PERSONAL **Newsletter**

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Home Office Expenses

Everyone has been told at some point or another by a family member, friend, or associate about how they save on their tax bill by "writing off" home office costs. Although this sounds like a tool that can be used to easily reduce your taxes, there are rules with strict requirements that must be met in order to deduct home office expenses. This article reviews these rules. First, the rule that allows you to deduct home office expenses from employment income is discussed. This is followed by a discussion of the rule that allows you to deduct home office expenses from your business income.

Deducting from Employment Income

If you maintain an office in part of your house or in an apartment you rent, a portion of your occupancy costs is deductible from your income, provided your employer certifies on Form T2200, Declaration of Conditions of Employment, that you are required to maintain the office and you are not reimbursed or entitled to be reimbursed for your costs. In computing the occupancy costs of a home you own, you may deduct a reasonable portion of expenses incurred for the maintenance of the premises, such as fuel, electricity, light bulbs, cleaning materials, and minor repairs but capital cost allowance, taxes, insurance, and mortgage interest are not allowed. If you are a commission salesperson, in addition to the foregoing expenses, you may deduct an appropriate portion of taxes and insurance paid on your home, but not mortgage interest and capital cost allowance.

Employees who rent a home or apartment can deduct a proportion of the rent. In other words, no deduction can be made to cover the rental value of premises set aside and used as an office in your own home. That is, one cannot say "I could receive, or would have to pay, $100 per month for this room of my house as office space, and therefore I can deduct that amount".

Your deduction for home office expenses is subject to two conditions. To make the claim for a "work space" in a "self-contained domestic establishment" in which you live, the space must meet at least one of the following:

1. the work space is where you principally perform the duties of your employment (i.e., more than 50% of your employment duties are performed in the work space); or
2. the work space is used exclusively during the period to which the deductible expenses relate for the purpose of earning income from your employment and is used on a regular and continuous basis for meeting customers or other persons in the ordinary course of performing the duties of your employment.

A "self-contained domestic establishment" is a dwelling house, apartment, or other similar place of residence in which, as a general rule, you eat and sleep. Under rule (1) you do not have to set aside part of the home exclusively for employment use so long as it is the work space where you principally perform your employment duties.

Allocation of Home Expenses

Employees using a work space in their home to perform their duties are only allowed to deduct from their employment income the proportion of their home expenses related to the work space. The apportionment of the expenses between the work space and the rest of the home must be made on a reasonable basis. The following allocation method uses a two-step process:

1. The qualifying home expenses are allocated to the work space on the basis of the work space area square footage divided by the total finished area square footage.
2. The qualifying home expenses allocated to the work space on the basis of square footage are allocated again on the basis of the employment use of the work space divided by the total use (including personal use) of that space. This second step is only relevant if the deduction is claimed under condition (1) above and irrelevant for condition (2) above, since the work space must be used "exclusively" for the purpose of earning employment income.

Example: Allocation of Home Expenses

If the square footage of the work space area is 10% of the square footage of the home's total finished area and the use of the work space is 60% for employment purposes and 40% for personal purposes, then 6% of the home expenses (e.g., electricity, heating, etc.) would be deductible as a home office deduction. Note that paint, cleaning materials, and other supplies may be allocated differently as follows: 100% if used for the work space and 0% if used for another section of the home.

Income Limitations

The amount you may otherwise deduct is limited to your income from the employment before claiming any deductions for the work space in your home. That is, you cannot use deductions for office-in-home expenses to create or increase a loss from the employment to which the expenses are related. Expenses which would create or increase a loss may be carried forward and are treated as having been incurred in the immediately subsequent year.

Recent CRA Audit Activities

In a recent Tax Court Case (*Adler v. The Queen*, 2010 DTC 1020 (TCC)), the cost of home workspace expenses was denied because, as the owner of his corporate employer, he would not in fact have been subject by that employer to any disciplinary action for failing to pay those expenses. By relying on this court decision, the CRA has been reassessing taxpayers who deduct home office expenses from their employment income where their employer is their wholly owned corporation.

