establishments (Economic Census data), in
    - Forestry, Fishing, Hunting, SIC 08 & SIC 09, (161 percent),
    - Child Day Care, SIC 835, at (138 percent), and
    - Management Services, SIC 874, (118 percent).

These high percentages of new businesses represent extremely rapid growth.

Exhibit 3 shows the industries with the highest concentrations of home-based businesses in terms of number (and percentage) of all home-based businesses. Home-based businesses are concentrated in relatively few industries.

- Over 60 percent of home-based businesses are in the service and construction sectors;
- Over 80 percent are in fifteen 2-digit SIC industries; and
- One quarter are in just six 3-digit SIC industries.

Further detail on the concentration of home-based businesses additional measures of concentration are provided in Appendix A.

## 2. All Firms

The previous discussion used Pratt’s data for new businesses. Data for all home-based businesses are available, but the source<sup>17</sup> does not have as much industry detail. Exhibit 3 shows the industry distribution of all home-based firms at the sector level of detail. A comparison with the more detailed data compiled by Pratt shows the same relative concentration among industries. The data for all home-based businesses show that:

- Services account for about half (48 Percent) of all home-based businesses;

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<sup>16</sup> The available data do not come from the same population. Pratt’s data on new businesses are from the 1992 Characteristics of Business Owners (CBO) Survey. “All businesses” are measured by 1992 Economic Census data on all establishments, which do not include the self-employed who have no employees. Such businesses, which make up an overwhelming majority of home-based businesses, dominate Pratt’s CBO data. Thus the actual number of businesses is somewhere between the Economic Census data and the Economic Census data plus Pratt’s CBO data (as the sum involves some double-counting). In principle, one might prefer the total number of enterprises for comparison. In practice, however, data on establishments are more readily available. Moreover, home-based businesses are so small that a comparison with establishments seems more appropriate.

<sup>17</sup> U. S. Department of Commerce, 1992 Economic Census, Characteristics of Business Owners, Table 24a.

- Three sectors each account for over 10 percent of all home-based businesses:
  - ◆ Retail Trade (15 percent),
  - ◆ Finance, Insurance, and Real Estate (12 percent), and
  - ◆ Construction (11 percent); and
  - ◆ No other sector has as many as 5 percent of all home-based businesses.

**EXHIBIT 3**  
**HIGHEST INDUSTRY CONCENTRATIONS OF HOME-BASED BUSINESSES**  
**BY NUMBER AND PERCENT OF ALL HOME-BASED BUSINESSES**

<u>SIC Code</u>	<u>Industry Group</u>	<u>Number of Home-Based Businesses (1,000s)</u>	<u>Percent of Total Home-Based Businesses</u>
<b>2-Digit SIC Industries</b>			
16, 17	Other Construction	156	12.5%
73	Building Services	149	12.1%
52, 59	Building Materials & Misc. Retail	147	11.8%
72	Personal Services	124	10.0%
87	Engineering, Accounting, Research, Management., etc.	124	9.9%
82, 83, 84	Education, Social Services, Museums	95	9.6%
80	Health Services	64	5.2%
65	Real Estate	46	3.7%
15	General Contractors, Other	38	3.0%
50	Wholesale Trade, Durable Goods	32	2.6%
42	Motor Freight Transportation	<u>29</u>	<u>2.3%</u>
	TOTAL	1004	80.8%
<b>3-Digit SIC Industries Included Above</b>			
874	Management Services	85	6.8%
835	Child Day Care	71	5.7%
175	Carpentry	45	3.6%
734	Services to Dwellings and Buildings	43	3.5%
738	Miscellaneous Business Services	37	3.0%
653	Real Estate Agents	33	2.7%

The difference between the industry distribution of *new* home-based businesses and that of *all* home-based businesses can be interpreted as an indicator of relative growth of home-based businesses, as there will be proportionately more new firms in rapidly growing sectors and proportionately fewer new firms in slowly growing or declining sectors. The data indicate that:

- Sectors with a relatively rapidly growing home-based business element include:
  - ◆ Construction and
  - ◆ Services.
  
- Sectors with a relatively slowly growing home-based business element include:
  - ◆ Finance, Insurance and Real Estate,
  - ◆ Agricultural Services, Forestry, Fishing, and Mining, and
  - ◆ Manufacturing.

**EXHIBIT 4  
DISTRIBUTION OF HOME-BASED BUSINESSES BY SECTOR**

<u>Sector</u>	<b>New Home-Based Businesses<sup>a</sup></b>		<b>Total Home- Based Businesses<sup>b</sup></b>		<b>New Businesses As a Percent of Total Businesses</b>
	<b>Number (1,000s)</b>	<b>Percent</b>	<b>Number (1,000s)</b>	<b>Percent</b>	
Agricultural Services, Forestry, Fishing & Mining	34	2.7%	583	3.6%	5.8%
Construction	194	15.6%	1,830	11.2%	10.6%
Manufacturing	33	2.7%	518	3.2%	6.4%
Transportation, Communications, and Utilities	49	3.9%	699	4.3%	7.0%
Wholesale Trade	41	3.3%	538	3.3%	7.6%
Retail Trade	179	14.4%	2,478	15.1%	7.2%
Finance, Insurance, and Real Estate	67	5.4%	1,941	11.9%	3.5%
Services	645	51.9%	7,784	47.5%	8.3%
<b>TOTAL</b>	1,242	100%	16,371	100%	7.6%

<sup>a</sup> Source: Exhibit 2.

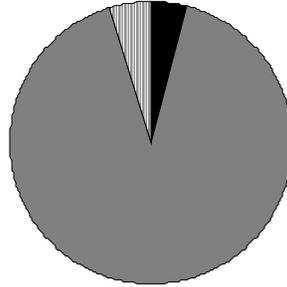
<sup>b</sup> Source: U. S. Department of Commerce, 1992 Economic Census, Characteristics of Business Owners, Table 24a. Home-based businesses in Industries Not Classified were excluded to make percentages more comparable with Pratt.

**C. TYPE OF ORGANIZATION**

Exhibit 5 and Exhibit 6 show the distribution of all proprietorships, partnerships, and subchapter S corporations, as well as home-based firms, by type of business organization. The vast majority of home-based businesses (91 percent) are individual proprietorships. Of the remainder, S corporations (5 percent), slightly outnumber partnerships (4 percent) among home-based businesses.

**EXHIBIT 5  
BUSINESS ORGANIZATION OF HOME-BASED BUSINESSES**

Subchapter S Corporation (5%)      Partnership (4%)



Individual Proprietorship (91%)

**EXHIBIT 6  
DISTRIBUTION OF HOME-BASED BUSINESSES  
BY TYPE OF BUSINESS ORGANIZATION**

<u>Form of Organization</u>	<u>All P, P &amp; S Businesses</u>			<u>Firms That Were Operated from a Private Residence</u>	
	<u>Total Number of P, P&amp;S (1,000s)</u>	<u>Percent</u>	<u>P, P &amp; S Reporting Home-Based Status (1,000s)</u>	<u>(1,000s)</u>	<u>Percent</u>
Individual Proprietorship	14,599	84.6%	13,446	7,207	91.1%
Partnership	1,090	6.3%	1,049	321	4.1%
Subchapter S Corporation	1,564	9.1%	1,514	379	4.8%
<b>TOTAL</b>	<b>17,253</b>	<b>100.0%</b>	<b>16,009</b>	<b>7,907</b>	<b>100.0%</b>

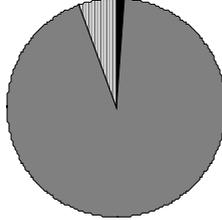
Source: U. S. Department of Commerce, 1992 Economic Census, Characteristics of Business Owners, Table 24d.

**D. EMPLOYEES**

Exhibit 7 and Exhibit 8 show employment of all proprietorships, partnerships, and S corporations, as well as home-based firms. The vast majority of home-based businesses (91 percent) reported no paid employees, and this fraction rises to 94 percent if firms that reported payroll expenditures but not actual employees are included.

**EXHIBIT 7  
EMPLOYMENT OF HOME-BASED BUSINESSES**

One to Four Employees (6%)    Five or More Employees (1%)



No Current Employees (93%)

**EXHIBIT 8  
DISTRIBUTION OF HOME-BASED BUSINESSES  
BY EMPLOYEES AND EMPLOYMENT SIZE**

<u>Form of Organization</u>	<u>All P, P &amp; S Businesses</u>			<u>Firms That Were Operated from a Private Residence</u>	
	<u>Total Number of P, P&amp;S (1,000s)</u>	<u>Percent</u>	<u>P, P &amp; S Reporting Home-Based Status (1,000s)</u>	<u>(1,000s)</u>	<u>Percent</u>
Firms With No Paid Employees	14,118	81.8%	12,946	7,198	90.6%
<u>Paid Employees</u>					
None at Time of Survey	436	2.5%	425	202	2.5%
1 to 4 Employees	1,716	9.9%	1,689	449	5.7%
5 to 9 Employees	504	2.9%	491	65	0.8%
10 to 19 Employees	256	1.5%	248	20	0.25%
20 to 49 Employees	145	0.8%	140	8	0.10%
50 to 99 Employees	45	0.3%	44	6	0.08%
100 or More Employees	33	0.2%	32	0	0.001%
Subtotal: Firms With Paid Employees	3,135	18.2%	3,068	750	9.4%
<b>TOTAL</b>	<b>17,253</b>	<b>100.0%</b>	<b>16,015</b>	<b>7,948</b>	<b>100.0%</b>

Source: U. S. Department of Commerce, 1992 Economic Census, Characteristics of Business Owners, Table 24c.

**E. SIZE**

Exhibit 8 shows employment size of home-based businesses. A majority (60 percent) of firms with paid employees had only 1 to 4 employees. Less than 2 percent of home-based businesses with employees – and less than 0.2 percent of all home-based businesses – have 20 or more employees. In regulatory analysis, firms with fewer than 20 employees usually comprise the smallest size class that is considered.

Exhibit 9 shows the gross receipts of home-based businesses. An overwhelming majority (96 percent) of home-based businesses had receipts of under \$50,000 in 1992, and over three quarters (77 percent) earned less than \$25,000. Only 3.5 percent had receipts of \$100,000 or more, and less than one percent had receipts of \$500,000 or more.

Home-based businesses operate part-time to a much greater degree than comparable non-home-based businesses reported on in the CBO. As shown in Exhibit 10, less than half of home-based businesses without employees, and no more than two thirds of those with employees, provide the primary source of income for their owners. Less than half of home-based businesses without employees, and less than a quarter of those with employees, operate year-round. Home-based business owners work, on average, 26 to 35 hours per week – 10 hours less than owners of similar non-home-based businesses.<sup>18</sup> This part-time characteristic may mean greater vulnerability to regulatory impacts because the base over which to spread costs is smaller.

<b>EXHIBIT 9 DISTRIBUTION OF HOME-BASED BUSINESSES BY ANNUAL RECEIPTS</b>					
<u>Form of Organization</u>	<u>All P, P &amp; S Businesses</u>			<u>Firms That Were Operated from a Private Residence</u>	
	<u>Total Number of P, P&amp;S (1,000s)</u>	<u>Percent</u>	<u>P, P &amp; S Reporting Home-Based Status (1,000s)</u>	<u>(1,000s)</u>	<u>Percent</u>
Less than \$5,000	5,227	30.3%	4,594	2,802	37.5%
\$5,000 to \$9,999	2,444	14.2%	2,244	1,263	16.9%
\$10,000 to \$24,999	3,076	17.8%	2,892	1,671	22.4%
\$25,000 to \$49,000	1,946	11.3%	1,841	987	13.2%
\$50,000 to \$99,999	1,616	9.4%	1,157	476	6.4%
\$100,000 to \$199,000	1,198	6.9%	292	89	1.2%
\$200,000 to \$249,999	302	1.7%	296	56	0.8%
\$250,000 to \$499,999	683	4.0%	361	58	0.8%
\$500,000 to \$999,999	372	2.2%	359	44	0.6%
\$1,000,000 or more	<u>390</u>	<u>2.3%</u>	<u>378</u>	<u>19</u>	<u>0.3%</u>
<b>TOTAL</b>	17,253	100%	14,414	7,465	100%

Source: U. S. Department of Commerce, 1992 Economic Census, Characteristics of Business Owners, Table 24b.

<sup>18</sup> Pratt, 1999, p. 51.

**EXHIBIT 10**  
**PRIMARY INCOME OF OWNERS AND**  
**WEEKS OF OPERATION OF HOME-BASED BUSINESSES**

	<b>Percent of Home-Based Businesses</b>	
	<b>No Paid Employees</b>	<b>With Paid Employees</b>
<b>Primary Source of Income<sup>a</sup></b>		
Contribution to Personal Income < \$25,000	48%	64%
Contribution to Personal Income > \$25,000	36%	67%
<b>Weeks of Operation per Year<sup>b</sup></b>		
Year-Round (Over 48 weeks per Year)	51%	78%
Over Half Time (24 to 47 Weeks per Year)	20%	12%
Less than Half Time (Less than 24 Weeks per Year)	29%	10%
<sup>a</sup> Pratt, 1999, p. 98.		
<sup>b</sup> Pratt, 1999, pp. 52-53.		

### **III. FEDERAL REGULATIONS**

#### **A. INTERNAL REVENUE SERVICE**

The Internal Revenue Service is an agency that affects all businesses. Its regulations, like Internal Revenue Code itself, are complex. The resulting burdens on home-based businesses are also multi-faceted and complex.

##### **1. Distinctive Characteristics of the Agency**

The IRS is virtually unique in the degree to which the underlying statutes are as complex as the regulations themselves. In many instances, regulations are no more than quotations of the statute. The complexity of the regulations, therefore, is largely the result of congressional actions, not the IRS's own decisions. Tax law is made more complex, however, by numerous tax court decisions, which make distinctions that are finer than the regulations themselves.

Tax law has developed piecemeal over many decades. There is a major "reform" every decade (or more often), and lesser tinkering are done every year. Aside from sheer complexity, this piecemeal development has two effects:

- Elements of tax law are not consistent with each other, necessitating more tax court decisions, and
- It is difficult to keep one's understanding of tax requirements current.

##### **2. Principal Filing Responsibilities of a Home-Based Business**

Exhibit 11 summarizes the IRS filing requirements typical of home-based businesses. Other filings may be called for, depending on the complexity of the business, the extent of tax avoidance, and special circumstances. The forms fall into three general categories:

- Income taxes;
- Employer taxes; and
- Expenses and depreciation.

There are parallel forms – and in some cases the same form – for businesses with different types of legal organization.

**EXHIBIT 11  
IRS FORMS RELATED TO HOME-BASED BUSINESSES**

<b>Type of Form</b>	<b>Form</b>	<b>Sole Proprietorship</b>	<b>Partnership</b>	<b>S Corporation</b>	<b>C Corporation</b>
Primary Income Tax Return	1040	Owner	Partner	Shareholder	
	1065		Business		
	1120S			Business	
	1120				Business
Mandatory Schedule	Sch. C	Owner			
	Sch. K-1		Business	Business	
	Sch. E		Partner	Shareholder	
Capital Gains	Sch. D	Owner	Business	Business	Business
Alternative Minimum Tax	6251	Owner	Partner	Shareholder	
	4626				Business
Withholding and Unemployment Tax	941	Employer	Employer	Employer	Employer
	940	Employer	Employer	Employer	Employer
	8190	Employer	Employer	Employer	Employer
	Sch. SE	Owner	Partner	Shareholder	
	W-2	Employer	Employer	Employer	Employer
	W-3	Employer	Employer	Employer	Employer
Information Forms for Other Payments	1099-D				Business
	1099-S	Any business selling or exchanging real estate			
	1099-M	Any business using contractors or making miscellaneous payments			
	1096	Any business filing any type of Form 1099			
Employee Benefit Plan	5500 & Schs.	Any business maintaining an employee benefit plan			
Credits	3800	Any business claiming more than one type of business credit			
	3468	Any business claiming an investment credit			
	4255	Any business selling investment credit property			
Business Property (Depreciation)	4562	Any business depreciating or amortizing business property			
	4797	Any business selling or exchanging business property			
	8829	Expenses for business use of the home			
Other Expense	2106	Employee business expenses			

**3. Measurable Burdens Associated with Paying Taxes**

a. Current Time Burden Estimates

Exhibit 12 shows the current IRS time estimates for different aspects of filing forms that would typically be filed by a sole proprietorship. Estimates are shown with and without employees.

**EXHIBIT 12**  
**TIME BURDEN ESTIMATES FOR A SOLE PROPRIETORSHIP**  
**WITHOUT AND WITH EMPLOYEES**

<b>Type of Tax</b>	<b>Form or Schedule</b>	<b>Learning About the Law and/or the Form</b>	<b>Recordkeeping</b>	<b>Preparing and Filing the Form</b>	<b>Total Annual Time</b>
<b>Income Tax</b>	1040	3 hr 45 min	2 hr 26 min	6 hr 39 min	13 hr 10 min
	Sch. C	1 hr 41 min	6 hr 4 min	2 hr 50 min	10 hr 35 min
<b>Capital Gains</b>	Sch.D	2 hr 54 min	1 hr 29 min	3 hr 12 min	7 hr 35 min
<b>A M T</b>	6251	1 hr 11 min	19 min	2 hr 12 min	3 hr 42 min
<b>Self-Emp. Tax</b>	Sch. SE	14 min	13 min	26 min	53 min
<b>Depreciation</b>	4562	5 hr 57 min	38 hr 14 min	6 hr 50 min	51 hr 1 min
	8829	7 min	52 min	1 hr 35 min	2 hr 34 min
<b>SUBTOTAL</b>		15 hr 49 min	49 hr 57 min	23 hr 44 min	89 hr 30 min
<b>Withholding</b>	8190 <sup>a</sup>	-	-	2 min	24 min
	941 <sup>b</sup>	40 min	12 hr 24 min	2 hr 5 min	15 hr 9 min
	W-2 <sup>c</sup>	-	-	30 min	30 min
	W-3 <sup>c</sup>	-	-	29 min	29 min
<b>Unemployment Information</b>	940	1 hr 17 min	13 hr 45 min	1 hr 48 min	16 hr 51 min
	1099-M <sup>c</sup>	-	-	16 min	16 min
<b>SUBTOTAL</b>		1 hr 57 min	26 hr 9 min	5 hr 10 min	33 hr 39 min
<b>TOTAL</b>		17 hr 46 min	76 hr 8 min	28 hr 54 min	123 hr 9 min

<sup>a</sup> Filed monthly.

<sup>b</sup> Filed quarterly.

<sup>c</sup> Based on one employee and one consultant.

SOURCE: Paperwork Reduction Act Notice, in the instructions for each individual form.

**b. Factors Affecting Burdens**

Current time estimates have numerous drawbacks. They are based on individual forms and schedules, so that they omit any other type of activity and they ignore interactions among forms (which may increase or decrease the time required). They are also averages, which makes them essentially irrelevant for home-based businesses in several respects.

**Business Size.** Home-based businesses are at the small end of the size range. The effort required for a small business is clearly much less than that for a large business.

On the other hand, recordkeeping and forms are activities that are subject to large economies of scale. The current time estimates do not even address the issue of how burden varies with size.

**Experience and Business Age.** Federal tax forms have an enormous learning curve. Filing an annual return for several years, or a quarterly return for a year, makes the process much easier and less time consuming – unless the rules have changed. For simpler or more frequently filed forms, it usually suffices to get out the previous form and mimic it using new numbers.

The experience factor has an important implication for the questions asked in this study. Burdens of federal tax recordkeeping and filing fall disproportionately on start-up businesses. By the time a business is ready to outgrow a home base, it has probably mastered the process. After start-up, hiring the first employee is the only event that adds significantly to the burden.

**Records.** The quality and design of business records is a very important factor in the paperwork burden of taxes. In addition to being accurate and complete, the records need to generate the numbers required by tax forms. Accounts should be designed with reference to – working backwards from – the line items of the tax forms. Accomplishing this by successive refinements of the record system can be a substantial part of the tax paperwork learning curve.

The quality of records raises an important question about impacts: How much of the recordkeeping is in the baseline, and how much is due to IRS requirements? A business must keep some records for basic management purposes and to obtain credit from any but personal sources. Only the recordkeeping above and beyond this level is burden attributable to the IRS.

As an accountant in the home-based business community pointed out, some people do not have the record keeping skills needed to manage a business properly. Learning such basic skills is not a burden of paying taxes. Most of the information required for IRS filings can be retrieved from a well-organized check book.<sup>19</sup> The IRS burden is organizing the information in the right form, not keeping such basic records as a checkbook in the first place.

**Computers.** Using computers can greatly reduce burdens involved in recordkeeping – even apart from electronic filing or payroll. Several factors are important:

- Computers make computations rapidly and accurately. Check books are a central example, but spreadsheets can also be a great help in keeping payroll or other more customized records – even if checks are written manually.

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<sup>19</sup> The check for withholding payments is an exception. It includes both withholding and FUTA payments.

- Computers retrieve and aggregate data. If receipts and payments are appropriately annotated by account, a computer will assemble the information for a tax filing.
- Information necessary for taxes is available on line. The web is usually (if not always) the fastest way to search for and retrieve information. The IRS also has business assistance tools and information available on CD-ROM.

#### c. Burdens on Home-Based Businesses

Exhibit 12 estimates that a sole proprietor without employees will spend about 89.5 hours on the income tax return. Of this:

- Learning about the law and the form accounts for 18 percent of the time;
- Recordkeeping accounts for 56 percent of the time; and
- Preparing and filing the form accounts for 26 percent of the time.

Recordkeeping is dominated by depreciation, for which recordkeeping accounts for 75 percent of the time. Indeed, recordkeeping for depreciation is 43 percent of the entire time required for the sole proprietor. Since Form 4562 is used by firms of all sizes, the estimated burden created by this item is certainly high and is a source of significant upward bias of the entire estimate.

Estimated time for learning about the law for depreciation is just over six hours for Form 4562 and Form 8829 combined. Yet IRS Publication 946 and IRS Publication 587, which cover these two forms, have a combined total of over 130 pages. Estimates in Exhibit 12, of course, are based only on the instructions for the forms. Because other background work is omitted, the IRS estimates for familiarization are far too low for a new small business, even if they may be adequate for a refresher review by an experienced businessperson. Learning how to keep records is another background activity that the IRS estimates largely overlook.

