RUNNING A BUSINESS FROM HOME

A number of circumstances and developments have come together over the past couples of decades to make a home-based business, once practically unknown, a common fact of business life. First and foremost, of course, is the technology—particularly communications technology—that enables the at-home business person to have access to all of the information and services available to his or her in-office counterpart. Given the right technology, it's easy for someone working from home to access the people, information, and services needed to run his or her business in the same way as it would be if he or she was at a traditional business office.

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While technology has made it possible to run a business from home, other developments have made the daily drive to an office, and the maintenance of an office in major urban centres, less and less appealing. The ever increasing price of gasoline has made the cost of that daily commute prohibitively expensive in some cases. As well, there is an increased awareness of the time cost to the individual and the more general environmental cost of having most major highways clogged each morning and evening with hundreds of thousands of cars sitting in traffic gridlock. And finally, the cost of renting office space in most major Canadian cities means that most small business owners must at least consider whether running their business from home, at least initially, makes more economic sense.

In every recession, there is an increase in the number of self-employed Canadians, and the recession which followed the financial crash in the fall of 2008 was no exception. According to Statistics Canada, between October 2008 and October 2009, self-employment in Canada increased by more than 4.3%, while the number of Canadians engaged in paid employment dropped by 3.3%. As well, the increase was entirely among what Statistics Canada terms "own account" workers, meaning self-employed individuals without paid help. And, again according the Statistics Canada, many of those who became self-employed over that period were in services.

While not all of the self-employed work from home, it's fairly common for those venturing into the world of self-employment for the first time to save costs by operating their business, at least initially, out of a home office. The fact that most Canadians who were newly self-employed over the past few years were working on their own and in the services sector would suggest that many of them would, in all likelihood, be home-based businesses.

Does starting a home-based business make sense?

Deciding whether to set up a home-based business actually has to start with deciding whether to start a business at all. Like any other kind of work, self-employment has its upsides and downsides. Individuals who are self-employed usually have more control over their time, and greater flexibility and autonomy than their employed counterparts. The flip side of those advantages is that a person contemplating self-employment has to have the ability to plan, organize and carry out the work of the business without supervision or, usually, feedback, and doing so requires a considerable degree of self-direction and self-discipline. For those who find it difficult to motivate themselves to work without direct supervision, success at self-employment is unlikely.

Deciding to become self-employed means losing some "perks" and accepting a measure of insecurity, as the statutory rights and social safety net measures which are taken for granted by employees will no longer be available. While the rules vary by province, nearly all those working as employees in Canada can count on having 2 paid weeks vacation each year, as well as up to 10 paid statutory holidays. And, in the event an individual's employment is terminated for reasons outside his or her control (usually referred to as termination "without cause"), the employee is entitled to a notice period set by law, or to compensation in lieu. And finally, if the employee is unable to immediately find another job, he or she can apply for and usually receive Employment Insurance benefits for a period of time. None of these statutory rights or social safety net protections is available to the self-employed.

The other aspect of self-employment that is often overlooked is the fact that all of the infrastructure and support which may once have been provided by an employer is not available, at least initially, to the self-employed. Most small business owners, certainly owners of a new business, will find that they are responsible for every aspect of running the business, from ordering supplies to sending out invoices to arranging for a computer repair. Where additional administrative or technical support is needed, the business owner will have to arrange (and pay for) it out of his or own pocket.

Finally, there are some other costs which the new business owner will have to take on for the first time. All employed and self-employed Canadians contribute to the Canada Pension Plan. While employees make their own contribution, through payroll deduction, the employer is required by law to make an equivalent contribution on behalf of the employee. When an employee chooses to become self-employed, the amount of required CPP contributions will effectively double, as he or she will be required to pay both the employer and employee portions. And, of course, any extended health or insurance benefits which were available through an employer will now have to be contracted for (and paid for) on an individual basis.

Once the prospective business owner decides that running a business is indeed for him or her, a different set of considerations come into play in deciding whether

running that business from one's home is possible. Some businesses can easily be run from a family home while others definitely cannot. Each business is different, or course, as is each business owner's circumstances. But some criteria are common to all, and the following should be considered in determining whether a new business can be a home-based business.

