



Home Office Business Expenses

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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 (e.g., relative to the square footage of floor space

used). Expenses that do not relate to the work space itself are not subject to the income restrictions. Thus, for example, telephone expenses, the costs of computers and fax machines, and stationery expenses 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 or her 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 subsequent 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.

In *Ryan v. The Queen*, 2006 DTC 2738 (TCC), the taxpayer performed physiotherapy in two clinics. Since most of his work for one of the clinics was done from his home office, it was his principal place of business for that clinic. The same could not be said for the other clinic, but his home office was used exclusively to earn business income and was used on a regular and continuous basis for meeting clients. Therefore, home office expenses were deductible.

In *Khoury v. The Queen*, 2006 DTC 3682 (TCC), the taxpayer was an artist whose only place of business was his home. He claimed that 50% of his home was used for business purposes. The Minister reduced this to 20% but the Court found this to be too low since it failed to consider the fact that virtually all of the basement space was being used exclusively for business purposes. The appropriate percentage was determined to be 40%.

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's 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.

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 Canada Revenue Agency (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.

Quebec Restrictions

Quebec taxpayers should note Quebec's restrictions in addition to the federal rules for its business taxpayers. Where expenses pertain to the household generally (usually this will be true for

electricity, water, heat, insurance, and so on, although in some cases the expense might be isolated if, for example, there is a separate electric meter for the office), Quebec imposes a further restriction. After the expense is calculated and a portion allocated to the office (usually based on floor space), 50% of the common expense deduction so allocated to the office is disallowed. There is no comparable 50% restriction on employees (where Quebec follows the federal home office rules without alteration). The 50% disallowance does not apply to expenses relating to the portion of a residence used in connection with the operation of licensed tourist home, bed and breakfast, or hospitality village accommodation (under the *Tourist Establishments Act*). The 50% disallowance does not apply to expenses relating to the portion of a residence used for the business of private receptions. In addition, the 50% disallowance does not apply to expenses that are specifically related to the use of the office (in particular, the cost of heating and lighting), provided that the basic tests permitting the deduction are met.