The estimates in Exhibit 12 for employer filings are nearly 34 hours. The estimates for recordkeeping and filing of Form 941 and Form 940 are certainly biased upward by large firms. Home-based businesses with very few employees will not take nearly that much time. The familiarization estimates seem low, especially for a business that is just taking on employees.

#### d. Current Re-estimation

The IRS is currently revising estimates of tax burden, using a survey-based approach that estimates the total tax burden for different types of individual business filers<sup>20</sup> and individual

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<sup>20</sup> Internal Revenue Service, *Individual Taxpayer Burden Model -- Project Documentation*, January 31, 2003.

non-business filers. The results are highly preliminary, but a gross estimate is that individual business filers as a whole spent about 60 hours per year on filing federal taxes, which was about five times the time spent by individual non-business filers.

These estimates do not differ greatly from the Exhibit 12 estimates of total non-employer time. If one adjusts recordkeeping for depreciation downward by about 30 hours, the estimates are quite close. As a rough estimate, a home-based business will add about one hour per week to a household's federal tax return effort. This average is subject to factors discussed above.

Preliminary direct cost estimates (expenditures incurred) are a little more detailed. They indicate:

- Sole proprietorships spent:
  - ◆ Under \$300 if they only filed Schedule C,
  - ◆ About \$500 if they used accounting services or filed Schedule E, and
  - ◆ Just over \$1,000 if they had employees.
  
- Partnerships and S corporations spent:
  - ◆ About \$900 if they only filed Schedule E,
  - ◆ \$1,200 to \$1,300 if they also filed Schedule E (rental income), also filed Schedule C, or did entity return preparation, and
  - ◆ \$3,100 to \$3,500 if they did entity returns preparation and used accounting services.

*In very round numbers \$500 would serve as an estimate of a home-based business's direct costs.*

#### **4. Information and Assistance**

**On-Line Information.** The IRS web site provides a considerable amount of useful information. It is also a source from which all IRS forms and publications can be downloaded. Questions are also answered, both in FAQ format and individually.

Information on the web site includes basic general information on business start-ups (both checklists and longer discussions) including some of the tax implications. Many specific topics are discussed, and searches can readily locate information and publications. Detailed information provided though downloadable publications that are fundamentally in hard copy.

**Publications.** The IRS has numerous publications to provide direction and assistance. Each form has its own set of instructions. If anything, there is almost too much information.

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These filers included sole proprietorships, S corporations, and partnerships with Form 1040 tax preparation services, financial advice, and various combinations of using accounting services, filing Schedule E for rental income, entity return preparation, and filing employer forms.

Individual discussions are often quite lucid. Definitions are clear and very often supplemented by examples and tables, or by parts of tax forms (in the publications) and worksheets (in the form instructions). Many of the longer publications and instructions have indices. Yet they manage to leave a reader feeling unsure about whether he knows enough. Several features contribute to this sense of confusion:

- The publications refer to provisions by tax code section number, without first explaining what the provision is.
- The publications refer to publications and worksheets by name, or refer to numbers as those “reported on Form” wxyz. This forces the reader to review earlier parts of the publication to find out what it is talking about.
- The publications emphasize clarity of definition either by giving examples that completely fit a definition, or by dividing cases into neat categories. This leaves a reader uninformed about situations that do not fit within the box.<sup>21</sup>
- The Publications omit some critical information that could be quite useful to a new home-based business. For example:
  - ◆ The discussion of keeping records says nothing about setting up accounts to match the IRS line items. Instead, in an example of a check disbursements journal, “frequent expenses have their own headings across the sheet.”<sup>22</sup>
  - ◆ Form 1099-MISC, which home-based businesses are likely to need or receive, is not discussed in the basic publications for a business without employees.

The Publications are not helpful in narrowing the search for information. Collectively, these publications attempt to cover almost all of an extremely complex tax law. This is a bit confusing for someone with only limited information needs. Most publications have numerous references to other often semi-duplicative publications.<sup>23</sup>

The publications are voluminous. A sampling of publications whose information one might expect to need – if no employees are involved -- is over 300 pages long.<sup>24</sup> Basic

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<sup>21</sup> For example:

You are an employee who works at home for the convenience of your employer. You meet all the requirements to deduct expenses for the business use of your home. Your employer does not reimburse you for any of your business expenses and you are not otherwise required to file Form 2106 or Form 2106-EZ.

In discussing the deductibility of home operating expenses, all expenses are divided into three categories:

- Expenses only for the business part of the home,
- Expenses for keeping up and running the entire house, and
- Expenses only for the parts of the home *not* used by business.
  - Internal Revenue Service, Publication 587, *Business Use of Your Home*, pp. 8, 18.

<sup>22</sup> Internal Revenue Service, Publication 583, *Starting a Business and Keeping Records*, Rev. May 2002, pp. 17-21.

<sup>23</sup> Often these references are bunched at the beginning of a publication, where they are almost meaningless to the reader, rather than integrated into the topic to which they are relevant.

<sup>24</sup> For example:

publications on employees add almost another 200 pages.<sup>25</sup> All of this material is three columns to a page. Information is fragmented, so that it is not always easy to find what is useful.

The qualities of the IRS publications can be illustrated by Publication 334, *Tax Guide for Small Businesses*, which is the basic overview of taxes for a business. This guide is well written. It is written for a sole proprietor. It is well organized, with headings that make it easy to scan. Terms are clearly defined and explained. It contains a table of forms that need to be filed to cover various liabilities. It has an extensive index. It includes two full-length examples of filing. But:

- It is 62 pages long;
- It makes about 90 references to 38 other IRS publications (*not* including references to forms or their instructions);
- It contains a good deal of information that a home-based business (or other relatively new small business) is not likely to need, such as:
  - ◆ The accrual method of accounting, the combined method of accounting, and changing accounting methods, as well as the cash method of accounting,
  - ◆ A two-page discussion of 20 business credits (virtually all unrelated to home-based businesses) and
  - ◆ A discussion of the *Report of Cash Payments Over \$10,000 Received in a Trade or Business*,
- It does not:
  - ◆ Attempt to explain what section 179 is or how it works (although it mentions section 179 repeatedly), or
  - ◆ Give an adequate discussion of the home office deduction or warn readers of tax repercussions of qualifying for a home office and then ceasing to qualify.

Form instructions are a bit better at providing the “decision tree” information that one basically needs to know. They have to be read thoroughly, however, and are often a tough, extensive read. This contributes a good deal to the burden of learning the requirements.

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- Publication 334, *Tax Guide for Small Business*, is 62 pages long;
  - Publication 533, *Self-Employment Tax*, is 20 pages long;
  - Publication 353, *Business Expenses*, is 52 pages long;
  - Publication 551, *Basis of Assets*, is 12 pages long;
  - Publication 583, *Starting a Business and Keeping Records*, is 27 pages long;
  - Publication 587 *Business Use of Your Home*, is 27 pages long.
  - Publication 946, *How to Depreciate Property*, is 107 pages long.

<sup>25</sup> For example:

- Publication 15, 15A, and 15B, *Employer’s Tax Guide*, total 148 pages; and
- Publication 505, *Tax Withholding and Estimated Tax*, is 49 pages long.

Tax forms sometimes deal with complexities in the tax law by reducing the computations to a series of rote steps, typically ending in taking the greater or lesser of two values. While this approach is meant to help the taxpayer get the numbers right, it does not always work that way. Moreover, this approach completely obscures the substance of the provision, thereby eliminating understanding of what is going on and ability to check the result.

Publications and instructions reflect the tax code. Fragmenting different topics into different publications mirrors the piecemeal nature of tax legislation. Complexities and peculiarities in the concepts being explained directly reflect the tax code. Inclusion of many provisions that do not apply to a specific, simple case reflects special provisions in the tax code.

The effect of the written assistance provided by the IRS is to give a lot of information but not much direction or sense of what completion is. Confusion and uncertainty can ensue.

## 5. Deductions

In general, as argued above, there is a distinction between direct regulatory impacts and recordkeeping or paperwork. In the case of the Internal Revenue Service, however, recordkeeping and direct impacts can overlap. The reason is that one can often avoid recordkeeping burdens by forgoing a deduction or other tax saving.<sup>26</sup> Uncertainties can lead home-based businesses to decline some deductions as a means of avoiding risk.<sup>27</sup> Thus individual provisions need to be examined as a whole. Issues that arise for home-based businesses include the following:

- The “Exclusive Use” test for deductibility of a home office;
- Deductibility of tangible personal property;
- Deductibility of health insurance.

### a. Home Offices

**Qualifying the Space for Deduction.** The Internal Revenue Code does not allow any deduction “with respect to the use of a dwelling unit which is used by the taxpayer” unless a taxpayer meets specific tests, such as exclusive, regular use of the home as the principal place of

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<sup>26</sup> Internal Revenue Service, *Individual Taxpayer Burden Model* notes:

Taxpayers can affect the allocation of burden among tax liability and... burden categories through their behavior... For example, taxpayers can spend more time and money... on tax planning in order to reduce the amount of tax they owe... Taxpayers may choose to ignore [a new tax] credit, resulting in no change to either tax liability or excess burden. Alternatively, ... [taxpayers] may claim the credit, thus reducing their tax liability but increasing their compliance burden. (pp. 2-3)

<sup>27</sup> Several members of the home-based business community reported that some accountants advise against taking the home-office deduction because it increases the chances of being audited.

business.<sup>28</sup> If a portion of the home qualifies for the deduction, the owner must compute the business percentage of the home.<sup>29</sup> This percentage is then applied to all costs associated with the home itself. Since a home-based business is a business run by a resident of the household, a home-based business readily passes most of these tests.<sup>30</sup>

The “Exclusive Use” test is the problem. To qualify for a home business deduction, the portion of the home must be used **only** for the trade or business. Only day-care facilities and areas used for storage of inventory or product samples are exempt. This test is nearly impossible for many – or most – home based businesses to meet. It denies any kind of deductibility of dual-use space, thereby partially eliminating one of the principal cost and convenience advantages of a home-based business. Moreover, any family member entering the space for any personal reason technically would disqualify the space for a deduction.<sup>31</sup>

The requirement of exclusive use is more stringent than any tax code provision that applies to other businesses. Under this standard, regular commercial office space should not be deductible if staff brings their children to work. Yet the owner of a rented recreational home

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<sup>28</sup> 26 USC Sec. 280A(c)(1) states:

- A portion of the dwelling unit which is exclusively used on a regular basis –
- (A) as the principal place of business for any trade or business of the taxpayer,
- (B) as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business, or
- (C) in the case of a separate structure which is not attached to the dwelling unit, in connection with the taxpayer’s trade or business.

In the case of an employee, the preceding sentence shall apply only if the exclusive use referred to in the preceding sentence is for the convenience of his employer.

For purposes of subparagraph (A), the term “principal place of business” includes a place of business which is used by the taxpayer for the administrative or management activities of any trade or business of the taxpayer if there is no other fixed location of such trade or business where the taxpayer conducts substantial administrative management activities of such trade or business.

The last sentence was added in a 1997 amendment to clarify the circumstances in which a home office could be deducted even if the business owner spent the majority of his working time elsewhere.

<sup>29</sup> This is most precisely done by taking the area (square feet) of the part of the home qualifying as a percentage of the total area of the home. Using the percentage of rooms is acceptable if the rooms are of similar size.

<sup>30</sup> For example:

- The homeowner, by definition, is not taking the deduction as an employee of another business.
- Virtually by definition, the home will be the owner’s principle place of business, because the home office is the place where administrative and management activities are done.
- Similarly, virtually by definition of home-based business the home is used for trade or business.
- The Regular Use test requires continuity of use of the home, rather than occasional or incidental use. Since the home is the only place of administration and management, any business that did not discontinue operations most of the time would pass this test.

<sup>31</sup> For example, disqualification could result from:

- A mother bringing a sleeping infant into the area to keep an eye on it while working;
- A less than obedient teenager deciding to use the business computer to go on line;
- Incoming personal calls on the business telephone line located in the office;
- Occasional personal use of specialized equipment such as an office copier or fax machine; or
- Completing a personal income tax on the sole proprietorship’s computer.

may use the property for personal use 14 days per year without disqualification of its deductibility.

**The Depreciation Deduction.** The portion of the home that qualifies for deduction must be depreciated as a 39-year nonresidential real property. That period is one third longer than the longest available home mortgage. The resulting annual amount deduction is small.<sup>32</sup>

If a home office becomes disused (or only partially used), of course, the deduction for depreciation stops. When a house is sold, the accumulated depreciation is effectively treated as capital gains. If the home office has qualified and been deducted for more than three of the five years prior to sale, the appreciation on the entire home-office percentage of the basis is treated as capital gains and taxed as such.<sup>33</sup>

The real benefit to a home-based business is not the deduction of depreciation on the office. If there is a qualifying home office, the owner can also deduct as a business expense a proportional share of all utilities (except telephone) and certain maintenance and repair expenses. If a home office is disallowed, these deductions are not available either.

**Tax Law Rigidity.** Tax law defines a home office as a real estate asset that is entirely and permanently converted to commercial use. This is an application of a legal requirement to an inappropriate situation. It is an attitude lacking in either regulatory flexibility or practicality.

The 39-year depreciation period is entirely unrealistic. Virtually no home office will qualify for long enough to be fully depreciated. Most people with home-based businesses do not live in one place that long or would not qualify every year. As a practical matter, treating a home office as a permanent commercial facility (until such use is discontinued) is not realistic. Home-based business owners are not *ipso facto* in the commercial real estate business.

The owned-home-office depreciation requirement is a doubly disproportionate burden. Most businesses rent their quarters, the commercial landlord depreciates the property, and the depreciation runs with the building. Home-based businesses whose owners rent their dwelling pay rent on the office. Only home-based business owners who are home owners are forced to depreciate their property themselves.

#### b. Deductibility of Tangible Personal Property

**Listed Property.** “Certain types of property,” which in this case includes computers, audio/visual equipment, etc., can be partially deducted, provided that at least 50 percent of use is qualified business use. The deduction is proportional to the business use. This category probably covers most or all of the equipment that the typical home office might deduct.

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<sup>32</sup> Publication 587 has an example, in which the basis is \$9,200, and the annual depreciation deduction is \$226.

<sup>33</sup> Since tax law treats a home office as a not being “lived in,” the deducted depreciation -- or the appreciation on the home-office percentage of the basis -- is exempted from the \$250,000 personal residence capital gains exclusion.

**Section 179.** Section 179 of the tax code allows the option of expensing tangible personal property<sup>34</sup> that has been acquired by purchase for business use (or at least 50 percent business use).<sup>35</sup> This is a major simplification for any micro-business, as depreciation (under IRS rules) is one of the most complicated and unfamiliar financial aspects of a business.

Expensing under section 179 – like all deductions – is limited to the taxable income from the active conduct of a trade or business during the year. Section 179 property that has been elected to be expensed but cannot be expensed because of the business income year may be carried over to the following year.

**Documentation of the Business Share.** The provision for deducting the business-use share of listed property is simple and clear in concept. In practice, it requires detailed recordkeeping to document the fraction of use. As a practical matter, only equipment with meters (e.g., automobiles and copiers) is amenable to such documentation. Otherwise, every user of the property must log on and off to keep track of total use. Enforcement of such logging of use in a household with children is virtually impossible.<sup>36</sup> This is a regulatory blind spot, which is represented by the examples in Publication 587 of calculating the deductible fraction of costs: These examples involve exclusive use of a computer by a single person.

**A Conundrum.** The piecemeal nature of the tax law has been noted above. Tangible personal property in a home-based business highlights the inconsistencies that result from not looking at the whole picture. Tax law simultaneously stipulates the following:

- Tangible personal property may be (at least partially) deductible if its use is as little as 50.01 percent business use, but
- The home-office is disqualified if there is any non-business use.

Yet IRS publications do not explain where the partially deductible furnishings and equipment are supposed to be used.

**Property Bought for Business Use and Personal Property Converted to Business Use.** Unlike listed property, other personal property is depreciated on an exclusive use basis.

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<sup>34</sup> There is a ceiling on the amount that can be expensed, which has been \$25,000 but has recently been raised to \$100,000 (if the business and purchases otherwise qualify). This ceiling would allow expensing all of the depreciable property put in service by virtually any home-based business during any one year.

<sup>35</sup> As with a qualifying home office, there is a recapture provision. If the property is disposed of (or if business use falls below 50 percent), the remaining value, after the depreciation that would otherwise have been allowed is subtracted, must be treated as ordinary income. This recapture provision has a far lower potential for impact than the treatment of a home office. Two factors mitigate the impact of recapture of tangible property:

- Useful lives of tangible property are relatively short. The shorter the useful life is, the more probable it is that the property will have been fully (or mostly) depreciated when it is disposed of.
- Tangible property (at least most tangible property that a home-based business would use) is generally moveable. Thus a business that moved out of a residence could take the tangible property along, continue to use it, and avoid recapture.

<sup>36</sup> “Listed property includes...any property of a type generally used for entertainment, recreation, and amusement.”

Computers (which are otherwise listed property) may be treated as property bought for, or converted to, business use if they are exclusively used for business. The depreciation rules for this property raise the same issues as the exclusive use test for an office. Even the concept of *converting* personal property entirely to business use is something of a fanciful notion in the environment of many home-based businesses.

### c. Deductibility of Health Insurance

The Internal Revenue Code contains special rules for health insurance costs of self-employed individuals. These rules have put sole proprietorships (and thus home-based business owners) at a tax disadvantage, compared with other businesses, in two respects:

- A smaller percentage was deductible, and
- The deduction was allowed for the individual, but not for the sole proprietorship.

**Deductible Percentage.** A C corporation may fully deduct health insurance costs as an employee benefit. In the mid 1990s, however, self-employed individuals<sup>37</sup> were allowed to deduct only 40 percent of such costs; 60 percent had to be treated as taxable income.

By statute, the percentage of health insurance costs that self-employed individuals may deduct has been increasing. Amendments in 1998<sup>38</sup> made health insurance costs fully deductible in 2003. Thus this statutory burden on home-based businesses has been lifted.

**Deduction Not Allowed for Self-Employment Tax Purposes.** The Internal Revenue Code states:

The deduction allowable by reason of this subsection shall not be taken into account in determining an individual's earnings from self-employment (within the meaning of section 1402(a)) for purposes of chapter 2.<sup>39</sup>

Self-employment tax must be paid on costs of health insurance and qualified long-term care insurance (which are deductible in other contexts). This provision reduces the value of the

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<sup>37</sup> For purposes of these provisions, "self-employed" means:

- A self-employed individual with a net profit reported on Schedule C, C-EZ, or F;
- A partner with net earnings from self-employment reported on line 15a of Schedule K-1 (Form 1065); or
- A shareholder owning more than 2% of the outstanding stock of an S corporation with wages from the corporation reported on Form W-2.

<sup>38</sup> Public Law 105-277.

<sup>39</sup> 26 USC Sec. 280A(l)(2)(B)(4).

insurance deduction by 15.3 percent.<sup>40</sup> Legislation<sup>41</sup> has been introduced to allow self-employed business owners to deduct their health insurance costs prior to calculating their payroll taxes.

## 6. Classification as an Independent Contractor

Home-based businesses are, by definition, independent businesses. The Internal Revenue Service, however, does its own defining of an independent business and an employer-employee relationship.

### a. Statutory Definition of an Employee

The Internal Revenue Code has three independent tests for determining who is an employee and who is not an employee.

- **Corporate Officers.** Corporate officers who perform services for the corporation and receive or are entitled to remuneration are defined as employees by statute.
- **Common Law Employees.** The statute defines “common law” employees,<sup>42</sup> but the common law concept of an employee is anything but clear cut.<sup>43</sup> The IRS tends to view an individual as an employee unless it is demonstrated that he is self-employed.
- **Statutory Employees.** Statutory employees include occupational groups that are specified by statute.<sup>44</sup> The term is limited to these groups.<sup>45</sup> These occupational

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<sup>40</sup> Nominally the self-employment tax reduces income by 7.65 percent. The business, however, also had to pay a share of 7.65 percent of pre-self-employment tax income, which is not deductible.

<sup>41</sup> The Self-Employed Health Care Affordability Act of 2003 (H.R. 1873).

<sup>42</sup> 26 USC 31.3121(d)-1(c) states that an employer-employee relationship:

Exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished... It is not necessary that the employer actually control the manner in which the services are performed; it is sufficient if he has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer, but not necessarily present in every case, are the furnishing of tools and the furnishing of a place to work, to the individual who performs the services...

Whether the relationship of employer and employee exists under the usual common law rules will in doubtful cases be determined upon an examination of the particular facts of the case.

<sup>43</sup> Some of the obvious questions are:

- What does it mean to have “the right to control and direct,” particularly if “it is not necessary that the employer actually direct of control the manner in which the services are performed?”
- Where is the dividing line between “the result to be accomplished “ and “the details and means by which that result is accomplished?”
- How much weight should be given to “other factors characteristic of an employer, [that are] not necessarily present in every case?”

<sup>44</sup> These occupational groups include:

groups have slightly different variants on what constitutes an employee, which also differ from the characteristics of common law employees.<sup>46</sup> These variants may well also come into play if interpretation is inevitably in “an examination of the particular facts of the case.”

## b. IRS Instructions

*The Employer’s Supplemental Income Tax Guide* (Publication 15-A) elaborates on the statutory discussion, particularly with respect to common law employees and indications of control and independence.<sup>47</sup> Publication 15-A provides a dozen examples in several different

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- Agent-drivers or commission-drivers who deliver food (except milk), laundry, or dry-cleaning to customers designated by their principals (regardless of who owns the vehicle), and whose compensation is a commission on sales;
  - Full-time life insurance salesmen whose entire or principal business is the solicitation of life insurance and/or annuity contracts primarily for one life insurance company and who ordinarily uses clerical services, office space and facilities, and materials provided without charge by the principal;
  - Home workers, who perform services off the premises of the person for whom the services are performed, according to specifications furnished by that person, and upon materials or goods furnished by that person, which are then required to be returned to him; and
  - Traveling salesmen whose entire or principal business activity is soliciting orders on behalf of, and transmitting the orders to, a single principal, who operate off the premises of the principal, who generally are paid by commission, and who generally are not controlled as to the details of the services or the means by which they cover their territories.

<sup>45</sup> There are also two categories of statutory non-employees: direct sellers and licensed real estate agents.

