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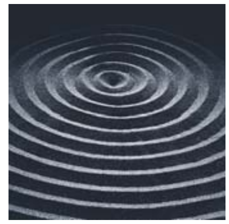

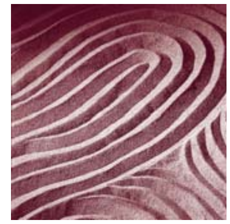

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Tax Considerations For Home-Based Business

Steven R. McLeod
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TAX CONSIDERATIONS FOR HOME-BASED BUSINESS

By Steven R. McLeod

"According to the Canada Revenue Agency (CRA), a principal place of business can also serve personal use."

Operating a home-based business is appealing to many. Avoiding the daily commute, spending more time with family and keeping the stuffy suit (or uniform) in the closet are all attractive prospects. The tax benefits of operating a business from home are also a positive, should the business be eligible to take advantage of them.

Special rules within the federal *Income Tax Act* (ITA) are designed to limit otherwise deductible expenses incurred by home-based businesses. Reigning in these expenses is important to the Canada Revenue Agency (CRA), as there is an enticing opportunity for business owners to deduct expenses that are otherwise personal in nature. Converting a portion of one'sresidence to income-producing use can also impact one's ability to claim the principal residence exemption. The rules discussed in this article are applicable to both franchised and non-franchised home-based businesses.

The main criterion for an individual business owner to deduct home workspace-related expenses is that the business be either a principal place of business or a workspace, used regularly and continuously, for certain business purposes. CRA's *Interpretation Bulletin IT-514, Workspace* in-home expenses, sets out helpful guidelines on how the CRA interprets these two independent tests.

Deducting business expenses—the general principles

Generally, the ITA allows an expenditure to be deducted if made or incurred for the purpose of gaining or producing income from a business or property. The amount to be deducted must be reasonable. Current expenses, unrelated to any part of a taxpayer's residence, are fully deductible if incurred for the purpose of producing income from a business. When computing income, for example, the owner of a home-based franchise cleaning service can deduct amounts paid for detergents and window wipes used in the business. If the business owner made a capital outlay, *e.g.* by purchasing a steam-cleaning machine, then the deductibility of that cost would be governed by the capital cost allowance regime (for depreciation) for depreciable property and the cost would be amortized over several years.

Home workspace-related business expenses

Special rules apply when taxpayers deduct business expenses that relate to part of their residence. Such expenses include property taxes, mortgage interest, operating costs such as heating and hydro, property insurance or even capital cost allowance on the portion of the home relating to the business (although deducting this allowance could impact

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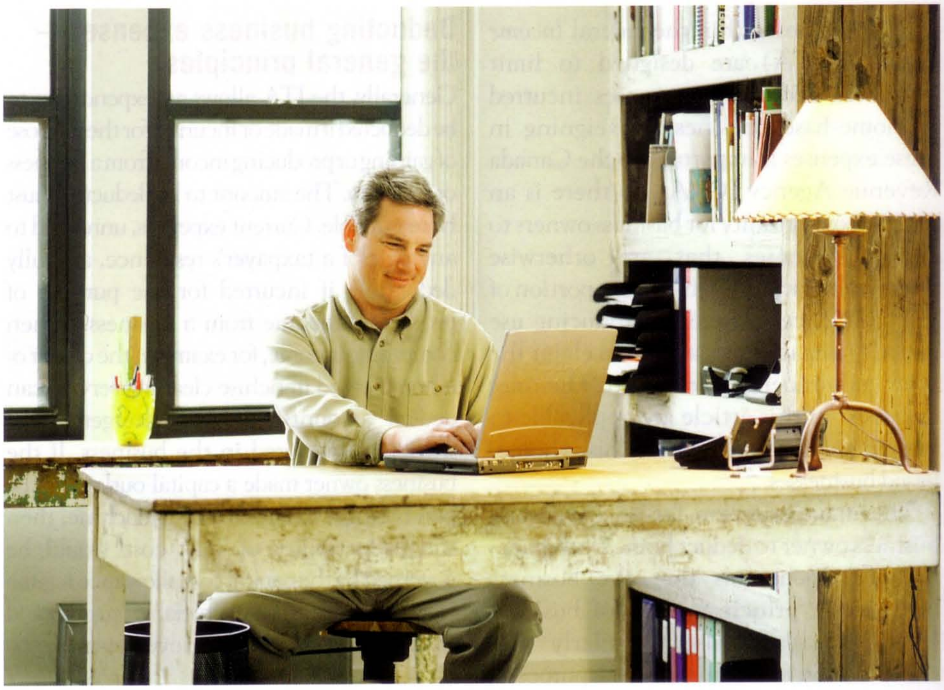

the availability of the principal residence exemption, as discussed below). The ITA does not entitle self-employed individuals to deduct otherwise deductible business expenses which relate to any part of a 'self-contained domestic establishment'[1] in which the individual resides, unless the workspace is one of the following:

1. The principal place of the individual's business.
2. Used exclusively to earn business income, and for meeting that individual's clients, customers or patients on a regular and continuous basis.

