

WORK SPACE IN THE HOME? WHAT EXPENSES CAN BE DEDUCTED?

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Law Now. Dec 1994/Jan 1995.Vol. 19, Iss. 3; p. 17

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The traditional job in our economy used to come with security and full employment benefits until retirement. This, however, is now virtually a relic of the past. Canadians are obliged to demonstrate more resourcefulness in the marketing of their skills as independent business people. The good news is that the wide range and declining prices of modern telecommunications and computer-related technology makes the place of business of little importance to the customer.

At the same time at home there would appear to be a re-discovery of family and the notion of "cocooning", the desirability to work at home. The phenomenon of "telecommuting" (which is working for one's employer from home), consulting for a variety of other people or organizations, job-sharing and independent home-based businesses as sole or supplementary sources of livelihood.

This last option is particularly attractive because it is a natural outlet for specialization, is a good method of keeping costs under control and permits the enjoyment of a home family life. These trends encourage use of the home as the place of business. In other words, small business is increasingly coming to mean business based in the home.

The net cost of work space is always a factor in the business' profitability. In the case of leased work space in an office building or shopping centre, the full lease costs are a deductible expense when calculating tax on the income from the business. The general test is that if the expenses are incurred in order to generate income, they are deductible. However, when it comes to claiming expenses for work space in one's home, the tax department is suspicious. It may have some concerns about whether the home enterprise is a true risk-taking business with a reasonable expectation of profit, or personal indulgence. Business expenses in the form of the cost of a few rooms in the house may be similar to, and in some cases indistinguishable from, personal expenses.

To allow claims for what are essentially personal expenses as business expenses would result in a distortion of taxation equity and a concomitant loss of public revenues. Last year several hundred thousand taxpayers claimed home work space deductions. The estimated total loss of treasury revenue for this deduction was almost \$1 billion.

In light of the march toward home-based businesses, the Canadian *Income Tax Act* since 1988 has special restrictions for deducting expenses for work space in the home. Section 18(12) provides that one cannot deduct expenses of a "self-contained domestic establishment" in which the individual taxpayer resides unless (1.) the home is the principal place of business, **or** (2.) it is used *exclusively* for the purpose of earning income from business *and* used on a regular and continuous basis for meeting clients, customers or patients for the business.

These rules are directed at self-employed individuals, including professionals. The taxpayer is permitted to deduct expenses such as rent, property taxes, mortgage interest, capital cost allowance, insurance and utilities such as natural gas for heating and electricity for lights and equipment relating to work space in the home when one or the other of these two tests is satisfied. These expenses should be apportioned between business and personal use on a reasonable basis such as percentage area dedicated to the business. Telephone, stationery supplies, equipment repair and similar expenses do not relate to the particular problem of work space in the home. They would be deductible according to the general rules of business expenses, not section 18(12).

The expression "self-contained domestic establishment" is defined in subsection 248(1) of the *Income Tax Act* as a dwelling house, apartment or other similar place of residence where one normally eats and sleeps. Since the special rules in section 18(12) about deductibility of this expense are concerned only where the taxpayer actually lives, any detached premises such as a stand alone office, garage or workshop or a residence where the taxpayer does not personally reside, could be claimed following the general rules of deductibility of business expenses.

There can be only one principal place of business. If there are several places of where the same business is actually conducted, a comparison of locations must be undertaken to see if the home operations are principal. The word "principal" is not defined in the Act, but "chief" and "main" are synonymous with it.

One should be aware that if capital cost allowance has been claimed by a taxpayer on a residential property, the principal residence exemption when that house is disposed of will be lost (see Interpretation Bulletin IT-120). Interpretation Bulletins are periodically issued by Revenue Canada to offer guidance on the application of various provisions of the Act. While these Bulletins are not authoritative in the sense that they are binding on a judge, they do provide an insight on how Revenue Canada itself will apply the Act. The Interpretation Bulletin dated February 1989, IT-514,

deals with section 18(12). It gives two examples of what might be considered a "principal place of business":

Where, for a example, a room in a contractor's residence is used to accomplish the functions relating to a contracting business, such as receiving work orders, bookkeeping, purchasing and preparing payrolls while the remaining activities of the business, the performance of the contracts, are carried out at the customer's location, the room would be considered as the contractor's principal place of business. Similarly, the work space in a farmer's home utilized to operate the farming business would normally be the farmer's principal place of business.