<sup>46</sup> These variants include the following:

- In most cases, statutory employees do not work on the employer’s premises.
- Statutory employees may use facilities and support services provided by the employer.
- Statutory employees are defined by working principally for one principal, but they may have a side-line or even work for other companies, for which they are not considered employees by this particular definition.
- Statutory employees may work with or on materials or goods provided by the employer, and if a product is involved may have to turn it over to the employer.
- Statutory employees are, in some cases, independent of the employer’s control of the details of their services.

<sup>47</sup> Three general categories and several subcategories are discussed:

- **Behavior control** concerns whether the business has a right to direct and control how the worker does the task. Specific factors indicating that the worker is an employee include the following:
  - ◆ Instructions the business gives the worker, such as:
  - ◆ Training the business gives the worker, particularly on how to perform services.
- **Financial control** concerns whether the business has a right to control business aspects of the worker’s job. Specific factors that tend to indicate that the worker is an independent contractor include the following:
  - ◆ The extent to which the worker has un-reimbursed business expenses,
  - ◆ The extent of the worker’s investment,
  - ◆ The extent to which the worker makes services available to the relevant market and not just to the one business, and

industries to illustrate the differences between an employee and an independent contractor.<sup>48</sup> In these examples, however, all (or almost all) of the factors consistently indicate either that the worker is an employee or that the worker is an independent contractor. There is no indication of the relative weights accorded to each factor or how a worker would be classified if the factors are *not* consistent.

### c. Impacts of Requirements on Home-Based Businesses

The definition of “employee” can complicate the affairs of a home-based business in several ways:

- The owner of a home-based business may need to establish that he is self-employed, rather than an employee of another business.
- The owner of a home-based business may have to establish the status of people who work for/with the business.
- Self-employment status is somewhat related to other aspects of tax filings.
- Classifying workers as employees (so as to meet IRS requirements) may conflict with local ordinances.

**Establishing Self-Employment.** There are many ways a sole proprietor can overstep the boundary between self-employment and employment<sup>49</sup> just as a matter of providing good service to a client.<sup>50</sup> Home-based businesses – especially sole proprietorships<sup>51</sup> -- are very small.

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- **Type of relationship** factors include the following:
    - ◆ How the business pays the worker, since independent contractors tend (except in certain professions) to be paid by a flat fee, rather than a regular wage amount or commission.
    - ◆ Written contracts describing the relationship the parties intended to create, which tend to indicate that the worker is an independent contractor,
    - ◆ Whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay,
    - ◆ The permanency of the relationship, as client-contractor relationships are usually for a specific project or period of time, and
    - ◆ The extent to which services performed by the worker are a key aspect of the regular business of the company.

<sup>48</sup> Internal Revenue Service, *The Employer’s Supplemental Income Tax Guide*, Publication 15-A (Revised January 2003), pp. 5-7.

<sup>49</sup> This is especially likely to be true of a consultant in a technical field, who is working as part of a team on a large-scale project. It is less likely to be true in industries, such as construction, where contracting out specialty work (e.g., plumbing or electrical work) to a licensed subcontractor is common practice.

<sup>50</sup> It can be inherently difficult to distinguish between coordination and “control and direction.” For example:

- An independent consultant may spend a good deal of time working on a client’s premises.
- While there, he may make use of the client’s facilities, equipment, support staff and materials.
- Adequate coordination may require participating in meetings and other interaction with a client’s staff.
- Doing so may require specifying hours and complying with procedures (e.g., security).

Consequently, working on a large project for a single client can easily take up enough time to constitute a principal business activity for a whole tax year. For a home-based business owner who has recently retired from -- or been downsized by -- a larger firm, that company may well be the principal source of business while the home-based business gets on its feet and markets other clients. Circumstances that lead a home-based business to serve principally one client for a protracted period of time can create an appearance of being an employee of that client.

Legally, it is the employer who is responsible for withholding and paying employment taxes for an employee. Thus it is the client who is at risk if the relationship is determined to be an employer-employee relationship instead of a client-contractor relationship. Although tax law provides relief if a business subject to an employment tax examination meets tests of a reasonable basis, substantive consistency, and reporting consistency,<sup>52</sup> the risk may be sufficient to make the potential client reluctant to use the services of a home-based business. That would cost a home-based business an important part of its potential market, and such an impact is most likely at the vulnerable start-up stage.

**Workers for a Home-Based Business.** Home-based businesses routinely team up with other home-based businesses. They typically consider such teaming to be client-contractor (contractor-subcontractor) relationships. Such a relationship is generally plausible if the two businesses are in different lines of work and the owners have similar levels of training and/or expertise. If a home-based business claims this type of arrangement for support staff and junior workers, however, it is likely not to meet the requirements for the worker's being self-employed. This is particularly likely if the worker principally provides services to that home-based business.

If the IRS determines that a business has improperly classified workers as self-employed, the employer is liable for current and back employment taxes on the employees, as well as penalties and interest. That is a substantial impact on the finances of a home-based business.

**Interdependent Tax Provisions.** A home-based business that claims the deductions for a home office and business equipment strengthens its *prima facie* case for being independent, as

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- Especially when schedules are tight, a consultant may take direction from a senior staff member of the client to enhance coordination of efforts.
  - A degree of specific training and orientation is generally necessary to coordinate members of a project team, which may include a prime contractor, sub-contractors, and independent consultants.
  - An independent consultant may (and generally, as a matter of marketing, seeks to) pick up additional work from previous clients, so that the relationship may well be indefinitely long.

<sup>51</sup> If a home-based business is organized as a corporation, it does not face the problem. Corporate officers (which the owners almost certainly are in so small a business) are statutory employees of the corporation. There is no question of their being employees of another business. Statutory non-employees, of course, also do not face this issue.

<sup>52</sup> Section 530 of the Internal Revenue Code (26 USC) sets up the following requirements: A reasonable basis for not treating workers as employees can be established by: Reasonably relying on a court case or ruling issued to the employer by the IRS, an earlier IRS audit that did not reclassify similar workers as employees, knowledge that a significant segment of the industry treats such workers as independent contractors, or reliance on some other reasonable basis, such as the advice of a business lawyer or accountant. Substantive consistency means that the workers in question and similar workers must all have been treated as independent contractors. Reporting consistency requires having filed Forms 1099-MISC for all of the workers in question.

it has demonstrated the existence of these. A home-based business that cannot qualify for these deductions or is afraid to claim them will not have this *prima facie* advantage. Conversely, a finding by the IRS that the home-based business is actually an employee jeopardizes the deductibility of the home office, which must then meet the convenience-of-the-employer test.

In most instances, the safest course of action will be to file all of the usual forms generally associated with an independent business. For a sole proprietorship, it is essential that the clients file Forms 1099-MISC to cover any payments. The home-based business owner's personal tax return should also clearly and consistently reflect the business. Paying self-employment tax is the most critical element, since the IRS's primary motivation to classify workers as employees is that employer withholding is a more reliable method for collecting the revenues than is the self-employment tax.

**Employee Definitions and Local Ordinances.** All zoning ordinances examined in this study limit the numbers of non-household employees that a home-based business may have. The most common limit is one outside employee per home-based business. Many zoning ordinances prohibit outside employees altogether. For outside workers that meet the definition of employees, a growing home-based business is generally faced with a lose-lose choice:

- Declare the workers to be employees and violate the local zoning ordinance, or
- Declare the workers to be independent contractors and violate the Internal Revenue Code.

## 7. Uncertainty and the Fear Factor

People fear the IRS. They worry about audits. This intimidation may be more of a burden than recordkeeping or paperwork.<sup>53</sup> It goes hand in hand with a lack of understanding – or a feeling of lack of understanding – of the tax code.

A symptom of this fear is a tendency of some accountants to recommend against trying claiming the home-office deduction because it is a red flag for an audit. Apparently, two or three decades ago a significant number of people tried to claim rent on a home office as a deduction. This practice was not legal,<sup>54</sup> and it did attract auditors. The law now allows a home-office deduction, but the fear continues.

Not claiming a deduction or expense to which one is entitled is always an alternative to the paperwork, documentation, and risk of audit entailed in claiming it. Fear of the IRS makes

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<sup>53</sup> Internal Revenue Service, *Individual Taxpayer Burden Model* (p. 2) lists as a type of excess burden: **Psychological Costs**, which include the dissatisfaction, frustration, and anxiety of taxpayers caused by interaction with the tax system.

<sup>54</sup> The issue was not so much that it was illegal to pay rent, but that the rent is nominally paid to oneself. Thus it should also be reported as rental income on the Form 1040, which was not being done. Such offsetting of income makes the payment of rent pointless.

risk-averse people more disposed to taking that alternative, even when it increases the total burden in a probabilistic sense.

## **B. OVERVIEW OF OTHER FEDERAL AGENCIES**

A review of major federal departments, their administrations, agencies, bureaus, offices, and programs, as well as several commissions and agencies, indicates that many of their missions and activities only occasionally pose significant potential for regulatory burdens on home-based businesses. Several factors, which are summarized here, contribute to this result. More complete discussions of the agencies reviewed are found in Appendix B. Several specific laws are assessed in Appendix C.

### **1. Non-Regulatory Activities**

Some agencies – or offices within agencies -- do not regulate or do so very occasionally. This is particularly true of several types of agencies:

- Offices engaged in research generally do not promulgate regulations.<sup>55</sup>
- Some agencies primarily provide information, economic development, or business development services.
- Some agencies (e.g., Federal Power Administration) have other non-regulatory missions.

### **2. Industry Regulations**

Many regulations implicitly or explicitly target specific industries, many of which have few home-based businesses. Examples include:

- Energy, communications, and transportation industries;<sup>56</sup>
- Manufacturing and mining;<sup>57</sup> and

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<sup>55</sup> Technology and the state of the economy are common topics of research. These types of research are concentrated in offices the Department of Energy, the Department of Health and Human Services, and the Department of Commerce. Other agencies carry out more applied research on topics such as transportation safety, which may indirectly support regulation but itself poses no regulatory burden.

<sup>56</sup> These industries are traditional objects of economic regulation. Other types of regulation, such as safety regulations and regulations for management of transportation systems are also common to these industries. Among transportation industries, motor vehicle carriers are the only industry with a significant concentration of home-based businesses, although it is not clear how many of these are in inter-state commerce. All trucks of a similar type are regulated alike, however, so that there is no basis for believing that home-based and non-home-based truckers of similar scales of operation have any different burdens.

<sup>57</sup> Many occupational safety regulations apply principally to industries that contain few home-based businesses.

- State and local governments.<sup>58</sup>

### 3. Business Size

Most home-based businesses are extremely small. Fewer than 10 percent have any paid employees, and less than 0.4 percent has as many as 10 paid employees. Consequently, many federal regulations do not apply to the vast majority of home-based businesses for one (or more) of several reasons.

- Many regulated industries require a scale of operations that is orders of magnitude larger than a home-based business can hope to achieve.<sup>59</sup>
- The Federal Trade Commission regulates businesses that have market power.
- Almost all home-based businesses qualify for size-based exemptions related to regulatory flexibility.<sup>60</sup>
- Department of Labor regulations apply to employers and employees.<sup>61</sup>

### 4. Location, Materials, and Environment

Although regulations have the potential to affect home-based businesses, as a practical matter, many regulations do not apply to most home-based businesses or (if applicable) do not have impacts that are specifically related to the home base of the business.

**Locations Remote from the Office.** In some lines of work (e.g., construction) work is done at a location remote from the home business office, and the regulations apply to the work site. Separation of home and work site has one (or both) of two effects:

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<sup>58</sup> Many programs in the Department of Health and Human Services and the Department of Housing and Urban Development provide grants or other funding to state or local government agencies. These state and local government agencies actually implement the programs. Regulations that govern the funding and set the rules for the programs have impacts on these state and local governments, not on businesses.

<sup>59</sup> This is true of many of the sectors just noted, such as energy generation and distribution, telecommunications, most forms of transportation (air, rail, transit, water, etc.), and mass manufacturing. With some notable exceptions (e.g., software engineering), most types of technology businesses also require fairly large scale.

<sup>60</sup> OSHA's general recordkeeping requirements and EPA's hazardous substance reporting requirements under Title III of the Superfund Amendments and Reauthorization Act of 1986, for example, exempt businesses with fewer than 10 employees.

<sup>61</sup> Sole proprietors and partners are not employees; only owners of corporations are employees. Very few home-based businesses have employees other than the owner, and even fewer are incorporated. Thus the vast majority of home-based businesses are not subject to Department of Labor regulations, which include OSHA regulations.

- Regulations that apply to a site often fall on a prime contractor or the site owner, not on a sub-contracting home-based business.<sup>62</sup>
- Even if a home-based business is subject to work-site regulations, the burden of the regulation is unrelated to whether the business is home-based or non-home-based.

**Hazardous Materials and Environmental Regulations.** While small amounts of hazardous materials may be found in such items as household cleansers, several factors tend to keep industrial quantities of materials that are sufficiently hazardous to be subject to an occupational health or safety regulation out of the home. Such materials would endanger the owner and family. Neighbors would object, and most zoning laws prohibit, such materials or the processes that use them. Similar factors tend to prevent the release or dump pollutants that would harm proximate property as well as to the environment.<sup>63</sup> Consequently, it is unlikely that any significant home-based businesses are engaged in industrial processes that create exposure to – or release of -- such materials.

## 5. Programs that Support Small Businesses

To complete the picture, programs of some federal agencies support or assist home-based businesses – either by providing direct assistance or indirectly by supporting community and economic development. Such programs (unless poorly designed) are not likely to have burdensome regulations. The main point, however, is that on balance they benefit small businesses rather than burden them.<sup>64</sup>

## 6. Conclusions

Federal regulations are a major burden to small businesses as a whole. In many instances, however, the specific impacts on most home-based businesses are considerably mitigated due to the fact that the businesses operate out of the owner's own home.

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<sup>62</sup> Many safety regulations involve hazards (tunnels, large equipment, multi-story structures, powered electrical equipment, etc.) that occur only (or almost always) on relatively large projects where there is a prime contractor.

<sup>63</sup> Proximity of pollution impacts is important. Motor oil and other pollutants are sometimes dumped into storm sewers, but these generally occur as the result of residential – not industrial -- use of these products.

<sup>64</sup> Examples include SBA assistance to small businesses, the Minority Business Development Agency (U.S. Department of Commerce), and small business procurement offices in many government agencies. Regulations of such programs generally govern qualifications for small businesses to participate in a program, the process of assisting them, or the assistance or acquisition process itself.

## IV. STATE AND LOCAL TAXES

### A. REGISTRATION AND GENERAL BUSINESS LICENSES

#### 1. Registration

For the most part, the states in the case studies use registration as a means of getting new businesses into the system. Taxation and direct regulation come later. Illinois provides an example. Businesses must register with the Illinois Department of Revenue, using Form NUC-1. The form is designed to identify the taxes for which a business may be liable. It requires the following types of information:

- Identification of the business;<sup>65</sup>
- Sales tax and reseller registration (if applicable);<sup>66</sup>
- Business Income Replacement Tax registration (if a corporation or partnership);<sup>67</sup>
- Withholding agent registration;<sup>68</sup>
- Mailing address for tax forms; and
- Signature affidavit.

This form is straightforward, and the instructions are clear. The useful information that it provides the new business probably offsets any burden.

It is possible to carry business registration to the point of being burdensome. Recent legislation in the District of Columbia extended business registration to all businesses (including home-based businesses). This ordinance was rescinded before it took effect. The issue was the breadth of the legislation, which could have required teenagers mowing lawns and doing babysitting to register as businesses and pay a registration fee.

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<sup>65</sup> Trade name and address of business; telephone number; FEIN; industry and business activity; date business started under current ownership; location (in a corporation or unincorporated county); type of ownership; name, address, title, and SSN of owners, partners, or executive officers; and seller of business (if purchased).

<sup>66</sup> Yes/No questions on retail sales; multiple sites; service person with incidental sales; out-of-state purchases; out-of-state location of business; sale of motor fuels, motor vehicles, tires, soft drinks, vending machine items; date of first inventory purchase; expected sales tax; and responsible individual.

<sup>67</sup> Fiscal year; date of start of business in Illinois (if out-of-state); date and state of incorporation and corporation file number (if applicable).

<sup>68</sup> Illinois Employment Security account number; date of issue of first paycheck; estimated withholding.

## 2. Information Dissemination

States are proactive about getting businesses into the system. At a minimum, they use paper forms and web sites to direct new businesses to the relevant tax and licensing agencies. The information on the Illinois registration form (see above) enables the Department of Revenue to classify businesses by the taxes they will be subject to. The District of Columbia developed an on-line registration that automatically registers businesses with the appropriate agencies.

States also have developed information guides of various forms. California, for example, provides small businesses with excellent orientation and information on taxes. Extensive web sites -- both the state and local -- are accessible and provide tax information that is scaled for small businesses. Sonoma County even has a web page specifically for home-based businesses. Vermont also has an excellent instruction pamphlet, *Applying for a Vermont Business Tax Account*, which combines registration and education.

California has set up the Small Business Tax Connection<sup>69</sup> especially to provide information on taxes. It publishes two exemplary guides to taxes: *Striking Gold in California*, and *Doing Business With California*.

*Striking Gold in California* is designed for the sole proprietorship, is clear, and sticks to the basics. It effectively integrates federal and state tax requirements, by providing parallel discussions of both. It addresses three core areas:

- Tax on your income;<sup>70</sup>
- If you have employees;<sup>71</sup> and
- If you sell merchandise.<sup>72</sup>

There are modest discussions about each tax, related registration requirements, and each type of form. Then there is a table that contains the answers to three questions for each form:

- What form do I use?

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<sup>69</sup> www.taxes.ca.gov. The Small Business Tax Connection is a joint venture of the California Franchise Tax Board, the California Employment Development Department, the State Board of Equalization and the U.S. Internal Revenue Service.

<sup>70</sup> Discussion is limited to:

- Federal Form 1040, Schedule C (or Schedule C-EZ), Schedule SE, and Form 1040-ES, and
- California Form FTB 540 (or Form FTB 540NR) and Form FTB 540-ES.

<sup>71</sup> Discussion is limited to:

- Federal Form 941, Form 941 (or Form 941-EZ), Form W-2, Form W-3, and Form 8109, and
- California Form DE6, Form DE 7, and Form DE88.

<sup>72</sup> Discussion is limited to California Form BOE-401-A (or Form BOE-401-EZ).

- When is it due?
- Where do I file?

Anything beyond these basics is merely alluded to.<sup>73</sup> There are extensive references for more information, including half a dozen organizations that provide assistance and a 12-page list of publications of the four agencies involved. A new business's problem is always how to find the right additional information, and *Striking Gold* addresses that issue quite effectively. It contains a seven-page topical index that provides references to other publications. Overall it provides a clear picture of the basics and easy access to additional information on specific topics.

*Doing Business With California* is a web site,<sup>74</sup> which contains several hyper-links to specific pages.<sup>75</sup> These web pages include relatively detailed discussions of the taxes, questions of definition, registration and (sales tax) permits, tax rates, forms, filing, and deadlines. This information is a great deal more detailed than *Striking Gold*.

*Striking Gold in California* provides exactly the sort of focused orientation, targeted to a specific audience that the voluminous, all-purpose IRS publications fail to provide. Doing Business With California is an effective complementary follow-up that provides more detail.

## B. STATE INCOME TAXES

For a sample of 15 states,<sup>76</sup> the individual income tax return forms and supporting schedules, partnership return forms, and S corporation return forms were collected and reviewed. The review focused on the source of business income on the state tax return and on adjustments in business income that had to be made for the state tax returns, relative to the federal tax return.

### 1. Sole Proprietorships

Sole proprietorships get most of the information they need for a state return from the federal return. Of the 15 states:

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<sup>73</sup> The most extended example states: "The State Board of Equalization also administers a number of Excise, Fuel, and Environmental Tax and Fee Programs. For information on these other programs please contact the State Board of Equalization at the toll-free number or Internet address listed on the back of this booklet."

<sup>74</sup> [www.taxes.ca.gov/incbus.html](http://www.taxes.ca.gov/incbus.html).

<sup>75</sup> These pages are headed:

- "If you have people working for you..."
- "If you have independent contractors..."
- "If you are a retailer or purchase goods subject to a sales or use tax..."
- "Income taxes for your business type, by form of organization."

<sup>76</sup> These states included case study states and states reported by MRP to have substantial regulatory review infrastructure. This sample was a preliminary step in selecting the states for case studies. States included in this discussion – but not in the case studies – are Arizona, Arkansas, Hawaii, Indiana, Iowa, Louisiana, Minnesota, New Mexico, North Carolina, Pennsylvania, and West Virginia. Illinois (a case study state) was not part of this analysis.

- Eight<sup>77</sup> take the adjusted gross income from Form 1040, Line 35 (or equivalent<sup>78</sup>);
- Three<sup>79</sup> take the federal taxable income from Form 1040, Line 41; and
- Three<sup>80</sup> take the net profit or (loss) from Schedule C (Form 1040, Line 12).
- One (Pennsylvania) requires a separate computation of income, although many individual expenses correspond to line items of Form 1040, Schedule C.<sup>81</sup>

Federal adjusted gross income and taxable income, of course, include the income reported from Schedule C, so that the states that use these measures of income indirectly use the business profits calculated on Schedule C.

## 2. Partnerships and S Corporations

The sets of forms that the states use generally resemble the elements of the federal forms, including Form 1065 (partnerships), Form 1120S (S corporations), and the respective versions of Schedule K. The information required is generally found on the federal forms, although with different definitions in some instances. In some instances a federal form is used.<sup>82</sup> In some instances, a state form is used to:

- Compute partnership and S-corporation profits (losses), which would not otherwise be reported; or
- Make adjustments from federal taxable income to state taxable income.

Most of the state forms mimic the corresponding federal forms, but the layout of the state forms is sometimes different. There are several general differences between the federal forms and the state forms, which can affect the incremental burden of filling out the state forms:

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<sup>77</sup> Arizona, California, Hawaii, Indiana, Louisiana, Maryland, New Mexico, and West Virginia.

<sup>78</sup> Form 1040A, Form 1040EA, and TeleFile Tax Record are alternative sources for data from Form 1040. Schedule C-EZ is an alternative to Schedule C.

<sup>79</sup> Minnesota, North Carolina, and Vermont.

<sup>80</sup> Arkansas, the District of Columbia, and Iowa.