- How much space will the business require? If the business requires a large amount of equipment or machinery to operate, it's probably not suitable to be run from a family home. Similarly if the business will need a great deal of space to store inventory or supplies, it's not likely that the amount of space required will be found in a residential setting.
- Will interaction with clients or customers of the business be carried out by phone or e-mail or "virtual" meetings via Skype, or other technology, or will face-to-face meetings be the norm? If the latter, will those meetings be carried out at the business's office, or somewhere offsite? And, if client or customer meetings are to be held at the business's office, is there a separate entrance which can be used by visitors to the business, or is the layout at least such that visiting clients or customers can access the business premises without having to walk through the "family" part of the home? If renovations are needed to create a self-contained business space attached to or within the home, is the price of those renovations cost-effective when compared to the cost of renting business premises elsewhere?
- If clients and customers will be coming regularly to the business's office, how will that affect those who live nearby? The impact on neighbours will depend on how much business-related traffic is created, and how much parking is needed and available. A business which creates unaccustomed traffic on a quiet residential street isn't likely to endear the business owner to his or her neighbours, especially if those neighbours also find their usual parking spots taken or their driveways blocked.
- Every town and city has zoning rules which govern (and restrict) the types of uses which are permitted in different areas (i.e., residential, commercial, light industrial, heavy industrial, mixed, etc.) Those zoning rules need to be determined and complied with, or the business owner may find him or herself shut down even before the business really gets started.
- Finally, and especially if clients and customers will be coming to the business premises, the business owner needs to make sure that it's possible to change or upgrade the insurance coverage on his or her home to reflect the fact that that home is now also the site of a business, with its own potential liabilities.

Taxation of income from a home-based business

Calculating business income

When it comes to calculating business income for tax purposes, a buck is buck is a buck. The tax rules applicable to the calculation of business income do not distinguish in any way income earned while working in large office tower from income earned working from one's home.

Business income from a sole proprietorship or a partnership (meaning all unincorporated business) is recorded and reported to the Canada Revenue Agency (CRA) on Part 1 of Form T2125, Statement of Business or Professional Activities. The business owner is not required to show each separate source of income: rather a total figure representing the gross (i.e., before deductions) business income for the year is entered on Form T2125, and then deductions are taken for expenses incurred in order to earn that business income. Both the gross income and net (after deductions) income figures are transferred to page 2 of the individual income tax return, on lines 162 and 135 respectively.

Note that while the business owner is not required to provide details of his or her business income for the year, or to file invoices or cheques documenting that business income, the CRA has the right to request any and all such documentation in order to verify the amounts reported on the business owner's return for the year. Consequently, it's important to keep such records for at least six years after the end of the tax year to which they relate.

Claiming business expenses

The general rule when claiming business expense deductions, wherever the business is located, is that all reasonable expenses incurred for the purpose of earning income can be deducted from that income for tax purposes. For sole proprietorships and partnerships (meaning all unincorporated businesses) business expenses are claimed on Form T2125, and the following listing of common business expenses is adapted from the listing found on that form.

- Advertising
- Meals and entertainment
- Insurance
- Interest
- Business tax, fees, licences, dues, memberships, and subscriptions
- Office expenses
- Supplies
- Legal, accounting, and other professional fees
- Management and administration fees
- Maintenance and repairs
- Rent
- Salaries, wages, and benefits
- Property taxes
- Travel (including transportation fees, accommodations, and allowable part of meals)
- Telephone and utilities
- Fuel costs (except for motor vehicles)
- Delivery, freight, and express
- Motor vehicle expenses

As is the case with business income, the business owner is not required to provide documentation in the form of receipts or cancelled cheques to prove that such expenses were in fact incurred. However, as with business income, the CRA has the right to ask the business owner to provide the documentation which supports the expense claim. And, where that documentation can't be provided, the expense claim will be disallowed.

It can be seen that some of the expenses listed above, like property taxes and maintenance and repair, are expenses incurred in relation to the business premises. Where the business is run from home rather than a commercial office, such costs are claimable, but not as a general business expense. Instead, those costs are reported, calculated and claimed in a separate section of the T2125 dealing with home office expenses.

Home office costs claimable by the self-employed

EIn order for someone running a business from home to claim deductions related to the costs of maintaining business premises, a basic two-part test must be satisfied. In order to deduct such expenses, at least one of the two following conditions must be met:

- the home office is the self-employed person's principal place of business; or
- the individual uses the space only for the purpose of earning business income, and uses it on a regular, ongoing basis to meet clients or customers.

Assuming one or the other of these criteria is met, a deduction for home office costs can be claimed. The rules governing the deduction of home office expenses for the self-employed are, in fact, quite generous. Subject, as always, to the overriding reasonableness requirement, self-employed individuals who operate a home-based business can claim the following:

- heat;
- electricity;
- insurance;
- maintenance;
- mortgage interest; and
- property taxes.

Where the home being used in part for business purposes is rented, rather than owned, then a portion of the rent paid is deductible from business income.