Deducting from Business Income

Home office business expenses may be deducted from business income, but it's limited to the individual's income from the business (before the expenses). Work space expenses cannot generate a loss from the business, but any excess expenses can be carried forward and deducted in the following year, subject to the same limitation. The expenses that are subject to this income restriction include the prorated portion of rent, capital cost allowance, property insurance, property taxes, mortgage interest, and operating costs such as heating and lighting. These expenses must be apportioned between the individual's business and personal use. The apportionment must be made on a reasonable basis, such as square metres of floor space used. Expenses that do not relate to the work space itself are not subject to the income restrictions. Thus, for example, costs related to a business phone line or office supplies are ordinary business expenses and not subject to the income restrictions.

Restrictions

Specific restrictions are placed on deductions for the expenses of using part of your home as a place of business.

A. First, you may not make any claim whatever in respect of any "work space" in a "self-contained domestic establishment" in which you live unless you meet at least one of two tests:
   1. the work space is your principal place of business; or
   2. the work space is used exclusively for the purpose of earning income from business and is used on a regular and continuous basis for meeting the clients, customers, or patients of your business.

A "self-contained domestic establishment" is a dwelling house, apartment, or other similar place of residence in which, as a general rule, you eat and sleep.

B. Second, provided you qualify for a deduction under either (A)(1) or (2), the amount you may otherwise deduct is limited to your income from the business before claiming any deductions for work space in your home. This limitation would apply, for example, to an employee who also earns income in his or her spare time as a freelance writer doing this work at home. The freelancer might claim part of the home as a work space which is a principal place of business, but deductions would be limited to the amount of freelance income otherwise determined. It would not be possible to use the home expenses to reduce his employment income.

Any expenses for a year which are allowable under (A) but in excess of amounts deductible under (B) may be carried forward from year to year and applied against income of the same business to the extent permitted under the two rules for a succeeding year. The expenses must be deducted at the first opportunity to the extent permitted after applying the two rules for the year.

Note that under rule (A)(1), you do not have to set aside part of the house exclusively for business. A work space which qualifies under (A)(1) can also be used for personal purposes. Thus, the freelance writer in the illustration might use a second bedroom as both a guest room and an office. It would be a principal place of business for the writing business and therefore a claim is not prohibited by statute. The claim itself, however, would presumably have to be prorated both for square footage and time allocated to the business. For example, if the second bedroom comprised 20% of available floor space and was used as an office 60% of the time, 60% of 20% of related expenses (12%) would be deductible (or available for carryover).

(A)(2) requires that the work space be used exclusively to earn business income, meaning that it must be used in the business and for no other purpose. Furthermore, the work space must be used for meeting clients, customers, or patients on a regular and continuous basis. Whether this requirement is fulfilled will depend on the facts and, in particular, the nature of the business. A work space in respect of a business which normally requires infrequent meetings or frequent meetings at irregular intervals will not meet the requirement. For example, a home office used by a doctor to meet one or two patients a week is a work space which would not be considered to be used on a regular and continuous basis for meeting patients. On the other hand, a work space used to meet an average of 5 patients a day for 5 days each week would be considered used for that purpose on a regular and continuous basis.

The limitations in (A)(1) and (A)(2) extend to all expenses related to the work space: rent, insurance, property taxes, mortgage interest, heat and light. Expenses such as telephone, office supplies, and similar items, to the extent they are related to the business, are not considered to relate to the work space and are not subject to the restrictions in (A)(1) and (A)(2). That is, deductions may create a loss against other income. Furniture and equipment used in the business is not, strictly speaking, subject to the tests in (A)(1) and (2), above. Capital cost allowance may be available to the extent of business use.

Principal Place of Business

The phrase "principal place of business" is not defined in the Income Tax Act. If an individual's work space is the only "office" used in the business, the work space will qualify as the individual's principal place of business even if much of the business' activities are carried on outside of the work space. Thus, for example, if an individual carries on a construction or renovation business and the individual's home work space is the only office employed in the business, the work space will qualify as the principal place of business. If the individual has another office in addition to a home work space, the latter should qualify as the individual's principal place of business if a majority of the normal office functions of the business are carried out in the work space.

Capital Cost Allowance

In theory, if you own your home and set aside a separate space in it exclusively for use as an office, you can claim capital cost allowance on that proportion of the fair market value of your home at the time you commence to use it. This is rarely desirable, however, since it is likely to impair your claim for principal residence exemption when you come to sell your house. Essentially, if you claim capital cost allowance on the business portion of the house, or if you make structural alterations to accommodate your income-earning activities, the CRA will consider that you have a change of use with respect to the business portion of the house, and that portion will be disqualified from principal residence treatment from the time of the change.