<sup>81</sup> The Pennsylvania personal income tax (PA PIT) form generally parallels Form 1040, and there is a counterpart to Form 1040, Schedule C. Individual lines frequently have different meanings, however, although in many instances the federal value may be used or referenced. The PA PIT instructions point out the differences and organize this information both by supporting IRS form and by lines of PA-40 (the PA PIT form). The instructions recommend keeping separate books for federal and Pennsylvania returns, although this is probably not necessary for a business as small as a home-based business.

<sup>82</sup> Arkansas, Iowa, and the District of Columbia use the Form 1040, Schedule C result directly on the state tax form. These states have separate profit-or-loss forms for partnerships and S corporations.

- The federal Schedule K tend to have more categories of deductions and credits. Filling out the corresponding state forms generally can be done from the federal forms, but it is necessary to identify the items to omit on the state forms.
- Federal Form 1065 and Form 1120S both have an explicit schedule for capital gains, as well as other items that would be considered an individual's own income in a sole proprietorship but which are part of the income of a partnership or an S corporation.
- State tax forms apportion income as earned in-state and out-of-state. Apportionment is generally based on a weighted average of property, payroll, and/or sales. Home-based businesses will generally not hold out-of-state property, have out-of-state employees, or make out-of-state sales, so that all income can be apportioned in-state.

Thus additional familiarization and paperwork burdens appear to be a bit higher at the state level for partnerships and S corporations than for sole proprietorships, but differences are not great.

### 3. Adjustments in Taxable Income

States typically use somewhat different definitions of taxable income than the IRS does. Making adjustments to change the definition creates additional paperwork – and possibly recordkeeping – burdens. Business adjustments<sup>83</sup> include:

- Adjusting a deduction<sup>84</sup> – most frequently the federal bonus depreciation – by:
  - ◆ Adding a deduction or other item back into income, or
  - ◆ Replacing that deduction with a different state version of the same deduction, making two computations using the same records but different formulas;
- Adding the federal net operating loss carry-forward back into income;<sup>85</sup>
- Adjusting for taxes and credits;<sup>86</sup> or
- Other adjustments.<sup>87</sup>

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<sup>83</sup> Adjustments that are not based on the business include such facets of personal income as:

- Income related to retirement benefits and/or military service;
- Income related to personal expenses, such as education or child care;
- Income related to financial activities, such as capital gains (for proprietorships) and interest on out-of-state bonds, which are probably personal investments rather than part of a small business; and
- Personal deductions, such as appear on Form 1040, Schedule A.

<sup>84</sup> Arizona, California, Hawaii, Minnesota, North Carolina, and Pennsylvania require this.

<sup>85</sup> California and Indiana require this.

<sup>86</sup> Indiana and Vermont require this.

<sup>87</sup> Arizona subtracts certain wages of American Indians. California subtracts half of self-employment benefits and adjusts federal amortization.

In seven of the 15 states there is no adjustment of business income or expenses; in six there are only one or two items to be adjusted. Except for Pennsylvania,<sup>88</sup> these adjustments are not particularly extensive and are covered by the recordkeeping needed for the federal return.

#### **4. Potential for Burdens on Home-Based Businesses**

For the most part, state income taxes on the forms of business organization typical of home-based businesses – sole proprietorships, partnerships, and S corporations – appear to impose minimal burdens over the federal taxes. A majority of the states reviewed take profit (loss) numbers directly from the federal forms. Most of the cases of separate state forms closely follow the corresponding federal forms. These forms add no additional recordkeeping requirements and quite minor additional paperwork.

Most states require only limited adjustments in federal definitions of business income. The greatest burden for the business owner appears to be learning what the differences are and what the computation required for the state is. These adjustments require essentially no additional recordkeeping and minor additional paperwork. Pennsylvania provides a counter-example in which the tax structure itself imposes greater burdens on business owners.<sup>89</sup>

The additional familiarization, recordkeeping, and paperwork, burdens due to state income taxes that are incurred by home-based businesses are no different than the additional burdens on non-home-based businesses with comparable tax returns. In this sense, the burden on home-based businesses of state income tax forms and computations is not disproportionate.

### **C. STATE EMPLOYER TAXES**

States with income taxes require employers to withhold. All states collect unemployment insurance. Some states collect other employer taxes as well. California collects four: the Personal Income Tax, Unemployment Insurance, an Employment Training Tax, and State

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<sup>88</sup> Pennsylvania law excludes elections to accelerate or defer expenses or spread expenses over more than one year.

Additions to federal income for Pennsylvania Personal Income Tax include:

- Employee benefits that cover the owner,
- Costs of life insurance for which the business is not the beneficiary,
- The portion of self-employment tax paid by the business, and
- Wages excluded to obtain federal credits.

Subtractions from federal income for Pennsylvania Personal Income Tax include:

- All allowable expenses above federal dollar or percentage limits and
- Costs to qualify for Pennsylvania tax credits.

<sup>89</sup> The Pennsylvania tax code excludes the deductibility of benefits to the owner, including employee benefits that cover the owner, costs of life insurance for which the business is not the beneficiary, and the portion of self-employment tax paid by the business. Since relatively few home-based businesses have employees, these exclusions have the effect of putting higher tax burdens on home-based businesses. Pennsylvania is clearly the exception, however, rather than the rule.

Disability Insurance. In terms of burden, however, California makes up for the extra taxes by collecting them all in one process.

## **1. Withholding**

The typical requirements for withholding include:

- A form that accompanies payments, which is submitted on a monthly or quarterly basis, and
- An annual reconciliation form,<sup>90</sup> with which payment is sent only if owed.

The payment and reconciliation forms are generally quite simple. They require business name, address and Federal Employer Identification Number (which are preprinted in some cases), the amount of the payment, and in most cases penalty and interest if payment is overdue.<sup>91</sup> Reconciliation consists of being sure that the total of the payments equals the total reported on the W-2 forms.

Recordkeeping requirements in addition to federal withholding are minimal. The withholding rate is different, but it comes off the same payroll accounts in the same manner. The only real recordkeeping costs should be setting up the accounts to generate the state figure.

## **2. Unemployment Tax**

State unemployment taxes take the form of a percentage of gross wages (usually less than 1.0 percent) up to a ceiling (usually less than \$10,000), after which no tax is due. State unemployment taxes are typically paid on a quarterly basis, and there typically is not an annual reconciliation form.

Unemployment tax forms are necessarily a bit more complex than withholding forms. The name and social security number of each employee is required, together with the wages for that employee in the reporting period. Total wages are then divided into taxable (wages for each employee under the cumulative ceiling) and exempt wages (wages over the ceiling). The taxable amount is then multiplied by the tax rate to obtain the total. Additional elements may include penalty and interest (if taxes are overdue), and/or wage payments by month. General information is typically preprinted.

Recordkeeping essentially consists of keeping track of the quarter in which each employee's cumulative wages break the ceiling. In earlier quarters, the whole wage is taxable; in later quarters, none of it is. For the small number of employees that a home-based business is likely to have, this information can be read directly off payroll records.

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<sup>90</sup> Of the 15 states, only New Mexico does not require an annual reconciliation.

<sup>91</sup> California (with its combined form) also requires names of employees, social security numbers, and the amounts for each employee. West Virginia requires a count of the employees.

## D. SALES, USE, AND EXCISE TAXES

Sales, use, and excise taxes are more complex as a system than they are from the perspective of a small business.

- **Sales Taxes** are broad ad valorem taxes on tangible goods sold at retail, including items whose sale is incidental to a service
- **Use Taxes** are collected in lieu of sales taxes where sales taxes were not collected.<sup>92</sup>
- **Excise Taxes** are ad valorem taxes that apply to a quite specific good or service.

Both states and local jurisdictions levy these taxes. Coverage and tax rates vary a great deal. Burdens on many home-based businesses are mitigated by a number of factors:

- Relatively few businesses are in retail or in the specific industries affected by excise taxes.<sup>93</sup>
- At most, an individual business is likely to face only one or two of these taxes.
- Home-based businesses make relatively few purchases from out-of-state vendors who do not collect a sales tax.<sup>94</sup>
- Paperwork is simple, and only minimal information is usually required.
- Some states collect both state and local sales taxes in one filing.
- Computations are simple and amenable to computerization.

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<sup>92</sup> In practice, this means that use taxes are collected on untaxed items purchased from another state.

<sup>93</sup> Common excise taxes – in Illinois, for example – include:

- Hotel taxes;
- Electricity, gas, and water taxes;
- Telecommunications taxes;
- Amusement taxes;
- Automobile renting taxes;
- Restaurant and tavern taxes;
- Real estate transfer taxes; and
- Motor fuel taxes.

Of these taxes, the hotel tax is the only tax likely to be paid by home-based businesses (Bed & Breakfasts).

<sup>94</sup> An out-of-state retailer is required to collect a state's sales tax if it has any store, distributor, or other presence in that state. Staples, to pick an example, has such a presence in 48 states.

- Use taxes on very small businesses generate too little revenue to justify enforcement.

## E. BUSINESS PERSONAL PROPERTY TAXES

This tax applies to tangible personal property<sup>95</sup> owned by a business. While similar to a real estate tax, the business personal property tax presents a lot of opportunities for burdens. Compared to real estate, personal property items are far more numerous. Real estate is reassessed only because its market value changes; personal property must be depreciated. Real estate taxes raise considerable amounts of revenue, but the revenue from smaller items of personal property is literally not worth the effort.

Exhibit 13 summarizes key elements of personal property taxes in the case studies. These taxes are levied, at local option, by towns,<sup>96</sup> cities, and counties. Beyond that each state deals with the problems differently.

### 1. The District of Columbia

The District of Columbia has designed a business personal property tax that maximizes burdens. The District supplies the parameters and requires each business to compute its own tax.

**Coverage.** The Depreciation Guidelines lists personal property by depreciation rate, of which there are six. The basis for the different rates is not obvious.<sup>97</sup> It is clear that this tax is intended to be all-inclusive. The recordkeeping burden could not be any greater.

**Computation.** The form provides schedules for computing depreciation for each item.<sup>98</sup> The form then requires that tangible personal property be aggregated into four categories,<sup>99</sup>

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<sup>95</sup> “Personal” property is a category that is distinct from real property (real estate) and financial assets. Real property taxes are almost universal at the local jurisdiction level, and business tangible personal property taxes are perhaps best understood as a comparable tax.

<sup>96</sup> In most states, the local option is exercised by adopting the tax. In Vermont, the tax is enacted by state law, and individual towns must vote *not* to levy it.

<sup>97</sup> There are nearly 100 enumerated categories, not counting sub-categories such as lists of furniture. These include a number of items so small that they would bring in well under \$1.00 of revenue each. Examples include coffee makers; music boxes; pots, pans, serving dishes, and utensils; linens; video movie tapes; wood pallets, and small hand tools. Some items are taxed at 100% of cost when “new in reserve” but are depreciated when “in service.” Examples relevant to Bed & Breakfasts include china, glassware, pots, pans, serving dishes, utensils, silverware, and linens. Some of the items seem to be built in improvements to the real property, rather than personal property. Examples include fire extinguishing systems, intercom systems, and mail chutes.

<sup>98</sup> The following information is required for each item:

- Type of property;
- Date acquired (month/year);
- Depreciation rate used;
- Original cost;
- Accumulated depreciation at the end of the last D. C. fiscal year (June 30); and
- Remaining cost (current value) at the beginning of this D. C. fiscal year (July 1).

**EXHIBIT 13**  
**CHARACTERISTICS OF BUSINESS PERSONAL PROPERTY TAX**  
**IN CASE STUDY STATES**

	<u>California</u>	District of <u>Columbia</u>	<u>Illinois</u>	<u>Maryland</u>	<u>Vermont</u>
Tax Levied by	County	D.C. <sup>a</sup>	N.A.	City/County	Town
Tax Enacted by	County	D.C. <sup>a</sup>	Repealed <sup>b</sup>	City/County	Town
Tax Form Supplied by	State	D.C. <sup>a</sup>	N.A.	State	Town
Tax Collected by	State	D.C. <sup>a</sup>	N.A.	State	Town
Valuation done by	County	Business	N.A.	State	<b>Town<sup>c</sup></b>
Depreciation Computed by	Year	Month	N.A.	Year	Year
Exemption Threshold	\$100,000	\$50,000	N.A.	\$10,000	None
Annual Depreciation Rates					
Straight line @ 5%	-	X	N.A.	X	-
Straight line @ 6.67%	-	X	N.A.	-	-
Straight line @ 10%	-	-	N.A.	X	<sup>d</sup>
Straight line @ 12.5%	-	X	N.A.	-	-
Straight line @ 20%	-	X	N.A.	X	<sup>d</sup>
Straight line @ 25%	-	-	N.A.	-	<sup>d</sup>
Straight line @ 30%	-	X	N.A.	X	-
Straight line @ 33.3%	-	-	N.A.	X	-
Straight line @ 50%	-	X	N.A.	X	-
Other	<sup>e</sup>	N.A.	N.A.	N.A.	<sup>f</sup>
Final Depreciated Value	<sup>g</sup>	25% <sup>h</sup>	N.A.	25% <sup>h</sup>	10%

<sup>99</sup> These categories are:

- Books, cassettes and other reference materials, which is depreciated at 50% per annum -- where mentioned in the Depreciation Guidelines);
- Furniture, fixtures, machinery, and equipment, which are depreciated at 10%, 12.5%, or 20% per annum, depending on the specific item.
- Unregistered motor vehicles or trailers and other tangible personal property, which includes items from all Depreciation Guidelines categories; and
- Supplies, which are taxed at original cost.

- <sup>a</sup> The District of Columbia combines state, county, and city functions.
- <sup>b</sup> By state statute, the personal property tax has been replaced by a business income surtax.
- <sup>c</sup> Legal responsibility. In practice, valuation is done by the business.
- <sup>d</sup> Montpelier only.
- <sup>e</sup> Accelerated depreciation, based on useful lives of 3, 4, 5, 6, 8, 10, 12, 15, 20, and 25 years.
- <sup>f</sup> State law (32 V.S.A. § 3618) offers two options:  
 At fifty percent of its cost during the time that it has not been fully depreciated for federal income tax purposes under the laws of the United States... [or]  
 At its net book value during the time that it has not been fully depreciated for federal income tax purposes under the laws of the United States [after which] it shall be appraised at 10 percent of its cost.  
 Burlington uses odd depreciation schedules (some accelerated; some not) with useful lives of 12, 18, and 21 years.
- <sup>g</sup> 2% for computers; otherwise 6%, 8%, 9%, 10%, 11%, 12%, 16%, 17%, 31%, or 58%, depending on useful life.
- <sup>h</sup> Certain technology equipment can be depreciated to 10% of original value.
- <sup>i</sup> 30% for large machinery and equipment in Burlington.

which are unrelated to the depreciation rates in the Depreciation Guidelines. Having to compute depreciation for each item is quite burdensome. Having to look up depreciation rates on one list and then aggregate items by an entirely different set of categories makes the process considerably more complicated.

**Depreciation Time Frame.** The District’s depreciation scheme follows federal depreciation practice in starting depreciation in the month – not just the year – that the item was put in service. This requirement has two burdensome effects:

- It complicates the computations for the first year, and
- it means that similar items purchased at different times in the same year must be tracked individually, rather than depreciated as a group.

**Exclusion.** After the total remaining cost has been calculated, the form subtracts an exclusion of \$50,000 before computing the tax. This sets a threshold of \$50,000 in current value, which excludes virtually all home-based businesses. The instructions, however, require a business to do all of the recordkeeping and calculations in order to demonstrate that it is qualified for the exclusion.

## 2. Simplification in Other States

**Rescission.** Illinois repealed the business personal property tax. To make up for the loss of revenue, Illinois enacted the Personal Property Tax Replacement Income Tax, which is collected with (and in addition to) the income tax. This tax is not levied against sole proprietorships. The tax rate is 1.5 percent of net income for S corporations and partnerships and 2.5 percent of net income for C corporations. The State collects the tax and distributes it to local governments according to a population-based formula.

**Coverage.** In California, Maryland, and Vermont, smaller items are treated with benign neglect. The forms give categories that correspond to the depreciation rates, as well as

instructions and/or examples as to what items go into each category. Where to draw the line on small items is effectively left up to the filer.<sup>100</sup>

**Computation.** California and Maryland require only that the filer list the personal property, the date of purchase, and the purchase value. Then the County (California) or State (Maryland) does the processing and sends the taxpayer a bill. Maryland then distributes the revenue to the cities and counties from which it was collected. In both of these states, the tax form is also developed by the State, although some California counties print their own versions. In Vermont, the process is supposed to be done by each town, but often is left to businesses. Vermont, however, provides interesting examples of simplified depreciation.

- State law allows using the federal rates, which would already have been computed.
- By state law, property may be valued for half its initial value during its useful life and at 10 percent thereafter.
- Some towns just make up their own simplified depreciation schedules.<sup>101</sup>

**Depreciation Time Frame.** All of the states use a year for the depreciation. This considerably minimizes the information required (year of acquisition). It also allows more grouping of property, which simplifies computations.

**Exclusion.** Maryland, California, and Vermont have exclusions:

- Maryland does not require business personal property tax to be paid by a home-based business whose personal property is worth less than \$10,000. This exclusion requires only a simple declaration.<sup>102</sup>

<sup>100</sup> In Vermont the tax is supposed to be handled in the same manner as the real property tax. Each town compiles a Grand Tax List of property, designed to include both real property and business personal property. By law, the property is appraised by a town official, the Lister, who acts on detailed instructions provided by the State. In practice, the Listers do not have time to process business personal property, and so the valuation – as well as the decision whether to file at all – is left to the individual business.

<sup>101</sup> Montpelier’s highly simplified form quoting the state law, and then provides the following information:

<u>Category of Personal Property</u>	<u>Life</u>	<u>Examples of the Category</u>
Computer/Data Processing Equipment	4 Years	Computer Hardware and Accessories
Machinery & Equipment	5 Years	Office Machines, Copiers, Cash Registers, Phone Systems, Manufacturing Equipment, etc.
Furniture & Fixtures	10 Years	Tables, Chairs, Desks, File Cabinets, Shelving, etc.

<sup>102</sup> The form states:

6a. Is this [business] location the principal residence of the business owner? (Yes/No)

6b. Is the total original cost of all the property, including inventory and excluding licensed vehicles, less than \$10,000? (Yes/No)

If you answer yes to both 6a and 6b, your property is exempt. Skip to signature line on page 2.

- California has a threshold of \$100,000. This threshold applies to each county, as a business must file with every county in which it does business.
- Vermont has no statutory threshold. Since each town has legal responsibility for valuation and assessment, however, small businesses effectively are exempted.<sup>103</sup>

**Burden.** In one way or another, most of the states in the case study have succeeded in reducing the burden of a business personal property tax on very small businesses, especially on home-based businesses. This has been done principally by having the taxing jurisdiction do much of the work, and by exclusion (in practice or in law) of both small items and very small businesses.

## F. LOCAL LICENSING FEES, BUSINESS TAXES, AND OTHER FEES

Local governments depend heavily on real property taxes, which are not considered here because either a home-based business would pay them anyway (if owner-occupied) or does not pay them at all (if rented). There are also various local business fees and taxes.<sup>104</sup>

Exhibit 14 summarizes local business taxes of the cities and counties in the study. Some of these are pure registration fees.<sup>105</sup> In some instances, the locality wants businesses registered for purposes of regulation.<sup>106</sup> Most of these license fees have at least an element of revenue generation. Several local jurisdictions have found home-based businesses to be a convenient source of revenue.<sup>107</sup> Taxes sometimes vary among different kinds of home-based business.<sup>108</sup> These differences tend to be reflective of policy preferences found elsewhere in the study.

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<sup>103</sup> Listers have plenty to do with real property, however, and they are the ones with the legal responsibility for appraising their property. If the business does not file a list, the Lister's workload is lessened. One small Vermont town in the case study rescinded the tax because it did not consider the revenue (about \$8,000 per year) worth the burden *on the town*. Another larger town rescinded the tax for the same reason and because the town considered the patchwork nature of payment to be inherently unfair.

<sup>104</sup> Three types of fees and taxes were identified:

- **Business license fees** are usually an annual fee that is charged for the "privilege" of doing business in the city or county. The fee may be a fixed fee, it may vary with capacity, or it may vary with sales.
- **Business taxes** are ad valorem taxes that are broader than excise taxes but are focused on businesses other than general retail.
- **Home occupancy fees** are essentially business license fees for home-based businesses.

<sup>105</sup> Bakersfield's low, one-time home occupancy fee is an example.

<sup>106</sup> Auctioneers, massage establishments, gun dealers, and taxicabs are examples.

<sup>107</sup> Some jurisdictions have relatively high home occupation taxes:

- Merced County and Sonoma levy no other local business taxes,
- Peoria only a handful of other types of businesses, and
- Siskiyou County collects five times the regular business license fee from home occupations.

Some jurisdictions have benefited fiscally from legalizing home-based businesses. Chicago, Long Beach, and Los Angeles all amended their tax codes specifically to include home-based businesses at the time when they legalized home occupations.

The registration form is usually a fairly modest registration form that does not appear to require much time, although inspections are involved in some instances. Only four of the jurisdictions -- Siskiyou County, Long Beach, Los Angeles, and Chicago – have fees or taxes of over \$100 on home-based businesses. Long Beach and Los Angeles start their taxes at about Chicago’s level and charge more only if revenues are substantial. A fee of \$125 to \$175 may be a bit of a hurdle to an undercapitalized start-up business, but only occasionally do home-based businesses have to pay more than other businesses.

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- Chicago did so explicitly, although it already had a catch-all license fee for businesses that were not already charged.
  - Los Angeles provoked a major legal fight with writers and other home-based artists, who argued that they could not be taxed on Constitutional grounds.

<sup>108</sup> For example:

- Bakersfield, Chico, and Long Beach tax Bed & Breakfasts more heavily than other home-based businesses.
- Bakersfield exempts home day care from local fees and taxes.
- Peoria does not require a permit and fee from certain no-impact home occupations, and Siskiyou County charges a lower fee.