The Interpretation Bulletin in this way suggests that the term "business" will be narrowly interpreted, and in a way that many businesses would be able to take advantage of. As the two foregoing examples illustrate, if the business functions (the paperwork associated with the business) are carried out in the home, that will be the principal place of "business", even if most of the actual work to earn income takes place outside of the home. If the taxpayer has two offices, one in the home and one elsewhere, it will have to be established which one is principal. The space used under this part of the test for "principal place of business" can also be used for personal purposes. This part of the test does not require the work space in the home to be exclusively for the business.

The "exclusive use" test is entirely alternative and separate. It would seem to devise a higher standard than the "principal place of business" test. Fewer businesses can meet it. Under it, the work space need not be the principal place of business. It can be a sub-office, provided that sub-office is "used exclusively for...earning income". If one's business is to meet clients, customers or patients, they will have to be met in this space exclusively and not outside of the home.

The "exclusive use" space must be a segregated area, one or more rooms used for the business and for no other purpose of any kind. In addition to the sole business use of this space, the work space must also be used on a regular and continuous basis. The regularity and frequency of meetings required will depend on the nature of the business activity and the particular facts of each situation. It does seem, however, that this space must be actually used for meetings with such outside third parties and not private paperwork. The Interpretation Bulletin states that "a work space in respect of a business which normally requires infrequent meetings or frequent meetings at irregular intervals would not meet the requirement". The types of businesses which would therefore qualify, according to the interpretation of Revenue Canada, are those which, by their nature, involve regular meetings with third parties. Freelance writing and off-site consulting are examples of businesses

which would not qualify under this rule. On the other hand, a physician who meets with several patients in the home each working day of the week would qualify.

The taxpayer would simply elect the category above which most readily applies to his or her business circumstances: the "principal place of business" or the "exclusive use" with meetings on a "regular and continuous" basis. There is a further restriction on the claiming of this deduction, regardless of the test that one uses to qualify for it.

This restriction is that the total deduction for work space expenses cannot exceed the total income from the business generated in the home and elsewhere in the taxation year. In other words, this deduction cannot create or increase a tax loss for the business. This rule presumably is to ensure that the home-based business produces a modicum of economic success. Nevertheless, the portion of these expenses that cannot be deducted for reason that it would create a loss may be carried forward and used in the immediately subsequent taxation year. If in that next year, the business qualifies under one of the two tests above, the unused portion of expenses may be deducted, again up to the "no tax loss" threshold. An indefinite carry forward to the point of reducing income to zero is permitted as long as either the "principal place of business" or "exclusive use / meetings on a regular and continuous basis" test is satisfied from year to year.

There is no limit on the number of businesses that can be conducted from the home. All claims must be otherwise deductible as business expenses and the taxpayer is always under a duty to be reasonable in claiming deductions. The taxpayer must still demonstrate that the business is truly a business with a reasonable expectation of profit. It would not qualify if it was a one-off activity or a hobby from which the taxpayer expected to derive mostly intrinsic rewards.

Finally, it is important to keep in mind that these special rules about deducting expenses for work space in the home apply only to "self-employed individuals". Today a one-person business can incorporate in Canada. A consulting business in the corporate form for example, operated from the home, will not be subject to any of the restrictions and tests contained in section 18(12). This may be reason enough in itself to incorporate. This application only to "self-employed individuals", as well as Revenue Canada's favourable interpretation of the term "business" in the "principal place of business" test, may be the two primary reasons why there is to date no reported case in Canada of section 18(12) being litigated in court.