Most of the items on the list are relatively self-explanatory, although the question of the types of costs which fall under the category of "maintenance" can cause some confusion. Generally, costs which are incurred to clean, care for and keep the property in good repair would qualify as maintenance costs (including, for instance, the cost of professional cleaning on a regular basis). On the other hand, costs which involve significant additions or changes to the home are not. For example, costs incurred in repairing a leaky roof would come under the heading of maintenance: the cost of replacing the same roof would not.

One of the notable items missing from the listing of costs eligible for deduction is that of mortgage principal. While mortgage interest costs can be deducted from business income, amounts paid on account of mortgage principal on account of a home used for business purposes are never deductible.

The expenses listed above necessary to the operation of a home are, of course, paid for the entire home, and not just the portion used for business purposes. Consequently, it's necessary, when claiming such costs as a business expense, to claim only that percentage which is attributable to the portion of the home used for business purposes. The usual way in which the allocation is made is based on square footage. The total square footage of rooms used for business purposes is subtracted from the total square footage and the result is divided by the total square footage. The result, when multiplied by the total costs for the year, represents the "personal use portion", which must be deducted from those total costs in order to arrive at the amount which is deductible from business income.

The calculation is perhaps most easily understood by looking at an example, and the following scenario, involving an 1800 square foot house in which 180 square feet are used for business purposes, is adapted from and example provided on the CRA Web site.

Heat	1,200.00
Electricity	1,000.00
Insurance	650.00
Maintenance	350.00
Mortgage interest	8,000.00
Property taxes	1,800.00
Other expenses (specify) Water	300.00
Subtotal	13,300.00
Minus: Personal use part	
(1620 ÷ 1800 × $13,300)	11,970.00
Subtotal	1,330.00
Plus: Capital cost allowance (business part only)	0.00
Subtotal	1,330.00

Expenses partly deductible in year of expenditure

The example shown above, and the Form (T2125) used to claim home office expenses, includes a line on which the taxpayer can claim capital cost allowance, or depreciation, on the portion of the home used for business purposes. It's not often that a taxpayer is better off forgoing a deduction from income which he or she is entitled to claim, but this is one of those instances.

Under the Canadian tax system, when an asset is sold, tax is levied on the amount by which the asset has increased in value over the period of ownership. However, our tax system also provides for an exemption from that rule for owner-occupied homes. In other words, when homeowners sell the home in which they have lived, no income tax is payable on the amount received, no matter how much the home has increased in value over the period of ownership.

That “principal residence exemption” is one of the most valuable tax “breaks” available to Canadian taxpayers, since the family home comprises a major part of the net worth of most families. However, when capital cost allowance is claimed on a part of a home, the principal residence exemption which would have been available on the sale of that property is eroded in a proportionate amount.

Take, for example, a taxpayer in the above example who decides to claim capital cost allowance on a part of his property representing 10% of the square footage (the amount used for business purposes) each year during the time he or she owns that property. Assume that the property is then sold and the sale price exceeds the original purchase price by $100,000. 10% of that gain, or $10,000, will be subject to tax at the taxpayer’s highest marginal rate in the year of the sale. In almost all cases, the tax payable on that gain will be significantly greater than the amount of tax saved by the capital cost allowance claim made over the period of ownership.

Of course, if there is no increase in the value of the property over the period of ownership, or the value of the property actually declines, there is no downside to making that capital cost allowance claim. However, the future value of property is, of course, something that no one can predict with accuracy.

Most businesses, home-based or otherwise, required some period of time before they become profitable, and many run at a loss during their start-up years. A deduction from business income is, of course, of no current value to a business owner who has no income against which that deduction can be taken. When it comes to business-use-of-home expenses, the business owner is permitted to carry those expenses forward and claim them against income earned from the business in a future year. There is no limit on the number of years for which such business-use-of-home expenses can be carried forward.

Conclusion

There’s a lot to recommend running one’s business, especially a new business, from home. The cost of obtaining premises in which to locate that new business, especially in large urban centres, can be prohibitive, and every dollar saved on such expenses improves the bottom line of the business. Dispensing with the daily drive to and from the office saves time, aggravation and the ever-increasing cost of the gas needed to make that drive. And, expenses like mortgage insurance and property taxes, which must be incurred

in any case become, in some part, deductible for tax purposes. Finally, being able to work from home provides the business owner with greater autonomy and control over his or her own time, increasing the chances of achieving that elusive work-life balance.

Self-employment isn’t for everyone, nor is working from home. But, where the circumstances are such as to make it possible, the rewards are significant.