**EXHIBIT 14  
LOCAL BUSINESS TAXES**

State and County or City	Ad Valorem Business Tax		Business License Fee		Home Occupation Fee
	Minimum Tax	No Minimum	Fixed Fee	Variable Fee	
<b>CALIFORNIA</b>					
<b>Contra Costa County</b>				\$100 <sup>a</sup>	
Merced County					\$27
Siskiyou County			\$66		\$340 <sup>b</sup>
<b>Sonoma County</b>					\$71
Bakersfield		0.03% <sup>c</sup>	\$30 <sup>d</sup>		\$25 <sup>e</sup>
Chico				f	
Long Beach				g	g
Los Angeles	h				\$25
<b>Oakland</b>	h		\$30		
Redding				\$50 or \$90 <sup>i</sup>	
San Jose				\$150 <sup>j</sup>	
<b>ILLINOIS</b>					
Carbondale			\$100 <sup>k</sup>		
Chicago			\$125 <sup>l</sup>		\$125
Elgin			\$100 <sup>m</sup>	n	
Peoria			\$25 <sup>o</sup>	p	\$30 <sup>q</sup>

<sup>a</sup> \$100 plus \$10 for every employee, including the owner.

<sup>b</sup> Includes \$250 payable to County Treasurer, \$65 payable to Health Department, and \$25 payable to County Clerk.  
No-Impact "telephone and office only" home occupations have a home occupation fee of \$50

<sup>c</sup> Professional services are taxed at 0.065%; transient lodging and family day care are exempt.

<sup>d</sup> Effective tax rate on Bed & Breakfasts.

<sup>e</sup> One-time fee. Family day care homes are exempted.

<sup>f</sup> Family day care homes are exempt.

Bed & Breakfasts with 3 to 5 guest rooms pay a fee of \$18/guest room.

Other businesses pay a hybrid tax based on gross receipts for first \$5,000 and employees for higher gross receipts.

<sup>g</sup> Bed & Breakfasts, professionals, and independent contractors pay a tax of \$259.70 + \$13.48/employee,

Other home-based business pay a tax of \$159.27 + \$6.74/employee, and

Other types of businesses have other tax rates.

<sup>h</sup> Tax rates vary with type of business.

<sup>i</sup> Bed & Breakfast: \$50

Large Family Child Care: \$90 + \$6/employee

Professional: \$90 + \$6/employee for first 8 employees + \$4/employee for over 8 employees

Sales & Miscellaneous: \$50 + \$8/employee for first 4 employees + \$4/employee for over 4 employees

<sup>j</sup> \$150 + \$18/employee for over 8 employees.

<sup>k</sup> Applies to merchants, transient vendors, peddlers, and massage establishments. Massage therapist license fee is \$50.

<sup>l</sup> "Limited business license" applies to businesses not otherwise licensed. Applies to home repair & massage therapist.

\$50 for street performers; \$70 for bicycle messengers & peddlers; \$75 for day care; \$250 for massage establishment;

\$500 for weapons sales & service; \$1,000 for auctioneers.

<sup>m</sup> Taxis, per cab.

<sup>n</sup> \$20 for peddlers; \$50 for massage therapists & landlords; \$75 for massage establishments; \$100 for transient vendor.

<sup>o</sup> Taxis, per cab.

<sup>p</sup> \$25 for massage therapists; \$50 for peddlers & transient vendors; \$100 for auctioneers & massage establishments.

<sup>q</sup> Typing, writing, operating telephones, sewing machines or computers does not require a permit.

## V. STATE AND LOCAL REGULATIONS

### A. STATE REGULATIONS

Most state agencies promulgate regulations that are related to their own programs and/or the issues for which they have responsibility. The complexity of agencies in the executive branch varies from state to state, and the potential for regulations varies accordingly.

Detailed information on regulations is available from the states themselves, but the sheer volume of regulations is formidable. A recent study for the SBA's Office of Advocacy by MRP<sup>109</sup> has provided a convenient portal into the world of state regulations. MRP identified states that have laws patterned after the Small Business Regulatory Enforcement and Fairness Act (SBREFA), state executive orders similar to federal E.O. 12866, and/or organizations within the state government (most often a commission in the governor's office or a joint legislative committee) that reviewed regulations. Using the MRP study, we identified 11 states with such regulatory oversight bodies.

- Six states<sup>110</sup> conduct regular formal regulatory review sessions. We downloaded meeting agendas for several months, annual reports, and in one case (California) the entire 2002 regulatory agenda. These sources give at least the agency and subject of each regulation, and they usually include at least a short description of the regulation.
- Two states<sup>111</sup> have more decentralized review, in which task forces or departments review regulations dealing with specific types of issues. For these states we downloaded these categories of regulation, which are shown in Appendix D.
- Three states<sup>112</sup> did not systematically review regulations. Instead, the small business advocacy group held public meetings to determine the issues of most concern to the small businesses in the state. Some, but far from all, of these were regulations.

The discussion below is based on these sources, as well as case studies. Regulations by six states that were reviewed in detail are summarized in tables in Appendix E, and summarized below, by general area of the regulation.<sup>113</sup>

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<sup>109</sup> Management Research and Planning Corporation (MRP), *Analysis of State Efforts to Mitigate Regulatory Burdens on Small Businesses*, Report to the Office of Advocacy, United States Small Business Administration, June 1, 2002.

<sup>110</sup> Arizona, California, Illinois, Iowa, Pennsylvania, and Vermont.

<sup>111</sup> New York and Tennessee.

<sup>112</sup> Hawaii, Kentucky, and New Mexico.

<sup>113</sup> For specific regulatory issues, these categories can be rather arbitrary. Classification is not entirely consistent from state to state. Nevertheless, these categories do provide a convenient framework for reviewing the potential impact of state regulations.

- **Labor Regulations.** Only home-based businesses with employees are affected by labor regulations. Hour and wage, workers' compensation, and unemployment insurance appear to be the main types of regulations with burden potential, but several factors mitigate impacts on home-based businesses:
  - ◆ Forms and paperwork are fairly straightforward,
  - ◆ Forms and paperwork mirror federal forms and use much the same data, and
  - ◆ Burdens on home-based and non-home-based businesses are the same.
  
- **Environmental Regulations.** These regulations affect only home-based businesses that would release controlled substances,<sup>114</sup> such as truckers (emissions) and painters (architectural and industrial coatings). Such regulations are job-site specific.
  
- **Natural Resource Management.** Forest products and fishing (both commercial and sport), but very few other home-based business, are related to natural resources.
  
- **Human Service Regulations.** Child care (discussed below) is a major industry for home-based businesses. Adult day care and residential care, may also be home-based.
- **Health and Safety Regulations.** These regulations pertain mostly to facilities to which the public has access.<sup>115</sup> Residential structures have the least stringent fire regulations, since egress is easy. Some important home-based businesses (e.g., child care) have specially tailored regulations. There may be impacts on rental businesses (lead paint regulations) and businesses related to food (health regulations).
  
- **Transportation Regulations.** Commercial motor carriers are the principal type of home-based business affected by transportation regulations.<sup>116</sup> Such regulations apply principally to the job site (i.e., the vehicle), and they apply equally to home-based businesses and comparable non-home-based businesses.
  
- **Economic Regulation of Industries.** Classic economic regulations and regulation of specific industries may affect a few industries, such as insurance agents, small-scale construction contractors, and real estate agents, where the home is used as an office and actual job functions are done out of the office. Many industries affected by such

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<sup>114</sup> Home-based businesses are not actively engaged in activities subject to industrial environmental regulations (e.g., ocean transport of oil or use of radionuclides). Home-based businesses do not have the type of facilities (e.g., solid waste landfills or mines) or use the materials (toxic, fecal, hazardous, or radioactive) that are typically regulated.

<sup>115</sup> Most home-based businesses do not provide access to the public. Many of these regulations are specifically targeted to relatively large buildings. Others apply to matters such as public health services, medical institutions, and health service programs, which have no direct bearing on home-based businesses.

<sup>116</sup> Regulations related to motor vehicles and operator licenses affect people in their personal – not business – roles.

regulations either require a larger scale than home-based businesses or are incompatible with a residential neighborhood.<sup>117</sup>

- **Other Regulations.** Some substantial groups of state regulations have no bearing on home-based businesses:
  - ◆ Regulations about education address institutions (schools) their employees (teachers), and their programs (curriculum).<sup>118</sup>
  - ◆ Government operations regulations almost entirely deal with state employees, state facilities, state agencies, and law enforcement and corrections.
  - ◆ Most human service regulations deal with large human service programs.

For the most part, there state regulations appear to have little impact or burden on home-based businesses. The reasons were succinctly summarized by the former head of the now-disbanded California Economic Regulation Review Unit,<sup>119</sup> who observed that:

- Most state regulations are very narrowly targeted, either at a specific industry or a specific problem. Thus no state regulation is likely to have a significant impact on so broad a sector as home-based businesses.
- Most state regulations address issues that do not occur in a residential setting.

The study's findings are consistent with these observations.

## **B. PROFESSIONAL LICENSING REGULATIONS**

States are the principal governmental entity that license professionals. The professions themselves are naturally grouped into medical professions and non-medical professions. Appendix F summarizes the professions that states license and certify.<sup>120</sup> Licensing is typically done by separate professional boards for each profession. In general, either the boards either are independent state entities or they are located within one or two departments, such as the Secretary of State or (for health professionals) the Department of Health.

### **1. Proposed Regulations**

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<sup>117</sup> Examples of such regulated industries include public utilities, gaming, retail of alcoholic beverages, athletics, cemeteries & funeral homes, milk marketing, insurance companies (except for agents), other financial institutions, legal forms of gaming, almost all real estate development, and vehicle dealers.

<sup>118</sup> There are probably educational regulations covering home schooling as well, but they were not encountered. Home schooling is sufficiently widespread and different from other schools that different regulations are a necessity. Moreover, home schooling is generally not conducted principally as a business.

<sup>119</sup> Don Perry, Interview on July 15, 2003.

<sup>120</sup> The term "licensing" is construed broadly to include certification and registration. In some instances different states use different terms with reference to the same profession.

Regulations concerning professionals were also covered in the review of states with regulatory oversight organizations. Findings are presented in Appendix E. Issues related to these findings are discussed below, along with the case study findings.

## **2. Case Study Findings**

The contents of licensing regulations were reviewed for the five case study states. The regulations were classified for content in order to provide a systematic and complete view of the Licensing requirements. Detailed information is provided in the Case Study Addendum.

Specific requirements differ somewhat among states and professions. States have different emphases and different degrees of detail, but the substance is generally quite similar. Differences among states are accentuated by the fact that each state has its own format for the regulations, and this format is generally used for most professions. Some licensing requirements are much more extensive than others. Yet all tend to draw on the same core set of elements.

## **3. Elements of Professional Regulation**

Almost all of the regulations concerning professionals fall under one of a few specific topics, which include:

- Fees;
- Training;
- Licensing and the licensing examination;
- Continuing education;
- Standards of practice; and
- Procedures of the licensing board.

**Fees.** Fees cover licensing and other services of the board. Paying the fees is mandatory for obtaining a license and practicing the profession in a state.

**Training.** Regulations usually specify training that is required prior to applying for a license. For medical professions the training is particularly extensive. Training requirements cover general qualifications and usually include a specific course of training and/or a certain level of education in the field. They may also include a required number of hours of practice under the close supervision of a licensed professional. Many regulations governing training have a special section for licensing of foreign-born professionals, whose training may be sufficient but done in a manner that does not meet the standard regulatory requirements.

**Licensing and the Licensing Examination.** Licensing provisions include examination requirements, applications, and other paperwork, as well as procedures involved in obtaining a license. The licensing requirements are mandatory for practicing the profession in a state.

Licensing of professionals is done at the state level. In some states, local jurisdictions also require registration. In Kentucky, small businesses raised the issue that each local jurisdiction in which a company did business required separate registration, using different forms and asking for somewhat different information. In some cases, this meant registering over a dozen times.<sup>121</sup> That is clearly an objectionable and unnecessary paperwork burden. Yet this burden does not fall disproportionately on home-based businesses. If anything, a home-based business seems likely to “do business” in fewer jurisdictions than a non-home-based business.

Licensing confers real benefits on licensees. Licensed individuals are generally perceived (probably realistically) as being more qualified than non-licensed professionals. One complaint of some non-medical professionals in New Mexico was that New Mexico did not license their occupation, but adjoining states did. This put the New Mexico professional at a competitive disadvantage.<sup>122</sup> In health professions, licensing is often critical for reimbursement by Medicare and Medicaid. A state that does not license a profession may therefore put a burden on some occupations (e.g., social work). In some occupations, practitioners may use licensing as a means of product differentiation (e.g., massage therapists). Thus it is not uncommon in states that do not license practitioners in some profession for those practitioners to lobby for licensing.

**Continuing Education.** Most professions require some type of continuing education to keep the practitioner current in the field. Licensing regulations spell out these requirements.

**Standards of Practice.** Standards cover professional activities and how they are done. In professions with several levels of licensing (e.g., nursing), these regulations specify what a particular license or certification allows a person to do on the job. In medical professions, two areas are perhaps significant enough to be considered as separate topics: Handling of drugs, and supervision of lower level licensees. Standards can be divided into three sub-categories:

- Standards of practice include requirements that are procedural or administrative and may have little to do with the actual practice of the profession. Proper display of the license is an example of this type of standard.
- Standards of practice sometimes cover specifics of how a profession is to be practiced. Administration of anesthesia in dentistry is an example.
- Standards of practice sometimes explicitly include a code of ethics. This is most common in mental health and counseling professions.

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<sup>121</sup> Kentucky Commission on Small Business Advocacy. *Annual Report 2002: Helping Small Businesses Navigate Kentucky's Regulatory Environment*, December 2002.

<sup>122</sup> New Mexico Small Business Advocacy Council, *Report on Small Business Advocacy Council Meetings*, 2001.

A few licensing codes have requirements concerning equipment or general space parameters (e.g., barber/beauty shops or mortuaries). Such requirements may conflict with local zoning requirements, (e.g. limitations on the remodeling that can be done in a home business). Such situations, however, appear to be quite exceptional.

**Procedures of the Licensing Board.** A substantial portion of licensing regulations is devoted to the licensing board, its members, and its procedures. Other topics may include alternative procedures for obtaining a license (e.g., reciprocity between states; renewal, suspension or revocation, and reinstatement of a license; and procedures for all related hearings. Except for disciplinary actions, such provisions do not affect the practice of the profession.

#### **4. Impacts on Home-based Businesses**

Licensing regulations deal with the qualifications and other characteristics of the individual professional; the examination and licensing procedures; certain aspects of practice of the profession. They have no bearing on the location of an office and only rarely address any characteristics of the office. Home-based offices are a natural setting for many small-scale professional businesses. Home offices are especially appropriate for professionals who go out to practice (e.g., nurses or home inspectors). The review of state licensing regulations found nothing that would impinge on home offices or otherwise have an impact specific to home-based professionals.

### **C. STATE AND LOCAL REGULATION OF SPECIFIC HOME-BASED BUSINESSES**

States rarely directly regulate industries that involve home-based businesses, nor do state regulations have much effect on the office components of business that are suitable for home-based offices. Local governments issue licenses and permits. Licenses are often revenue-generating mechanisms, and they are also used to regulate certain kinds of business or activity. Usually either these businesses are unsuitable for home offices (e.g. adult entertainment and liquor stores) or the regulations apply to activities outside of the office (e.g. taxi cabs or solicitors). There are some exceptions, however, in which states regulate – and local jurisdictions license – businesses and activities that are home-based. Instances that were found in the study include:

- Child day care;
- Industrial homework;
- Bed & Breakfasts; and
- Massage therapy.

These regulations are discussed further below:

#### **1. Child Day Care**

Day care for children is far and away the most consistently and extensively regulated type of home-based business.<sup>123</sup> Regulations are promulgated by the state human services agency that is responsible for children and families. Local jurisdictions tend to rely on the state regulations, although they typically are responsible for inspections and other implementation of the rules.

All of the states in the study have one type of license for home-based day care and another for larger, non-home-based programs. Some states have more subclasses. The licenses for “family” or “home” day care facilities have several features in common:

- They are defined as being in a home where at least one caregiver resides.
- They are designed to accommodate a situation where there is a single caregiver, although additional caregivers or aides are anticipated as well.
- There are size limitations for the license.<sup>124</sup>

Day care “centers” are larger facilities (sometimes with slightly overlapping size ranges). They are expected to have a multi-tiered staff. There is no maximum size (and multi-center organizations are anticipated), but capacity is measured in child-to-staff ratios.

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<sup>123</sup> Standard topics in child care regulations include:

- Qualifications, training, and experience, and other background of the care providers and staff;
- Continuing education and in-service training;
- Requirements (particularly health requirements) for admission to the program;
- Health records and other record keeping;
- Capacity and child-to-caregiver ratios;
- Compliance with applicable codes;
- Cleanliness and safety of the facility;
- Sleeping facilities and arrangements;
- Programs and their components;
- Disciplinary measures;
- Hygienic practices;
- Procedures for dealing with children who are ill;
- Food handling and meals;
- Transporting children safely;
- Safety, screening, and size of outdoor play areas;
- Emergency procedures and plans; and
- Communication with parents and parental access.

<sup>124</sup> These include something like the following:

- Maximum capacity (typically 8, sometimes with an allowance for up to 4 school-age children after school with an aide present),
- Maximum number of infants (2 or 3 with a single caregiver) and restrictions on the number of other children allowed if infants are cared for, and
- Other limits on numbers under a particular age (usually 5 or 6).

Multiple children from the same family or household are exempt from licensure unless unrelated children are also cared for. In that case, the caregiver’s own children count toward the maximum number of children. In some states, small numbers of unrelated children (up to 3 in Illinois) may be cared for without a license.

Regulations governing “family” or “home” day care are a classic example of regulatory flexibility. To encourage day care in the home, and in recognition of inherent differences between home-based and non-home based day care, state regulations covering the two types of facilities are quite distinct. The more obvious differences include the following:

- Home day care and day care center regulations anticipate different staffing.<sup>125</sup>
- Qualifications of staff are quite distinct.<sup>126</sup>
  - Age requirements for staff are typically a little lower for home day care staff.
  - Many operational requirements for a day care center are more detailed and proscriptive than the parallel requirements for home day care.
  - Day care center regulations allow groups of children that are larger than the entire capacity of a day care home.
  - Continuing education requirements for home day care staff are equal to or greater to continuing education requirements for day care center staff.

One of the more interesting differences in the two sets of regulations is that they are typically written quite differently. In none of the five states studied do the two sets of regulations follow the same outline, and at times it is rather difficult to find the parallel requirements in both regulations. Compared with the day care center regulations, the home day care regulations are generally written in more informal, simpler language; often have correspondingly simpler requirements; and seem written more to give instruction. At a minimum, the two sets of regulations were written independently and for different audiences.

There are some differences between states that were sharp enough to suggest differences in regulatory approach. California and Illinois provided an interesting contrast.

- **California.** California law is extremely supportive of home day care. It classifies day care as a residential use, classifies even the largest day care homes as single-

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<sup>125</sup> Home day care regulations discuss three types of staff (caregiver, substitute, and aide), of whom no more than two are expected to be present at any time. Day care center regulations set out a hierarchy of 3 or 4 levels (possibly more for a multi-site operation), headed by a director, who does no direct care giving.

<sup>126</sup> The following is representative:

- Requirements for a home-based caregiver typically include no formal general education requirements (and never more than high school or GED), 15 hours or less (sometimes zero) of training related to child care, perhaps an orientation session by the agency, and certification in CPR and first aid.
- Requirements for a day care center staff typically include a high school diploma (or GED), additional degrees or years of college (depending on level) with a minimum number of credit-hours in childhood development, and/or hundreds of hours of applied experience at a lower skill level in a child care center, as well as certification in CPR and first aid.

family dwellings, and partially exempts them from fire code regulations (directing the State Fire Marshal to develop more tailored regulations). They suggest a strategy of getting caregivers into the licensing system, so as to ensure a fundamental level of safety and health as widely as possible.

- **Illinois.** The Illinois day care regulations are by far the longest and most detailed encountered in the study.<sup>127</sup> They are so detailed that the State has published pamphlets to help parents evaluate the quality of day care. These pamphlets seem to capture the substance completely enough that they would not serve too badly as actual regulations. Although the individual requirements are not really that difficult to comply with, the general effect of the regulation is one of weeding out potential providers to produce a relatively high standard of quality.

Day care is a type of home-based business that is valued in its own right and considered to be an amenity in residential neighborhoods. This social value is consistently reflected in regulatory policy that tailors the regulations to accommodate this type of business without making major sacrifices in quality or public safety and health. Reading and absorbing the regulations, and determining how a facility could be brought into compliance would easily take several hours, perhaps a few days. The regulations provide useful information and direction, however, and the amount of time that would be required is inversely related to the quality of care that would be provided if the day care home were not in compliance. Viewed in this light, the burden does not appear to be excessive, particularly if the prospective caregiver is serious about the business.

## 2. Industrial Homework

State industrial homework laws mirror the federal Fair Labor Standards Act. These laws go back to the early 20<sup>th</sup> century, when they targeted home-based garment industry, which sometimes operated on a very large scale.<sup>128</sup> California's Industrial Homework regulations illustrate the burdens that can arise when old laws are left on the books and nominally apply to new and different circumstances:<sup>129</sup>

- The law applies to any “employee” who “manufactures” any “article” in the home and provides it to another party who supplied the materials and is not the ultimate consumer.
- California regulations use the broadest possible definitions:

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<sup>127</sup> The Illinois regulations lay out alternatives in a fairly exhaustive manner and spelling out requirements in great detail. They include extensive requirements for background checks, not just of the caregivers but of other members of the household as well. They list dozens of crimes, for which a conviction would mean disqualification.

<sup>128</sup> Illinois's statute bases its license fees for an employer on how many hundreds of workers are employed.

<sup>129</sup> Illinois presents a picture of how industrial homework has played out, which contrasts with California. This comparison is included in Appendix G.

- ◆ “Manufacture” is defined to include “to make, process, prepare, alter, repair, or finish in whole or in part, or to assemble, inspect, wrap, or package any articles or materials.”
  - ◆ There is no delimitation on what constitutes an “article.”
  - ◆ “Garment” is defined to cover virtually anything that can be worn.
  - ◆ The regulation stipulates “the presumption that persons working in their homes for remuneration... are employees and not independent contractors.”
- Industrial homework “manufacture” of garments and articles of food and drink is illegal.

If all the dots were connected, a wide range of home-based businesses would be prohibited, and would-be independent contractors could become employees by working through a middleman.