Principal place of business

Whether or not a workspace is the principal place of business is relevant if the individual has other business offices, or performs services in respect of the business outside of the home. 'Principal' is not defined in the ITA, but the CRA considers it to be synonymous with 'chief' and 'main.' An example of a principal place of business provided by the CRA in IT-514 would be a room in a residence used for receiving contractor work orders and bookkeeping, while the remaining activities of the business, *i.e.* the performance of contracts, are carried out at the customer's location. The CRA considers this room to be the contractor's principal place of business.

This is a reasonable application of the law, accepted by the courts. Recently, the Tax Court of Canada considered a couple working on fishing boats to have their "principal place of business" in their home office—where paperwork was performed—rather than on the boats. This interpretation also benefits many home-based franchise owners who perform services at their client's locations.

The CRA acknowledges the principal place of business can also be used for personal purposes, and still consider it principal. This means, for example, if a home-based businessperson has a television in his or her room/office, the office will not, by virtue of that, cease to be considered a principal place of business.

Regular and continuous meeting of clients

Should the home workspace not be the principal place of business, expenses related to it may still be deductible if it is used for meeting clients, customers or patients on a regular and continuous basis. What constitutes 'regular and continuous' is largely determined by the nature of the business activity. An example provided by the CRA in IT-514 concerns the circumstances of a doctor. The CRA would not consider a home office used by a doctor in meeting one or two patients a week to be a workspace used on a regular and continuous basis. However, a workspace used to meet an average of five patients a day for five days each week would be in regular and continuous use.

The courts have held that a doctor meeting patients does not require their physical presence in the home office, and

that a meeting can be performed by telephone. In one case, the Tax Court of Canada considered the use of a home office by a doctor who met, on average, one patient a week, but tended to seven patient telephone calls per evening, to qualify as meeting patients on a 'regular and continuous basis.'

Since the special rules described in this article govern the deductibility of home workspace expenditures, a good practice is to maintain a log of the business activities that take place in the residence. In some cases, as when the residence is the only place of business, documenting the activity would not be necessary, as the workspace would be the principal place of business. In contrast, where the home workspace is not the principal place of business, but used on a regular and continuous basis for certain business purposes, documenting the in-home business activity serves as a good defense for substantiating the deductibility of related expenses.

Where individuals are able to deduct home workspace related expenses, they can only do so to the extent they do not exceed the income from the business for the taxation year, determined prior to deduction of expenses related to the workspace. This rule prevents the business from creating, as a result of those expenses, a loss for income tax purposes from the business for which the workspace is used. As a concession, the ITA provides that the portion of the (otherwise deductible) expenses related to a workspace that cannot be deducted in a taxation year (by reason of this restriction) will be considered an expense related to the workspace in the following year, if the business still satisfies the two tests described above. Therefore, as long as the home workspace remains a principal place of business, the expense can be carried forward indefinitely.

However, other home-based business expenses unrelated to the workspace can contribute to creating a loss for income tax purposes. For example, the business' phone line, office supplies, etc. do not relate to the workspace and are not subject to this restriction.

Principal residence exemption

Generally, the ITA does not tax capital gains arising from the sale of an individual's principal residence. Where a portion of a residence is converted into a home-based place of business, there may be adverse implications for the availability of the principal residence exemption once the residence is sold.

When a business owner converts a portion of his or her residence to income-producing use, the ITA nominally considers that portion of the residence to have been disposed of and reacquired at fair market value. While any gain on this deemed disposition would be covered by the principal residence exemption, a gain arising upon the sale of the property after that time, attributable to the workspace, would not be covered by the exemption. This is a strict rule that the CRA thankfully does not enforce if all of the following conditions are met:

1. The income-producing use is secondary to the main use of the property as a residence.
2. There is no structural change to the property.
3. No capital cost allowance is claimed on the property.

Should the business owner stand to realize a large capital gain on the eventual sale of the residence, careful consideration should be given regarding significant alterations to the residence, either to facilitate the business or claim capital cost allowance. Deducting the depreciation on the business portion of the residence may be less beneficial than receiving the tax-free capital gain arising on a sale of the home (as the capital gain relates to the business portion of the residence), pursuant to the principal residence exemption.

Conclusion

Special rules govern the deductibility of home workspace expenditures. A business owner who uses his or her home for business should consider these rules to ensure related expenses are deductible in computing taxable income. The prerequisite for the deductibility of such expenses is that the business is either a principal place of business or a workspace, which is used to interact with clients on a regular and continuous basis. Likewise, due consideration should be given to the cost of giving up the principal residence exemption where the business requires structural alterations to the residence. In this regard, receiving the tax-free gain under the principal residence exemption is likely more beneficial than deducting the depreciation on the portion of a residence used in the business.

Notes

1 'Self-contained domestic establishment' basically means a house or apartment, but the ITA also defines it as "a similar place of residence in which a person as a general rule sleeps and eats."

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