Tax essentials: Office rent / home office expenses

If you rent office space for your business, you can deduct this expense for tax purposes. But what if your office is in your home? You can deduct the cost of maintaining a home office as long as you pass one of the following two tests:

1 **Your home office is your principal place of business**. Basically, this means that you work more than 50 per cent of the time from your home office. This can be a difficult test to meet if you have another office that you rent or you work a large portion of your time at client sites.

2 **Your home office is used exclusively for business purposes and is used on a regular and continuous basis for meeting clients, customers or patients.** This test is designed primarily for individuals such as doctors, chiropractors or massage therapists. They might have an office where they usually work away from their home but they might also see clients or patients at home. These individuals can deduct home office expenses as long as they use the office space exclusively for business purposes (in other words, the office is not part of their personal living space).

There's one point to note. As long as you work primarily out of your home office (50 per cent of the time), you don't have to use your home office exclusively for business purposes to be able to deduct home office expenses. The office can be combined with personal living space. What you have to do is prorate the expenses related to your home office between its use for business and personal purposes. If you use it 60 per cent of the time for business and 40 per cent for something else, then only 60 per cent of the expenses that relate to the maintenance of the home office will be deductible.

What expenses can you deduct? Basically, you can deduct the business portion of the following amounts that relate to your home office:

- Rent (if you rent your home)
- Utilities
- Maintenance and repairs
- Insurance
- Property taxes
- Mortgage interest

For example, assume you own a three-bedroom townhouse and you use one of the bedrooms as a home office. You make monthly mortgage payments of $1,200, of which $800 is interest. You also have to pay $200 a month for utilities, property taxes, and insurance expenses. The office is 20 per cent of the total square footage, which you use 80 per cent of the time for work. You will be able to deduct $160 a month for home office expenses which is calculated as follows:

Interest	$800
Utililities, property taxes & insurance	200
Total costs	$1,000
Office portion @ 20%	200
Time used for business @ 80%	160

If your marginal rate of tax is 45%, then your monthly tax savings would be $72.

Note that you cannot create a business loss by claiming home office expenses. However, you can carry forward the undeducted amount indefinitely and deduct it from business income in the future.

Principal residence exemption and home office expenses

If you own your home and use it for business purposes, you need to consider the impact, if any, that this will have on your ability to claim the principal residence exemption when you sell your house.

Under Canadian tax rules, your family is entitled each year to designate a home in which they live as their principal residence. The home designated can be the place where you regularly reside or a vacation property such as a cottage. If a property has been designated as your principal residence for each year that you own it, you will not have to pay any tax on capital gains that you realize when it is sold.

If you convert a portion of your house to a home office, however, the use of that part of your house will change from personal use to business use. If you apply the tax rules literally, you are deemed to have disposed of that portion of your house at its fair market value at that time. This gain will not be taxed if your home is designated as your principal residence. However, any gains that accrue on the business portion of your residence after that time will be subject to tax when you ultimately sell the property.

Fortunately, the CCRA takes a much more reasonable approach when there has been a change from personal use to business use for a portion of your home. Your entire house will continue to qualify as your principal residence, after a conversion of a portion of the property to a business use, as long as you meet the following conditions:

- The business portion (i.e. your home office) is reasonably small when compared with the size of the entire house;
- You do not make any structural changes, such as an addition, in creating your home office space; and
- You do not claim any capital cost allowance (CCA) on the business portion of your home.

In order that you preserve your ability to claim the entire property as your principal residence, it is normally advisable that you do not claim CCA on the business portion of your home. However, there may be circumstances when it is to your advantage to claim CCA -for example, you may not expect your home to increase in value in the future so that the ability to claim the principal residence exemption may not be valuable to you. Before claiming CCA on the business portion of your residence, however, always discuss your situation with your BDO advisor.

If you make significant changes to your home for business reasons, such as an addition, this portion of your home may not qualify for the principal residence exemption. You can claim CCA on this part of your house at the rate of four per cent annually on a declining balance basis. When your home is sold, you will have to pay tax on any capital gains realized on the business portion of the residence and on the recapture of any previously claimed CCA deductions on your property.

Source: DBO Dunwoody LLP