### 3. Bed & Breakfasts

Except for stipulating that they are subject to a hotel tax or transient lodging tax, states rarely seem to regulate Bed & Breakfasts as such. Illinois is an exception. The Bed and Breakfast Act law is basically a health law. For the most part, its requirements are understandable, generic,<sup>130</sup> and should not impose significant burdens.<sup>131</sup>

Carbondale, Illinois is one of the few local jurisdictions encountered in the case studies that actually licenses Bed & Breakfasts. Carbondale’s license procedure has several components:

- An application must be submitted with information about the proposed use.<sup>132</sup>
- City departments must review and/or inspect the application and the premises.<sup>133</sup>

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<sup>130</sup> Examples include:

“Perishable foods shall be stored at temperatures that will protect them against spoilage.”  
“Clean linen shall be stored and handled in a sanitary way.”

<sup>131</sup> The most difficult requirement probably is sanitization of utensils, pots, and pans. This requires their “being submerged in a hypochlorite solution with a chlorine concentration continuously maintained in one hundred parts per million, or another approved sanitizing solution.” Conventional dishwashers are allowed to wash dishes, but not pots and pans. Most kitchens do not have sinks that are capable of both washing and then sanitizing the larger cooking utensils. Otherwise the requirements should not pose any real problem.

<sup>132</sup> The application must be accompanied by:

- A site drawing showing the relative locations of existing and proposed structures, parking areas and driveways, and the property lines, and
- Existing and proposed floor plans of all structures.

<sup>133</sup> Responsibilities of city departments are as follows:

- The Planning Office determines zoning requirements and whether a site plan is necessary.
- The Building and Neighborhood Services Division determines any modifications needed to meet housing regulations and handicapped-accessibility standards.
- The Fire Department determines any modifications needed to meet requirements of the State Fire Marshal’s and the State Bed & Breakfast Act.

- The applicant must certify that these and other requirements<sup>134</sup> have been met.

These licensing requirements do no more than pull together and coordinate compliance with applicable laws and codes. The actual paperwork is minimal. The initial requirement for a drawing of the site, and subsequent determination whether a more formal site plan is necessary, shows flexibility. Securing compliance before the Bed & Breakfast opens minimizes the chances of unpleasant surprises from an after-the-fact inspection, which could be much more burdensome and costly than handling compliance issues up front. The effect is not particularly burdensome.

#### **4. Massage Therapists**

Massage -- both establishments and practitioners -- is licensed for health reasons and to keep the business from sliding over the line into adult entertainment. Many jurisdictions simply ban massage as a home occupation. Elgin, Illinois, by contrast, licenses certified massage therapists in residential districts. For the most part, Elgin appears to have crafted a regulation that allows a massage professional to operate a home-based business. Home occupation restrictions -- only five visitors per day and only between 8:00 a.m. and 6:00 p.m. -- apply, the license does allow massage therapists to operate in the home.

### **D. CODES**

Three types of codes have the general potential to affect home-based businesses. Building codes, fire codes, and health codes are generally established at the state level and are often based on model codes of national or regional organizations, such as the National Fire Protection Association (NFPA) codes and the BOCA National Plumbing Code. Local codes usually incorporate the state codes by reference with no more than minor adaptation.

#### **1. Building Codes**

Building codes addresses various aspects of design, construction, maintenance, and use of buildings. They sometimes mesh with fire codes in “fire and life safety” provisions (as the California Code puts it). Codes typically apply different standards to different types of structures

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- The Health Department determines any modifications needed to meet local standards and requirements of the State Bed & Breakfast Act.
  - The Police Department verifies information pertaining to the applicant.

<sup>134</sup> The applicant must also:

- Obtain liability insurance; and
  - Register with:
    - ◆ The Illinois Department of Revenue, and
    - ◆ The City’s Finance Department.

(e.g., single-family dwellings, duplexes, and larger multi-family buildings). Several aspects of building codes minimize their impact on home-based businesses.

- **New Construction.** Building codes focus principally on the design and construction of new buildings and often apply only to structures built after the code was enacted.
- **Renovation.** Renovation most frequently involves updating of systems<sup>135</sup> or partial structural changes (additions, etc.). Codes do not come into play for minor renovations. Renovation code requirements for renovation are not usually as stringent as code requirements for new construction.
- **Livability Codes.** Livability codes apply to the state of repair of a dwelling. They are designed to ensure basic health and safety, and they involve such things as lead paint and properly functioning systems. Requirements are generally quite basic.<sup>136</sup>
- **Use Changes.** In some states, a change of use of the building triggers building code requirements. This ensures that improvements the new use meet code requirements.
- **Use.** Low-density residences have the least stringent building codes, as the buildings are relatively small and easy to get out of. Home occupations<sup>137</sup> are often classified as accessory uses to a residence and are considered (and required by zoning codes) to be secondary uses. This classification has two important implications, which tend to keep burdens of building codes to a minimum:
  - ◆ Start-up businesses are not generally considered changes in use, and
  - ◆ Home-based businesses are generally subject to low-density residential codes.

## 2. Fire Codes

A great deal of the emphasis of fire codes is on safety in public places where a substantial number of people may assemble.<sup>138</sup> The fire codes that do apply to home-based businesses have fairly simple requirements, even for Bed & Breakfasts and day care homes, to which “the public” has access. The concerns of fire codes that affect home-based businesses address only a few basic issues:

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<sup>135</sup> Systems are typically brought up to code. Electrical upgrades, for example, may include new wiring, a higher capacity breaker box, hard-wired smoke detectors, and ground fault interrupters on outlets in bathrooms and kitchens. In some cases, upgrading the systems (e.g., installing central air conditioning, or adding electrical outlets for computers) is the whole point of the renovation. Renovations are also required to mitigate health and safety problems. Dealing with lead paint and improving emergency exits are two examples.

<sup>136</sup> Phrases such as “reasonable” and “good working order” appear frequently. Frequently no more is required of paint than that it adhere to the walls. Particularly in the District of Columbia, they appear to be targeted more at landlords than at owner-occupied housing.

<sup>137</sup> Home day care and Bed & Breakfasts are the only significant exceptions. They have their own requirements.

<sup>138</sup> To give an example, Chapter 1 of the regulations concerning the California State Fire Marshal (19 CCR 1.03) – titled “General Fire and Panic Safety Standards” – applies only to public institutions, “assemblages where 50 or more persons may gather together,” and public structures for showing of motion pictures with “a capacity of 10 or more persons.”

- **Smoke Alarms.** Fire codes address such basic matters as the number, location, and working condition of smoke detectors.<sup>139</sup>
- **Fire Suppression.** For most home-based businesses,<sup>140</sup> typical requirements are:
  - ◆ A fire extinguisher on every floor to which the public has access,
  - ◆ Fire extinguishers that meet a stated rating standard, and
  - ◆ Maintenance of fire extinguishers, so that they remain charged.
- **Egress.** Fire codes require emergency exits (“means of egress”) and prohibit such things piling things in the exit or locking the fire door. Requirements are usually basic and generic.<sup>141</sup>

A home-based business should have no trouble meeting even the most detailed of these requirements. Even if the written regulations are not burdensome, however, interpretation of the regulation by the enforcing agency may be a potential source of burden. Iowa provides a cautionary tale.

Reasoning that Bed & Breakfast Homes and Inns “are basically tiny hotels,” the Iowa Public Safety Department proposed to require interconnected, hard-wired fire detectors in every guest room. When the rule came before Iowa’s Administrative Rules Review Committee, there were allegations that the proposed rule conflicted with some local fire codes and “concerns centered on the cost of installing interconnected fire alarms.” The Department requested, and the ARRC granted, a “session delay” to develop compromises with innkeeper groups. A

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<sup>139</sup> The Illinois fire code (425 ILCS 60), for example, requires that residential smoke detectors must be approved and be located “on every floor and within 15 feet of every bedroom.” In dwellings constructed after December 3, 1987, they must be hardwired. Maryland requires smoke detectors that “provide an alarm suitable to warn the occupants within the unit”(COMAR 05.02.03.14.).

<sup>140</sup> New construction often must have a sprinkler system. Requirements such as fire doors and fire-resistant materials are usually found only in larger, more public buildings and in new construction requirements.

<sup>141</sup> The most extensive regulatory requirements related to fire were found in Maryland and Vermont:

- Maryland’s requirements principally require safe, unobstructed escape routes. - COMAR 05.02.03.14. -
- Vermont’s requirements included the following:
  - Doors that are maintained in good repair, are smoke-tight when closed, and easily opened.
  - Windows that are easily opened, have minimum dimensions, and are within specified distances of the floor (inside) and the ground (outside), and
  - Stairs that are cleared of combustible materials, meet dimensional requirements, and have a handrail.
- Vermont Department of Labor and Industry, *Opening and Operating a Bed and Breakfast in Vermont.* -

compromise was struck to allow battery-operated smoke detectors in existing facilities.<sup>142</sup>

### 3. Health Codes

Health codes focus primarily on public health, particularly with respect to food. Their scope is largely limited to such home-based businesses as Bed & Breakfasts, caterers, and home-based manufacturers of food products.<sup>143</sup> Potential burden arises primarily from two sources:

- Health codes usually were written with industrial or commercial facilities in mind, and the occasional odd requirement simply does not fit the home kitchen.<sup>144</sup>
- Health codes may define “food” and “food processing” very broadly,<sup>145</sup> so that provisions may apply to activities where they yield little benefit.

The occasional difficult provisions could easily be clarified or modified for home-based food preparation, but this evidently has not been thought of. As it is, there appears to be little enforcement of these provisions in home-based businesses. Thus actual burdens are not widespread and appear to be relatively minor.

### E. BURDENS

Conventional regulations by state and local governments have only occasional and minor burdens specific to home-based businesses. Impacts are often mitigated by an accommodating degree of flexibility.

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<sup>142</sup> Iowa Administrative Rules Review Committee, *Meeting Briefings*, 6/7/2001 and 1/8/2002.

<sup>143</sup> Day care homes have their own simplified requirements for food handling, in place of the general health codes.

<sup>144</sup> Examples of how this can play out are found in the California Health and Safety Code:

- No pets are allowed, not just in the room but in the *establishment*.
- All floors must be capable of being “flushed... with water.”
- Floors of toilet-rooms must have similar properties and “shall be washed and scoured daily.”
- Depending on the exact meaning of “reside” and “place,” the statute may prohibit any home-based business related to food. - Section 111970, Section 111985, Section 112000, and Section 112035.

<sup>145</sup> “Food,” as used in this chapter, includes all articles used for food, drink, confectionery, or condiment, whether simple or compound, and all substances and ingredients used the preparation thereof.

“Food processing establishment”... shall mean any room, building or place or portion thereof, maintained, used or operated for the purpose of commercially storing, packaging, making, cooking, mixing, processing, bottling, canning, packing, slaughtering or otherwise preparing or handling food except restaurants.

- California Health and Safety Code, Sections 111950 – 112055; 17 CCR 12245 – 12280.

## VI. ZONING

### A. PURPOSES OF ZONING REQUIREMENTS

Zoning regulations enhance the quality of life by controlling and separating different land uses. Broad zoning classifications include:

- Agricultural, rural, and conservation zones;
- Residential zones;
- Commercial or business zones;
- Industrial zones;

Sub-classes within each major class are differentiated by density and/or specific type of use allowed. Larger jurisdictions have mixed-use zones as well. Buffer zones that add distance to the separation of land uses. Overlay zones serve specific purposes (e.g., historic preservation) that are different from land uses.

Residential zones are of primary interest for this study. Maintaining the residential character and quality of life (not to mention property values) is the general purpose of residential zoning. Residential sub-zones differ primarily by the density of development (dwellings per acre or square feet per lot) and by the types of dwellings allowed (single-family, two-family, multi-family). Among the objectives of residential zoning are:

- Maintaining the residential character and appearance of a neighborhood;
- Minimizing traffic, in terms of both circulation and parking; and
- Preventing other negative impacts.

Zoning regulations define permitted land uses in different zones. A home-based business is a commercial (or borderline industrial) land use in a residential neighborhood. In the past, the conflict between commercial land use and residential land use has been resolved by prohibiting home-based businesses. Where zoning codes have not been changed, home-based businesses are still in danger of being discovered and shut down.<sup>146</sup>

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<sup>146</sup> A recent episode from Michigan provides an illustration:

Discretion is not always possible for Leelanau County's local zoning administrators... If somebody files a complaint that one of their neighbors may be violating the township's Zoning Ordinance, local officials feel compelled to at least investigate the issue. It's not a perfect system, but it takes into account that neighbors who get along require less zoning enforcement. Even if the zoning infractions tantamount to going 26 mph in a 25 mph zone, zoning administrators can be compelled to act – especially if the complaining neighbor insists.

Over the last 15 years or so, however, most zoning codes have been revised to accommodate home-based businesses to some extent. While prohibition is still used with certain types of business, zoning codes now typically regulate home-based businesses by placing restrictions on their operations and by designating the specific zones in which they may operate.

The question is whether the restrictions that have been devised are necessary to achieve the purposes of residential zoning or whether they are unnecessarily strict in a way that adversely affects home-based businesses.

## **B. ZONING PROVISIONS**

For the case studies, we downloaded and reviewed zoning ordinances, with particular attention to “home occupations” (the principal class of home-based businesses). Some types of home-based business, including Bed & Breakfasts and day care, are treated as separate categories in zoning codes. These two categories are businesses onto whose premises the public comes.

Restrictions on home-based businesses used in zoning codes reviewed in this study can be classified into the following groups:

- Regulation of the residential character and outward appearance of a dwelling and lot;
- Restriction of the traffic flow and maintenance of parking;
- Prohibition of external effects on adjacent properties and the neighborhood; and
- Prohibition of certain types of business.

### **1. Residential Character and Outward Appearance**

Zoning codes use various provisions to maintain the residential character of the neighborhood and restrict changes in appearance. These include:

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That’s exactly what happened recently in Suttons Bay Township, where a woman was quietly operating a small home-based business in a residential district. Her neighbor complained even though he would have never known the business was there had it not received some positive ink in this newspaper for winning an industry award. Still, the complaining neighbor was right – employing people from outside the home amounted to a Zoning Ordinance violation.

The process, however, went on for several months as the business owner filed an appeal and sought a zoning change with the planning commission. While those efforts failed, they did buy her time to find another location without having to shut down.

- “Zoning Ordinances and Speed Limits,” *The Leelanau Enterprise*, 11 September, 2003, p. 4.

- Requiring that the business use be secondary or incidental to the residential use;
- Restricting physical changes to the dwelling;
- Restricting outdoor activities;
- Restricting signage; and
- Restrictions on commercial vehicles.

a. Secondary, Incidental Use

**Resident Business Owner.** Virtually all codes require that the dwelling is the principal residence of the business owner, and most allow unrestricted employment of residents of the dwelling. A business owner may not purchase a residence and convert it into a business without living there. This is virtually the definition of home-based business.

**Accessory Buildings.** Zoning codes are not consistent in their treatment of accessory buildings and garages. Some zoning codes prohibit their use. Others strongly encourage it or designate accessory buildings for storage. Rarely is any underlying purpose or benefit stated. Unless there is such a reason, a prohibition on accessory building use seems inappropriate.

**Space Allowed.** Most zoning codes restrict the space that a home-based business may occupy. Some jurisdictions measure the space allowed for use as a percentage of livable space; Others use square feet as an alternative, or additional, measure.<sup>147</sup> There is considerable imprecision and variability about what this space limitation means.

- Zoning codes differ on whether accessory buildings or unfinished cellars are included in the base of the percentage or not.<sup>148</sup>
- The consistency of use is virtually never addressed.<sup>149</sup> It is clear that the meaning of space is much more expansive than the I.R.S. definition of a deductible home office.

Since the space limitation is generally meant as an upper limit and an indicator of secondary use, these elements of imprecision are probably not a real issue. Twenty-five percent

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<sup>147</sup> In the jurisdictions reviewed, this ranges from 25 percent of the floor space (common in Illinois) to “a minority” of the space (found in Vermont). Where square footage is used, the allowable space is typically 250 sq. ft. to 400 sq. ft. A few jurisdictions have much tighter restrictions; Chicago’s is 10 percent of a single-family dwelling and 15 percent of a unit in a multi-family dwelling. On the other hand, some jurisdictions (e.g., the District of Columbia) allow more space for certain specific uses such as an art studio or child day care.

<sup>148</sup> The most common practice is simply not to mention such spaces either way. Some jurisdictions (especially in Maryland) do specify, but what they specify varies. In a few instances (mostly rural) a much larger area is allowed in an auxiliary building than in a dwelling.

<sup>149</sup> Presumably the limitation applies to space that is set up for the business, but one wonders how the time-honored kitchen (or dining room) table is counted.

seems reasonable, but much tighter restrictions probably are not. Applying a percentage to all finished living space appears appropriate, but allowing unfinished cellars or accessory buildings to be used in addition seems reasonable as well.

#### b. Physical Changes

Restrictions on physical changes vary enormously among local jurisdictions. This is one area in which the more severe restrictions are clearly excessive.

- At one extreme, some zoning codes have broad performance restrictions stating that the residential character of the dwelling must be maintained.
- At the other extreme, zoning codes prohibit any exterior physical change, and some codes prohibit internal changes as well.<sup>150</sup>
- Zoning codes also have intermediate restrictions, such as prohibiting:
  - ◆ Any major structural change to the exterior, or
  - ◆ Specific exterior changes such as new entrances, additional bathrooms, or handicap-accessible doors.

Any blanket prescriptive prohibitions are probably inappropriate. Particularly in older neighborhoods, residences are always being remodeled. Such remodeling often involves additions, new rooms, new entrances, and new bathrooms, among other things. As people age and become infirm, wheelchair ramps begin to appear as well. To prohibit the same type of remodeling and additions that are typical of residences is excessively strict.

Design is the real issue. Remodeling for a home-based business should be essentially indistinguishable from residential remodeling in the same neighborhood. Compliance can be reviewed in a building permit process.

#### c. Outdoor Activities

Many zoning codes specify that all business operations must take place inside the dwelling, not outside. Many prohibit outdoor storage and/or outdoor displays. Chicago prohibits construction or landscaping companies that store materials or equipment on the premises.

Outdoor storage certainly has eyesore potential. If something is unobtrusive enough to have no visual impact, it probably could be stored indoors. This prohibition seems appropriate.

Outdoor displays are designed to attract attention. They are inherently and intentionally obtrusive. Thus prohibition appears to be a reasonable policy decision.

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<sup>150</sup> The District of Columbia strikes a balanced by prohibiting changes that would make it difficult to return the space to residential use.

Absolute prohibition of outside operations (on the premises) is probably too broad, as some types of operations could be performed outside quite unobtrusively. Specific uses can be accommodated, if the need arises. Talbot County, MD, which lies on the eastern shore of Chesapeake Bay, for example, allows home-based operations that repair boats in the most rural zones, thereby accommodating local watermen.

#### d. Signage

**Restrictions.** Restrictions on size – usually a square foot or two – are common. Signs are typically required to be flush-mounted on a wall, rather than free-standing. Some codes prohibit features that would attract attention, such as illuminated, flashing, or moving signs.

Such restrictions appear to be designed to allow customers who intend to come to a business to find it, but not to attract attention or to draw drop-in customers. That objective is reasonable, and the restrictions described above appear to be a reasonable means of attaining it.

**Prohibition.** Some zoning codes prohibit any signage except for residential signs. A few zoning codes also prohibit publishing the business address in a telephone listing or any print advertising. Such prohibitions are part of a strict “no visible evidence of a business” approach.

A no-impact approach makes it easier to justify allowing home-based businesses. Yet many businesses will be at least inconvenienced if customers cannot readily identify their places of business. If “no visible evidence of a business” is a real community preference, prohibiting signage makes sense. Zoning authorities should verify that these are the community values.

#### e. Commercial Vehicles

Commercial vehicles parked in front of a house have a distinct visual impact; they are far more intrusive than signage. Zoning codes deal with this impact in several ways, which include:

- Restricting the size of any vehicle, typically to one-ton capacity;
- Restricting the type of vehicle to a passenger vehicle, typically specified as no more than a mini-van, pick-up, or SUV;
- Restricting the signage on a commercial vehicle, either:
  - ◆ Limiting signage to a logo or simple door-panel identification, or
  - ◆ Prohibiting it altogether;
- Imposing off-street, out-of-sight parking requirements; and/or
- Restricting use of the vehicle, such as loading or unloading or temporary storage of equipment (e.g., landscaping equipment on a flat-bed truck or trailer).

Each of these approaches strikes a different balance, since each approach addresses a different aspect of the visible impact. Few home-based businesses require a heavy-duty vehicle.

Some would benefit from signage on a vehicle, but they could use removable signs. Most (but perhaps not all) businesses would not need to load or unload a vehicle at the premises.<sup>151</sup> How to deal with commercial vehicles is a genuine policy question involving neighborhood preferences. Some combination of the above measures seems reasonable.

## 2. Traffic

Traffic generation and parking is a real hot-button issue for home-based businesses. There are four aspects of this larger issue:

- Customer traffic;
- Deliveries;
- Employee traffic;
- Parking.

Most zoning codes appear to treat these as separate issues.

**Customer Traffic.** There are basically two types of provisions that zoning codes use to control clients and other “visitors” to home-based businesses:

- Some zoning codes place restrictions on visitors, including limits on:
  - ◆ The number of visitors per day,
  - ◆ The number of visitors who may be on the premises at any one time, and/or
  - ◆ The hours that visitors may come.
- Some zoning codes use a standard that focuses on impacts or limits visitors to what is normal for the neighborhood.

Restrictions on visitors are an extremely blunt regulating instrument. Many factors influence a visitor’s impacts -- the visitors’ mode of transportation,<sup>152</sup> the density of development of a neighborhood, the availability of daytime parking, and how long a visitor stays. Except for restrictions on evening hours, zoning codes that specify visitor limits disregard these factors. In extreme definitions of “no-impact” home occupations, *no* visitors are allowed.

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<sup>151</sup> Prohibitions on outdoor storage reduce the probability that materials or equipment will be loaded or unloaded at the premises, but the same prohibitions may induce a business person, such as a landscaper, to leave a loaded vehicle *in front* of the premises. Perhaps ironically, one zoning code requires materials to be delivered by the owner’s vehicle – as opposed to a much larger commercial truck.

<sup>152</sup> Many zoning codes have a blind spot about visitors. California zoning codes tend to restrict pedestrian and vehicular visitors equally. Yet a visitor who arrives on foot (probably having taken public transportation) and one who arrives by car have very different impacts.

A performance standard is far more flexible. An appropriate general standard would appear to be the level of visitor impact generated by a single household. In reality, most home-based businesses draw far fewer visitors, in a less concentrated manner, and at a more convenient time of day than the average residential party. The root problem – if one exists – is parking.

**Deliveries.** Deliveries are restricted to minimize impacts such as large trucks and double-parking. Zoning codes limit the number of deliveries and occasionally the size of the truck.<sup>153</sup> Most often they restrict deliveries to the U.S. Postal Service or commercial carriers like FedEx or UPS. This provision functions like a well-designed performance standard. Commercial carriers already serve residential neighborhoods. Their deliveries are self-limiting, both in frequency per day and in the bulk of what is carried.

**Employee Traffic.** Most zoning codes allow only one non-resident employee per business<sup>154</sup> or else prohibit them entirely. In a few instances (e.g., a home-based medical office) a second non-resident employee is allowed, and in even fewer instances a third employee or even fourth (part-time) employee is allowed. The limitation on non-resident employees is almost always stated in terms of the *number* of “employees.” In most cases, making up one full-time equivalent out of two or three part-time employees (who come at different times) is not allowed.

A few zoning codes restrict only the number of employees working on the premises, implying that more employees may work elsewhere. Most zoning codes do not address – and appear not to have considered – this possibility. It seems probable that most large home-based businesses rely on this gray area.

Virtually no reasons are ever given in the code for the employee limitation. The most likely explanation appears to be inertia – zoning codes are still behind the learning curve – or a general sense that non-resident employees are somehow inappropriate.<sup>155</sup> Parking is the most likely impact of a non-resident employee, although an employee who works on the premises need not have an impact on parking.<sup>156</sup> Not all employees drive to work. Moreover, many employees could telecommute most of the time, working in his/her own home. Many businesses inherently involve working off the premises; others could arrange to operate mostly that way.

There are essentially three ways that a home-based business can deal with employee restrictions:

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<sup>153</sup> Examples of such restriction are no more than 2 axles and no more than 10,000 pounds gross vehicle weight.

<sup>154</sup> More often than not, codes allow (or fail to prohibit) more than one home-based businesses to be located in one residence, so long as the cumulative effect is not to violate the restrictions. In this case, there may be multiple employees present – one for each business.

<sup>155</sup> One rationale (encountered in Vermont) is that what the enabling statute provides for is a resident to run a business in his own home, with the implication that no *non*-resident employees are authorized. In some cases (e.g., Maryland) where the concept of a no-impact business has been emphasized, a non-resident employee is excluded from the definition of no-impact because *some* impact would result. Local jurisdictions adopt such provisions.

<sup>156</sup> An employee may create no larger an impact than any other visitor. An employee needs parking for the whole work day, but the need for parking occurs during the time when this need interferes least with residential parking. Parking and traffic impacts do not justify a jurisdiction-wide prohibition or limit on non-resident employees.

- It can ignore the law and expand in violation of zoning restrictions.
- It can move into a non-home-based facility “early” – when it reaches the zoning limit, rather than when it outgrows the home base.
- It can adapt to the zoning restrictions and organize itself to stay small.

The employee restriction may be a serious – perhaps critical – limitation on the ability of a home-based business to grow and thrive. It defeats the policy objective that home-based businesses serve as business incubators. Flexibility or small scale of operations may make it more efficient to hire several different part-time employees rather than one full-time employee. The initial growth – adding a second, third, and fourth employee – and the flexibility of part-time employees with different skill sets are precisely what zoning regulations typically prohibit. The normal path for a business is to stay in place until it outgrows its facilities and then move in order to expand. Moving early can unnecessarily consume a business’s resources and income at an early stage in its growth.

**Parking.** Parking needs of home-based businesses are clearly a major zoning concern. Zoning codes address this issue in several ways (listed below in roughly increasing order of flexibility):

- Require off-street parking for visitors;
- Build extra parking space into the zoning requirements for home occupation;
- Require that the cumulative demand for parking of the residence and the home-based business combined not exceed the residential zoning requirements for parking; or
- Prohibit the diversion or use of residential parking when it is needed as such or require that home-occupation parking not exceed normal residential levels.

In low-density residential zones, street parking opens up during the day as commuters leave the neighborhood. Specific requirements (off-street parking or requiring more spaces) or limits on parking are not necessary.<sup>157</sup> Specific requirements such as off-street parking can have unintended consequences,<sup>158</sup> and limits on parking related to home-based businesses may be the

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<sup>157</sup> Rural areas are an exception, because two-lane roads have no parking lanes. Off-street parking is a necessary matter of safety, but it also is readily available.

<sup>158</sup> Requiring off-street parking may result in building highly visible paved off-street parking, which is hardly a more desirable solution than street parking. Some savvy jurisdictions have recognized this and have required screening or prohibited off-street parking in the front yard.

wrong solution for a problem.<sup>159</sup> Prescriptive requirements can be more restrictive than is necessary and less flexible than is possible.

Limiting combined (residential and business) demand for parking is more flexible. A performance standard keyed to normal residential levels of parking is even more flexible. If daytime parking is plentiful, the standard requires no action; if impacts of business parking are imperceptible, the home-based business is in compliance. If parking is not available in a residential area, the visitor (or employee) is clearly displacing residential parking, and the business owner must make some kind of arrangement. This approach holds the home-based business owner responsible to take action only when there is a problem.

**Combined Impacts.** The various aspects of traffic impacts are related. Neighborhood impacts of visitors and employees boil down to parking impacts, which are largely a non-issue in neighborhoods with available daytime parking. Most other restrictions are largely redundant and excessive.

### 3. Externalities

**Nuisances.** Most zoning codes have a list of nuisances that are limited or prohibited. Dust, electrical interference, glare, noise, odors, smoke, and vibrations comprise most of the nuisances covered, and most of these are on any given list. These are unquestionably undesirable externalities. The basic question is not *whether* they are restricted but *how*.

At one extreme, some zoning codes prohibit any of these nuisance impacts at all, or any that is perceptible at the lot line. That may be reasonable for some effects (e.g., electrical interference or vibration) but not for others (e.g., noise, odors, and smoke). It could, for example plausibly prevent a professional musician from giving lessons or practicing at home. .

Another approach is to prohibit such effects when they are caused by equipment used in the business. That addresses the problem. It may be both inadequate (some effects may come from other sources) and overly strict (equipment may have minimal but perceptible effects). Some zoning codes restrict the type of equipment used to residential or “hobby” equipment.

A more general approach, which is fairly widely (if unevenly) used, is to prohibit nuisance impacts that are “objectionable” or “obnoxious” or that exceed the levels normally found in a residential neighborhood. This seems more equitable. Yet it may be a little too permissive, when one considers the amount of noise emitted by the average lawn mower, leaf blower, power saw, or bagpipe. The characteristic (objectionable or obnoxious) is also important. The average fireplace chimney or barbecue emits copious, odoriferous smoke that is a fairly significant pollutant. Yet most people find these odors pleasant, rather than obnoxious.

The best performance standard would appear to have both a level component and a quality component. For example: Dust, electrical interference, glare, noise, odors, smoke, or

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<sup>159</sup> Where the proximity to transit nodes leads people to park during the day, the situation can be better addressed by residential permits that limit the hours of – or in extreme cases prohibit – non-resident parking. These restrictions either make home-based business visitors park relatively briefly or the business will have to make some arrangement (such as off-street parking). Focusing on home-based businesses does not deal with the real problem.

vibrations caused by a home occupation shall not exceed levels normally found in that residential zone, nor shall such effects be inherently objectionable or obnoxious.

**Hazards.** Hazards are serious. Zoning codes usually do not allow hazardous substances to be stored, much less used, on the premises. Some zoning codes generally prohibit hazardous materials; others enumerate the kind of materials.<sup>160</sup> Most communities appear to believe that hazardous substances should not be in a residential neighborhood – at least not in significant quantities or for other purposes than household uses. Banning them from use by a home-based business seems quite appropriate.

#### 4. Prohibitions of Types of Businesses

Some zoning codes have long lists of prohibited businesses. They are prohibited because they contribute to some of the impacts discussed above, and also for other factors as well.

**Retail Sales.** Regular retail shops are almost universally banned for a variety of substantive reasons.<sup>161</sup> Many zoning codes then backtrack to consider what types of retail might be suitable and acceptable. The candidates include:

- Sale of goods made on the premises;<sup>162</sup>
- Mail order sales,<sup>163</sup> and
- Telephone sales.<sup>164</sup>

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<sup>160</sup> Combustible materials, explosive materials, and highly flammable liquids make up a common short list. Corrosive, radioactive, and toxic materials are more exotic additions. Frequently a zoning code will cite a regulatory standard for further precision as to what is covered.

<sup>161</sup> Retail sales could create serious congestion and parking problems in a residential neighborhood, not to mention noise and other nuisance impacts. In order to become successful, a shop could have to use the sort of displays that attract attention. Delivery by intrusive types of trucking could be an issue.

<sup>162</sup> These are usually handicraft or art works, are often allowed. The production processes tend not to generate nuisance impacts beyond the property line. Such goods are not usually made in very large volume, nor do they sell to a mass market, so that this type of good is likely to produce low levels of traffic. The home is an excellent place for a small gallery of products. The scale of everything works together here.

<sup>163</sup> These are low impact because the customer does not come to the business either to place the order or to pick up the product. If the operation grows, there may be bottlenecks for storage and pick-ups and deliveries will increase, but these are likely to be relatively unobtrusive.

<sup>164</sup> These are fairly similar to mail order sales in that they minimize customer contact and the front end. Delivery may be made by mail, or the customer may come to the business to pick up – and to look at more of the line. That is the type of purposeful visitor that many zoning codes make allowances for. This pattern works particularly well for consumable goods like cosmetics, where the customer has an opportunity to make choices in the shop and then reorders by telephone for mail delivery.

This type of specialty sale, which does not involve repeatedly going into the shop is the sort of sale that zoning codes are most likely to allow.

**Motor Vehicles, Equipment, and Body Work.** Anything to do with motor vehicles – repair, servicing, painting, body work, detailing, or storing – or other major equipment is typically prohibited. This prohibition is extended to appliances – at least large ones – and to such businesses as machine shops and welding. Vehicles are too big all to be stored inside. The work is noisy. It may be smelly, smoky, and dusty, and it may cause glare and even vibration. Painting should be done in a paint booth. And the whole thing is likely to be an eyesore.

**Animals.** Stables, kennels, and animal boarding; animal hospitals and veterinarian offices; and grooming and pet care operations all tend to be prohibited.<sup>165</sup>

**Large Facilities.** Some businesses are just out of scale with a neighborhood or draw too many people at one time for a neighborhood to absorb. Examples include restaurants, funeral homes, crematoria, warehousing, and wholesale distribution.

**Mixed Cases.** Some types of business are prohibited in some jurisdictions but expressly allowed in others. Businesses such as barber shops, beauty parlors, fortune telling, and nail salons are places where people traditionally congregate and which typically have a stronger visual presence than is acceptable in a residential neighborhood. Yet they are allowed as home-based businesses in some places (e.g., DC).

Medical offices, including dentists, optometrists, podiatrists, and other specialties that can operate effectively in one-professional offices are prohibited in some places but allowed to be run as home-based offices in others. There are pros and cons to medical offices:

- **Con.** Medical offices generate a steady, if modest, stream of clients throughout the day – typically more visitors than zoning laws allow. They almost certainly require one outside employee and may require (and be allowed) two.
- **Pro.** A medical office seems to be an ideal home occupation. It typically requires no exterior change (although a second outside door might simplify the internal flow of people) and has no outside activities or storage. The equipment is not noisy, nor does it generate other nuisance impacts. Moreover, for seniors it is a great convenience to have medical offices in the neighborhoods.

**Observations.** The rationale for prohibiting some activities is clear and convincing. For some that are generally prohibited, the inappropriate aspects may be much less serious in some zones, so that a jurisdiction-wide prohibition may be too strong. For other kinds of businesses that are treated in different ways in different jurisdictions, the community values seem possibly to be in force.

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<sup>165</sup> Large animals need a great deal of space. Smaller animals – dogs in particular – can be a serious public nuisance on the basis of noise alone. Animals in numbers substantially greater than one household's pets are not appropriate to a residential neighborhood.



## C. INTER-ZONE VARIATION

In principle, the purpose for defining different residential zones is to tailor zoning restrictions to differing conditions that result in different impacts of the same activity. As has been discussed above, visitor impacts of a home-based business are inversely related to the availability of parking, which (in turn) is inversely related to the density of development. The empirical question is whether parameters and restrictions on home-based businesses actually do vary among residential zones with different vulnerabilities to impacts.

### 1. Definitions

**Jurisdiction-Wide Definitions.** The parameters and restrictions for a home-based business usually occur in one (or more) of three places in zoning codes:

- They may be part of the definition of a term, such as “home occupation.” By themselves, definitions apply to the entire jurisdiction. This allows little flexibility beyond a permitted/prohibited distinction.
- They may occur as a separate section of a chapter on uses. Such chapters also apply to the entire jurisdiction and are less flexible than definitions.
- They may be defined as part of a list of uses in one zone. Defining a use in one zone only could provide additional flexibility, but typically other zones (e.g., R-2, R-3, and R-4) allow the same uses by reference (e.g., “all uses permitted in Zone R-1”).

**Alternative Definitions.** Some flexibility is added by defining several types of business that are home-based. This can be done in two ways:

- Most zoning codes have categories other than “home occupation.” The different categories of business.<sup>166</sup> Examples include:
  - ◆ Bed & Breakfasts;
  - ◆ Child day care and residential care;
  - ◆ Massage therapy (which has its own set of regulations in Elgin, IL); and
  - ◆ Joint Living and Work Quarters,<sup>167</sup> (found in Los Angeles and Oakland, California).
- Some zoning codes use variant sets of requirements for the same general category of home-based business. For example:

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<sup>166</sup> Zoning codes contain distinct provisions such as length of stay and number of guest rooms (Bed & Breakfasts), or the maximum number of children (day care). Home day care regulations require outdoor play, for example, while zoning codes typically prohibit outside activities for home occupations.

<sup>167</sup> Joint Living and Work Quarters (JLWQs) are home-and-studio lofts – particularly for artists and design professionals – which are located in renovated, disused industrial buildings.

- ◆ Several Maryland local jurisdictions have special classifications of home business.<sup>168</sup>
- ◆ Several other cities and towns have a second class of home occupation that allows more employees and visitors.<sup>169</sup>
- ◆ San Diego County, California, and Talbot County, Maryland, both define a “cottage industry.”<sup>170</sup>
- ◆ Illinois state law provides for two different classifications of home day care.<sup>171</sup>
- ◆ Several California jurisdictions have a smaller version of a Bed & Breakfast.<sup>172</sup>

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<sup>168</sup> For example:

- Frederick County’s and Gaithersburg’s “minor-impact” home business – and Montgomery County’s “registered home occupation” -- allow more vehicle trips per week than “no-impact” businesses. In Gaithersburg and Montgomery County, one employee (instead of none) is also allowed.
- Frederick County’s “professional office” allows two support employees (instead of one).
- Howard County has rural variants of home occupations that allow additional outside employees:
  - ◆ On lots of under 40,000 square feet, up to 2 individuals (up to 1 FTE) may be employed, and
  - ◆ On lots of over 40,000 square feet, up to 4 individuals – may be employed.
- Howard County’s “home-based contractor” allows one more commercial vehicle than usual to be parked and 4 to 12 employee trips per day (depending on lot size) for the specific purpose of parking or picking up vehicles and equipment.
- Montgomery County’s “home health practitioner” allows support staff, up to five patients at any appointment time, parking (if screened), an indoor waiting room, and sale of special prescriptions.

<sup>169</sup> For example:

- Elgin, Illinois’s “conditional home occupation” allows slightly more area, use of an accessory building, an outside employee (instead of none) and more visitors than a regular home occupation.
- Burlington, Vermont’s “conditional home occupation” allows more area, outside employees (instead of none), signs (instead of none), additional visits and parking, and sale of goods fabricated on site.
- Charlotte, Vermont’s “extended home office” allows up to 3 FTEs of outside employees (instead of none) and more vehicle trips.
- Hartford, Vermont’s “home business” allows 2 or 3 outside employees (instead of none).

<sup>170</sup> In both cases, up to three employees are allowed, but the category itself is allowed only in the most rural zones and it requires a special use permit.

- In San Diego County, “hand manufacturing” (defined as use of power tools under 5 hp) is allowed.
- In Talbot County, repair of motor vehicles – including boats – is allowed.

<sup>171</sup> These have different capacities, depending on staffing. Both the City of Carbondale and Lake County subdivide the smaller classification for zoning purposes.

<sup>172</sup> While Bed & Breakfasts in California generally are allowed up to five guest rooms. Nevada County, San Diego County, and Sonoma County allow one or two guest rooms with lesser or no permit requirements, no inspection, and/or lesser parking requirements. Oakland allows up to three paying guests in a home with no regulation.

## 2. Differentiation Among Zones

The stringency of zoning regulations can be varied from zone to zone in essentially two ways:

- Differently defined businesses (restrictions) can be allowed in different zones, or
- Different levels of permissibility can be allowed in different zones for the same definition of a business classification.

### a. Variant Definitions

Different classifications of much the same type of business, with different restrictions, are usually assigned to different zones.<sup>173</sup> Some variant definitions of home occupation are almost special cases. Home occupations are generally allowed in all residential areas; variants are found in only a few. Most of the range of residential zones is covered only by one definition of any type of business. Variant definitions do not allow much flexibility beyond these special cases.

### b. Permissibility

**Approval Processes.** Several different approval processes are used in zoning. These involve different levels of scrutiny and (in inverse order) different degrees of restrictiveness (or certainty). These include (in addition, of course, to prohibition):

- Permitted uses;
- Administrative review;
- Use permits; and
- Variants.

Terminology of permitting is not consistent across counties and cities, even in a single state. The same name for a permit may refer to different processes,<sup>174</sup> or a word may have

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<sup>173</sup> Examples include the following:

- Cottage industries are allowed only in the most rural zones;
- In Maryland, professional offices (Frederick County) and home health practitioners (Montgomery County) are not permitted in some zones where home occupations are generally permitted;
- In Howard County (Maryland) and Hartford (Vermont), different maximum levels of outside employees are allowed in different zones, with more employees being allowed in lower-density zones.
- Howard County allows home-based contractors only in rural and low-density residential zones.
- Elgin (Illinois) allows only residential therapeutic massage establishments in residential zones.

<sup>174</sup> The term “condition,” for example, may refer to the standard zoning code requirements or to the particular requirements of a Conditional Use Permit.

different meanings.<sup>175</sup> Review and permission processes in zoning codes are generally written new for construction, rather than to changes in use. For consistency, the following discussion uses and cites details and code provisions from one jurisdiction, Nevada County (California).

**Permitted Uses** are uses that are in compliance with the zoning requirements.<sup>176</sup> They require submission of a site plan (or plot plan) that is reviewed and approved. There is no permit as such. Approving a permitted use that meets the zoning requirements is automatic; there is no discretion to deny the application.<sup>177</sup>

**Administrative Review** is a somewhat more detailed review process that is used when zoning compliance is somewhat more problematic. It may or may not entail a public hearing. Its basic purpose is to ensure compliance with zoning requirements. The process results in an Administrative Development Permit, which is non-discretionary if the requirements are met.<sup>178</sup>

**Use Permits** (or “conditional use permits”) are required when a proposed use may not fully meet the standard zoning requirements. A use permit also is required when a specific use is classified as an exception, so that discretionary judgment is required. JLWQs and cottage industries fall in this category. Use permits may require “maps, diagrams, plans, elevations, written reports, and other information as prescribed by the Planning Director, necessary to adequately describe the project.” Public notice and a hearing are also required. Some degree of negotiation may be involved and may result in imposition of special conditions of approval.<sup>179</sup>

**Variances** are used when a proposed use is clearly in violation of zoning requirements, but the use is nevertheless reasonable. Other than working through the political process to get the zoning ordinance changed, a variance is the last resort of a potential home-based business.<sup>180</sup>

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<sup>175</sup> To give an example, “permitted” (allowed) may mean the same as “not permitted” (does not require a permit).

<sup>176</sup> “Permitted” uses are also referred to as “allowed uses,” uses that are “permitted by plot plan review,” uses that are “accessory,” uses that (in the case of home-based businesses) are “considered residential,” or uses that are in “zoning compliance.”

<sup>177</sup> “Uses associated with zoning compliance are those determined to be most clearly consistent with the purpose of the applicable district. They provide for the most basic review process.

- Nevada County Land Use Code, Section L-II 5.4.

<sup>178</sup> “Uses requiring a Development Permit are those that are generally consistent with the purposes of the zoning district, but require careful review to ensure compliance with all site development standards of the Land Use and Development Code.”

- Nevada County Land Use Code, Section L-II 5.5.

<sup>179</sup> “PURPOSE. To provide for those land uses that may be appropriate and compatible in a zoning district, depending on the design of the individual project and the characteristics of the proposed site and surrounding area.”

- Nevada County Land Use Code, Section L-II 5.6.

<sup>180</sup> “PURPOSE. To provide a procedure to allow a variation from the strict application of the provisions of this Chapter where special circumstances pertaining to the physical characteristics of the site are such that the literal enforcement of the requirements of this Chapter deprives such property of the privileges enjoyed by other properties in the vicinity and under identical zoning classification.”

- Nevada County Land Use Code, Section L-II 5.7.

**Findings.** Permissibility of different uses for the 38 local jurisdictions in 5 states that were included in the case studies is shown in Exhibit 15. There is a fairly clear pattern:

- **Home Occupations.** In the overwhelming majority of local jurisdictions, home occupations are permitted in all residential zones. In most other cases, they are conditional (administrative review) uses in all residential neighborhoods.
- **Day Care Homes.** In the overwhelming majority of local jurisdictions, child day care homes are permitted in all residential zones. Most cases where they were conditional or special use were in denser zones.<sup>181</sup>
- **Bed & Breakfasts.** Bed & Breakfasts have the most variety and are likely to be restricted or prohibited.<sup>182</sup>
- **Alternative Definitions of Home Occupations.** Other classifications are often special cases in a few zones and are likely to be conditional or to require use permits.

### 3. Flexibility

The composite picture for home occupations in the local jurisdictions reviewed is that the same definition usually applies in all residential zones. Home occupations are sometimes reviewed to ensure that they comply with the regulations but almost never are subject to the depth of review that could have allowed negotiation of less stringent requirements. Some alternative definitions of home occupations relax some standards – particularly with respect to traffic – but they apply to the relatively small segment of the population in rural areas. Child day care homes are much the same. Size definitions are the only distinguishing characteristic that involves differences either between zones or in type of review and degree of permissibility.

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<sup>181</sup> It appears that the zoning authorities want to review whether the home would meet the licensing requirements. The occasional zones where day care homes are not allowed at all are in the most rural zones in a jurisdiction.

<sup>182</sup> Patterns for Bed & Breakfasts include the following:

- Overall, they were much more likely than home occupations not to be permitted outright or not to be allowed at all.
- As a classification, they were far more likely to be subjected to different levels of review in different zones of the same jurisdiction.
- In several jurisdictions, a smaller Bed & Breakfast was allowed in more zones and/or subject to less review than the regular definition of Bed & Breakfast.
- In Vermont, where tourism is important, they were very rarely prohibited and were never required to have special use permits.
- In California, they were not permitted outright in any zone of any local jurisdiction, and they often required use permits. Moreover, in some local jurisdictions they were (by definition) allowed only in historic buildings.
- Bed & Breakfasts were the only major business classification that was not mentioned in some zoning codes – Contra Costa County (California) and Chicago (Illinois).

**EXHIBIT 15  
TYPE OF APPROVAL FOR HOME-BASED BUSINESS USES**

	<u>Home Occupations</u>	<u>Child Day Care Homes</u>	<u>Bed &amp; Breakfasts</u>	<u>Other Classification</u>
<b>District of Columbia</b>	P	P	P	
<b>California</b>				
Contra Cost County	P	P	a	a
Merced County	P	P/AR <sup>b</sup>	N/SU/N/N <sup>c</sup>	a
Nevada County	P	P/AR <sup>b</sup>	SU	a
Orange County	P	P	SU	a
San Diego County	P	P	SU/N/N/N <sup>c,d</sup>	SU/N/N/N <sup>e</sup>
Siskiyou County	SU	P	N/P/N/N <sup>c</sup>	a
Sonoma County	P <sup>f</sup>	P	SU <sup>g</sup> /N/N/N <sup>c</sup>	a
Angels Camp	P	P/UP <sup>b</sup>	SU	a
Bakersfield	SU	P	SU	a
Chico	P	P	SU	a
Long Beach	P	P	N/N/SU/N <sup>c</sup>	a
Los Angeles	P	P	SU	a
Oakland	P	P	P	a
Redding	P	P	AR	a
San Jose	P	P	SU	a
<b>Illinois</b>				
Lake County	P	P/AR/AR/AR <sup>c</sup>	P	a
Sangamon County	P	P	AR	a
Will County	P	SU	SU/N/N/N <sup>c</sup>	a
Carbondale	P/SU/SU/SU <sup>c</sup>	P	SU/SU/P/P <sup>c</sup>	a
Chicago	P	P	a	a
Elgin	P	P	N	a
Peoria	P	P	N/SU/SU/SU <sup>c</sup>	a
<b>Maryland</b>				
Frederick County	P	P	P	N/N/SU/SU <sup>i</sup>
Howard County	P	P	P/AR/AR/AR <sup>c</sup>	j
Montgomery County	P <sup>k</sup>	P	SU <sup>l</sup>	P/SU <sup>m</sup>
St. Mary's County	P	P	P/P/P/SU <sup>c</sup>	a
Talbot County	P	P	AR/SE <sup>n</sup>	SE/N <sup>o</sup>
Baltimore City	P	P	N/N/N/P <sup>c</sup>	a
Cumberland	P	P	P/N/P/P <sup>c</sup>	a
Gaithersburg	P <sup>k</sup>	P	P	a
<b>Vermont</b>				
Burlington	P	P	N/N/AR/AR	AR <sup>p</sup>
Charlotte	P	P	AR	P
Hartford	AR	N/AR <sup>n</sup>	P <sup>q</sup>	AR
Montpelier	P	P	AR	a
Thetford	P	AR	AR	a
St. Johnsbury	P	N/AR/AR/AR	P/N/N/AR	a

KEY: P = Permitted AR = Administrative Review U = Special Use Permit N = Not allowed at all.

<sup>a</sup> None mentioned in zoning code.

<sup>b</sup> Refers respectively to: Small Family Day Care / Large Family Day Care

<sup>c</sup> Refers respectively to zones that are: Agricultural-Residential / Low-Density Residential / Medium Density Residential / High-Density Residential.

<sup>d</sup> Host Homes, which may have up to three paying guests, are permitted in all zones.

<sup>e</sup> Cottage Industries.

<sup>f</sup> Home occupations with one non-resident employee are allowed with a special use permit.

<sup>g</sup> Bed & Breakfasts with one guest room are a permitted use.

<sup>h</sup> Allowed with administrative review in Residential/Commercial Zones 2 & 3.

<sup>i</sup> Professional offices.

<sup>j</sup> Registered Home Occupations are P/AR/AR/AR. Professional Offices are N/AR/AR/N. Contractors are P/P/N/N.

<sup>k</sup> Major impact home occupations are allowed with a special use permit.

<sup>l</sup> Bed & Breakfasts with 1 or 2 guest rooms are a permitted use in low-density & medium-density residential zones.

<sup>m</sup> Home Health Professionals permitted if Permitted ≤ 5 visits/week, no outside employees, and no discernible impact on the neighborhood. Otherwise, special use.

<sup>n</sup> Refers respectively to: Rural Residential / Town Residential.

<sup>o</sup> Cottage industries are allowed in rural conservation zones only.

<sup>p</sup> Home business or extended home office.

<sup>q</sup> AR in non-village residential

The overall picture of zoning restrictions on home occupations is that one size fits all residential zones. Making all home occupations subject to the same zoning restrictions regardless of characteristics of the residential neighborhood clearly is preferable to prohibiting them altogether. Yet there remains a great deal of scope for regulatory flexibility – for further relaxation of restrictions without perceptible impact on residential neighborhoods.

#### **D. QUASI ZONING UNDER REAL ESTATE LAW**

In the last two or three decades, home-owner associations and condominium associations have become a major factor in new residential development and condominium conversion of older rental buildings. Covenants, set up when the area is developed or the building is converted, often prohibit home-based businesses. Compliance becomes a condition stated in the deed and “runs with the deed.” These covenants are nominally private and voluntary contracts that fall under real estate law. Home-occupation legislation usually does not mention them – even if such state legislation exists – and provides no authority to override such restrictive covenants. Similarly, local zoning codes cannot override home-owner association prohibitions of home-based businesses, since contracts take precedence over more broadly applicable local land use regulations.

A similar situation can occur with leases. Landlords can prohibit home-based business in the language of a lease. By signing the lease, a tenant enters into a binding contract not to start a home-based business. State legislation and local ordinances respect such contracts.

Restrictive covenants and leases are private-sector analogs of zoning codes. Home-owner association bylaws can be changed by an internal political process, but this is often cumbersome and may require a super-majority. Landlords generally can be forced to change conditions in their leases only by economic pressure. They tend to become more willing to negotiate if they have difficulty renting their properties.

Private-sector agreements have rarely been addressed by any type of regulation or legislation. They are the new challenge for expanding home-based business opportunities.

## VII. POTENTIAL BENEFICIAL STATE INTERVENTIONS

State law gives local jurisdictions their authority to regulate land use. State law also governs private contracts that affect home-based businesses and their economic environment. If the political will to do so exists, states can curb local prohibitions and restrictions on home-based businesses in both the public and private sectors.

### A. LIMITS ON ZONING AND QUASI ZONING

The case studies encountered several state statutes that took the initiative to override local prohibitions of home-based business. These are summarized below:

#### 1. Vermont

The Vermont statute is short and to the point:

No regulation may infringe upon the right of any resident to use a minor portion of a dwelling for an occupation which is customary in residential areas and which does not change the character thereof.<sup>183</sup>

The Vermont Secretary of State has articulated a philosophy that recognizes the socio-economic significance of home-based business to the State.<sup>184</sup>

The Vermont statutory language is refreshingly blunt, and the Secretary of State's philosophy is encouragingly supportive. Neither addresses home-owner associations, although these do not appear to be a substantial problem in Vermont. Both provide strong leadership for the towns that enact zoning legislation.

Both the statute and the Secretary, however, are non-committal about employees. The statutory right is that of the resident to conduct an occupation, not to have employees. There is no indication to towns that non-resident employees are acceptable. One town in the study, St. Johnsbury, draws the opposite conclusion. The statute was cited as prohibiting such employees.

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<sup>183</sup> 24 V.S.A. § 4406.3.

<sup>184</sup> Many communities are recognizing that the fastest growing sector of the economy in Vermont is the small and micro-businesses, many of which operate out of people's homes. Bylaws are being written which allow such uses of property and which provide a basic right to conduct a minimal home occupation (generally speaking these are minor uses of the residence that are not detectable from outside the home), but which permit as conditional uses, requiring site plan approval, home industries and home businesses. In this way a community can meet the needs of its residents to work from the home, while ensuring that such occupation will not negatively impact the neighboring properties.

- Vermont Secretary of State, *Vermont Municipal Guide to Land Use Regulation*, June 1, 1998, pp. 60-61.

## 2. California

The California legislature is equally emphatic on the subject of family day care. In quick succession it:

- Asserts providing family day care as a matter of state policy;
- Overrides municipal zoning, building and fire codes, and government regulations;
- Declares any contracts, covenants, or leases that restrict or prohibit family day care to be void.<sup>185</sup>

This statute demonstrates the authority that a state legislature has. Yet this law applies only to family day care. Elsewhere California statutes fail to take a strong position in favor of home-based businesses and tend to be supportive of existing home-owner association bylaws.

## 3. Maryland

Maryland law addresses the issue of restrictive home-owner association and condominium bylaws. It does so less aggressively but more broadly than the previous two examples. The Maryland statute defines the concept of a “no-impact” business<sup>186</sup> and then:

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<sup>185</sup> (a) It is the intent of the Legislature that family day care homes for children should be situated in normal residential surroundings so as to give children the home environment which is conducive to healthy and safe development. It is the public policy of this state to provide children in a family day care home the same home environment as provided in a traditional home setting.

The Legislature declares this policy to be of statewide concern with the purpose of occupying the field to the exclusion of municipal zoning, building and fire codes and regulations governing the use or occupancy of family day care homes for children, except as specifically provided for in this chapter, and to prohibit any restrictions relating to the use of single-family residences for family day care homes for children except as provided by this chapter.

(b) Every provision in a written instrument entered into relating to real property which purports to forbid or restrict the conveyance, encumbrance, leasing, or mortgaging of the real property for use or occupancy as a family day care home for children, is void and every restriction or prohibition in any such written instrument as to the use or occupancy of the property as a family day care home for children is void.

(c) Except as provided in subdivision (d), every restriction or prohibition entered into, whether by way of covenant, condition upon use or occupancy, or upon transfer of title to real property, which restricts or prohibits directly, or indirectly limits, the acquisition, use, or occupancy of such property for a family day care home for children is void.

- California Health and Safety Code, Section 1597.40.

<sup>186</sup> A no-impact business:

- (1) Is consistent with the residential character of the dwelling unit;
- (2) Is subordinate to the use of the dwelling unit for residential purposes and requires no external modifications that detract from the residential appearance of the dwelling unit;
- (3) Uses no equipment or process that creates noise, vibration, glare, fumes, odors, or electronic interference detectable by neighbors; and
- (4) Does not involve use, storage, or disposal of any grouping or classification of materials that the United States Secretary of Transportation or the State or any local governing body designates as a hazardous material.

- Effectively bars new home-owner associations and condominium associations from prohibiting or restricting no-impact home-based businesses – and declares such restrictions unenforceable – unless the members have expressly voted in favor; and
- Requires that a prohibition against no-impact home-based businesses existing in legal documents may be eliminated by a simple majority vote of the eligible voters.<sup>187</sup>

By defining a no-impact home-based business, Maryland has taken a large step toward tipping the balance to an outcome favorable to home-based businesses.

## **B. INSURANCE REGULATION**

Insurance is a regulated industry. Very small businesses have major problems obtaining health insurance at a reasonable price – if at all. They are much too small to be underwritten as anything much different from an individual policy. The Kentucky Commission on Small Business Advocacy described the problem as follows:

In the era of escalating health care costs and shrinking coverage options, small businesses have been the hardest hit of all businesses. On their own, small businesses lack the numbers to assure competitive rates, many lack access to group plans, and currently self-insurance is not an option.

The KCSBA recommends the development of coalitions state-wide to address health care issues and ensure that all small businesses can be a part of larger plans, and have a seat at the table with respect to all issues impacting small business health care plans.<sup>188</sup>

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- An. Code, § 5-6B-01.

<sup>187</sup> “A provision in the articles of incorporation or a proprietary lease or a provision of the bylaws of a cooperative housing corporation (organized after July 1, 1999), which prohibits or restricts commercial or business activity in general but does not expressly apply to no-impact home-based businesses, may not be construed to prohibit or restrict the establishment and operation of a no-impact home-based business. Unless the voters of the cooperative housing corporation have voted expressly to the contrary, the operation of a no-impact home-based business shall be:

- Considered a residential activity, and
- A permitted activity.

A prohibition on the use of a residential unit as a no-impact home-based business is unenforceable unless it is approved by a simple majority of the total eligible voters of the cooperative housing corporation.

If a cooperative housing corporation includes in its articles of incorporation, bylaws, or proprietary leases a provision expressly prohibiting the use of a residential unit as a no-impact home-based business, The prohibition may be eliminated by the approval of a simple majority of the total eligible voters of the cooperative housing corporation, and The cooperative housing corporation must state this in its articles of incorporation, by-laws, or proprietary leases.”

- An. Code, § 5-6B-18.1.

<sup>188</sup> Kentucky Commission on Small Business Advocacy, *Annual Report 2002: Helping Small Businesses Navigate Kentucky’s Regulatory Environment*, December 2002, p. 10.

Maryland has addressed this issue in an unprecedented manner by using regulation of the insurance industry to force insurance companies to consider very small businesses as part of a large group in providing and underwriting health benefit plans.

The Maryland Health Insurance Reform Act<sup>189</sup> requires insurance carriers to issue health plan benefits to each “small employer” that meets certain requirements.<sup>190</sup> The Act was amended to include self-employed individuals who work and reside in Maryland and are organized as a sole proprietorship or any other legal form of organization.<sup>191</sup>

Under the Act, a carrier that offers coverage to a small employer must also offer coverage to all of that employer’s employees and all of their eligible dependents, including employees who work part time and have been continuously employed for at least four months. Employers are required to collect the premiums from each employee and remit them to the carrier, but employers are not required to contribute to the premiums as an employee benefit.

The implementing regulations<sup>192</sup> define the minimum required benefits of a standard health benefit plan. This health insurance may be offered through a variety of types of plans.<sup>193</sup>

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<sup>189</sup> Annotated Code of Maryland, Title 15, Subtitle 12, § 1201 - § 1217.

<sup>190</sup> To meet the basic definition of a “small employer,” a business must have employed at least 2 but not more than 50 eligible employees on at least 50% of the working days in the previous quarter. (An. Code, § 1203(b)(1)(i)) To be covered under a health benefit plan offered by a carrier, a small employer is required to:

- (i) elect to be covered;
- (ii) agree to pay the premiums;
- (iii) agree to offer coverage to any dependent of an eligible employee when coverage is sought by the eligible employee, in accordance with provisions governing late enrollees and any other provisions of this subtitle that apply to coverage;
- (iv) agree to collect payments for premiums through payroll deductions for coverage of eligible employees and dependents and transmit those payments to the carrier; and
- (v) satisfy other reasonable provisions of the health benefit plan as approved by the Commissioner.

- An. Code, § 1209(c)

<sup>191</sup> Additional requirements are that the self-employed individual:

- (i) elect to be covered;
- (ii) has attempted to earn taxable income;
- (iii) who has filed the appropriate Internal Revenue form for the previous taxable year; and
- (iv) for whom a copy of the appropriate Internal Revenue form or forms and schedule has been filed with the carrier.

<sup>192</sup> Code of Maryland Regulations (COMAR), Title 31 Maryland Insurance Administration, Subtitle 11, Health Insurance – Group, Chapter 06 Comprehensive Standard Health Benefit Plan.

<sup>193</sup> These include:

- (1) Indemnity;
- (2) Preferred provider;
- (3) Point-of-Service delivered in conjunction with an indemnity or preferred provider delivery system;
- (4) A health maintenance organization;
- (5) A triple option point-of-service; or
- (6) Preferred provider delivered in conjunction with a medical savings account (PPO/MSA) that:
  - (a) Qualifies under the Federal Health Insurance Portability and Accountability Act of 1996, and

- Carriers must offer coverage for an individual and for an individual, spouse, and dependent, and may offer coverage for other combinations of family members.
- Carriers must calculate a separate community rate for each composition of plan.<sup>194</sup>
- Premiums are age-related, so that the rate is adjusted for the average age of employees of the business, but (for each age) the same rate applies to all plans of the same composition throughout the state. Thus premiums will remain affordable if one person in a plan has a very expensive illness. In a small group, premiums can skyrocket if the premiums for that group are individually experience-based.
- Coverage and premiums also are not affected by an individual’s pre-existing conditions. There may be a waiting period of up to twelve months for preexisting conditions, however, except for health care services for pregnancy or newborns.<sup>195</sup>
- A carrier is required to establish an open enrollment period – a “time interval during which a carrier may not deny coverage, based on health status, to a self-employed individual under the small employer comprehensive standard benefit plan.”<sup>196</sup> This period, which must be at least 30 consecutive days in each 12-month period, has now been defined as the month of December. The regulations include detailed notice requirements about the open enrollment period.<sup>197</sup>

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(b) Is delivered as a high deductible preferred provider plan. (COMAS 31.11.06.01(C))

<sup>194</sup> COMAR 31.11.06.10.

<sup>195</sup> COMAR 31.11.06.11.

<sup>196</sup> COMAR 31.11.07.02(B)(4). Individuals enrolling outside the open enrollment period may be individually medically underwritten.

<sup>197</sup> These requirements include the following:

- (A) At a minimum, notice of each open enrollment shall be published in at least the most widely circulated newspaper that is delivered in the carrier’s service area.
- (B) The notice require in §A of this regulation shall:
  - (1) Be published in at least 12-point type;
  - (2) Be published for at least 14 consecutive days; and
  - (3) Clearly indicate that individual coverage, individual, spouse, and dependent coverage, and any other family compositions which are marketed by the carrier may be purchased under the small group comprehensive standard health benefit plan without medical underwriting.
- (C) Notice of the availability of open enrollment shall also be published in all literature regularly distributed by the carrier describing its available programs and coverage.
- (D) Publication of notice only in the legal section of a newspaper is considered insufficient notice.
- (E) The 14 consecutive days of publication required under §B(2) of this regulation shall occur during the period which begins 30 days before the beginning of the open enrollment period and ends on the fourteenth day after the beginning of the open enrollment period. (COMAR 31.11.07.04)

Maryland's statute demonstrates that obtaining health insurance is an area where state regulation of the insurance industry can be quite helpful to self-employed individuals and other home-based businesses.

## VIII. CONCLUSIONS

Regulations with disproportionate burdens on home-based businesses are concentrated in two areas: 1) Federal Internal Revenue Service regulations and 2) local zoning regulations.

### A. FEDERAL REGULATIONS

**IRS.** Internal Revenue Service regulations account for the preponderance of federal regulatory burden on home-based businesses. Average effort appears to be roughly an hour per week – more for new businesses that have to learn the system – and it falls on all home-based businesses. Burdens arise both from the complexity of the tax code and from specific provisions.

- The tax code treats home offices as commercial buildings, which they are not. 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. Other businesses do not face such requirements.
- The tax code requires that, in order to be deducted at all, a home office must 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.
- Tax code treatment is made more onerous by the fact that the deductibility of other expenses (e.g., utilities and legitimate maintenance) depends on 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.

**Other Federal Agencies.** No other federal agency has regulations with the type of across-the-board impact on home-based businesses that IRS regulations have. Several factors mitigate the burdens of most federal regulations on home-based businesses:

- Most regulations apply fairly narrowly to particular industries, processes, substances, etc. In part because they are based in the home, relatively few home-based businesses engage in activities that are covered by any such regulation.

- Regulations that are related to a job site other than the home (e.g., construction) do not have impacts that are specific to the home base of the business. In this respect, they do not disproportionately burden home-based businesses.

## **B. STATE REGULATIONS**

States are not a major source of regulatory burdens on home-based business. Many of the reasons are similar to those just noted for “other” federal regulations. Some additional factors come into play:

- State income tax requirements piggy-back on IRS filings.
- Professional licensing and related regulations are independent of business location.
- Child care regulations use regulatory flexibility principles for home day care.

Some states have enacted statutes that are supportive of home-based businesses. Expanding support along these lines would be beneficial.

## **C. LOCAL GOVERNMENT REGULATIONS**

Zoning codes in many jurisdictions have been substantially revised over the last decade or so to allow home-based businesses where they previously had been prohibited. This has been a major step forward. Many of these zoning codes, however, still contain stringent restrictions that do not appear to have commensurate benefits to the community.

- Many zoning codes incorporate outright prohibitions or prescriptive requirements or limits on various aspects of home-based businesses (e.g., employees, visitors, parking, exterior changes, or specific businesses). Some zoning codes use more performance oriented provisions relating to the character of the neighborhood, which is a more flexible and efficient approach.
- Few local jurisdictions utilize the different types of residential zones as a means of varying zoning restrictions to reflect different densities and types of residential neighborhood. Jurisdiction-wide restrictions, apparently designed for the most vulnerable neighborhoods, are far more common.

## **D. IMPLICATIONS FOR SMALL BUSINESS DEVELOPMENT**

IRS regulations are particularly burdensome for start-up businesses, which must spend a great deal of effort learning the requirements. Local zoning restrictions are especially restrictive for growing home-based businesses that are taking on employees. Both stages – start-up and growth beyond one person – are critical to the life cycle of a small business, and businesses at these stages of growth bear the greatest regulatory burdens of any home-based businesses.

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Business regulations related to free zone companies. Your business will be governed by the free zone authority in which your business is set up and in some cases might be additionally governed by another government entity. Specific laws relating to the type of business activity you conduct will also govern your business. FAQs.