Avoiding T2200 Headaches: Home Office Deductions

What's At Stake

Letting employees do at least some of their job duties from home can create headaches for payroll. This is especially true if employees want to deduct home office space expenses from their income tax. Normally, the deductions employees claim on their personal tax returns is their own business. But when those deductions are for expenses incurred in connection with their employment with your organization, it becomes your concern, too. That's because to claim such deductions, employees need their employers to complete the dreaded T2200 form, specifically Item 10.

Home Office Deduction Rules

Some employees set aside a room or part of their home to perform job duties. The space essentially becomes an office away from the office. Under certain conditions, the employee can deduct a proportion of the costs they incur in relation to the work space from taxable income. The home office deduction rules are set out in Secs. 8(1)(f), 8(1)(i)(ii) and (iii), and 8(13) of the *Income Tax Act*; and they're explained in two CRA documents: Guide T4404(E) (Employment Expenses); and Interpretation Bulletin IT-352R (Vehicle, Travel and Sales Expenses of Employees).

1. Conditions of Employment

The employment conditions for a home office deduction vary depending on whether the employee is on salary or commission.

Salaried employees: The employer must require the salaried employee to incur the costs as a condition of employment. The clearest indication of this requirement is where the employment contract spells it out. The obligation to set aside a portion of the home for employment use must also be at the employee's own expense. But even if the contract doesn't say that the employee must pay the expenses out of his own pocket, courts are willing to imply such an obligation as a matter of "common sense." If the employer reimburses the employee for his out-of-pocket expenses, the deduction doesn't apply.

Commissioned employees: Employees paid in whole or in part by commission or similar amounts based on sales or contracts negotiated are entitled to a deduction only if all three of the following conditions are met:

- The employment contract requires the employee to pay his/her own expenses;
- The employee is "normally required" to work away from the employer's place of business; and
- The employee hasn't received a non-taxable allowance for travel expenses during the tax year. (While it may sound odd to rule out a home office deduction on the basis of a travel allowance, this is precisely what Sec. 8(f)(iv) does.)

2. Space Must Be Part of the Home

The space must be part of "a self-contained domestic establishment where the individual resides," according to Sec. 8(13)(a). The CRA clarifies that this means a "home," including a "dwelling-house, apartment or other similar place of residence in which a person as a general rule sleeps and eats." Some employees claim home office deductions if they do a lot of work out of their cars. Such deductions would not be permissible.

3. Space Must Be Used for Performing Employment-Related Duties

The most important and frequently misunderstood requirement involves use of the space. To claim the home office deduction, employees must meet one of 2 conditions:

- The work space is where they "mainly," (i.e., more than 50% of the time) do their work; or
- They use the work space only to earn their employment income and use it on "a regular and continuing basis" to meet clients or customers.

To counteract a common misperception, you need to make it clear to employees that they're not entitled to a home office deduction simply because they do a couple of hours a work at home at night or on weekends.

4. Costs Must Be for Rent or Maintenance

The deduction covers costs the employee incurs to use the space to earn income from the employment. This includes 2 kinds of costs:

Rent: Under Sec. 8(i)(ii), taxpayers can deduct "office rent." IT-352R makes it clear that rent is deductible only if the employee is actually renting the space. In other words, employees who own their home can't deduct the rental <u>value</u> of the space.

Maintenance: Under Sec. 8(i)(iii), a deduction applies to the "cost of supplies that were consumed directly" in the performance of the employment. IT-352R specifies that "cost of supplies" covers maintenance costs such as electricity, heating, light bulbs, cleaning materials and minor repairs.

What's Not Covered: The home office deduction does <u>not</u> include mortgage interest, property taxes, home insurance or capital cost allowance.

5. Costs Must Be Attributable to the Work Space

The home office deduction doesn’t apply to 100% of the rent cheque or maintenance supplies used in the whole home. The employee must use a “reasonable basis” to attribute a percentage of the deducted expense to the part of the home used as a work space. The Guide T4404E lists examples of methods the CRA considers acceptable:

- Dividing the area of the work space by total area of the home to calculate rent attributable to work space; and
- Determining how much of each claimed maintenance expense was actually used to maintain the work space. Example: 0% of the cost of a light bulb would be deductible if the light bulb was used in the kitchen (if cooking isn’t part of the job); but the employee could deduct 100% of the cost of a bulb used to light the desk lamp in the office.

6. Deduction Can’t Create or Enlarge a Loss

Finally, the deduction applies only to employment income left over after the employee deducts all other employment-related expenses from the employment. In other words, the home office deduction can’t create or increase a loss from employment for the year. If the employee has a net loss, he can’t apply the deduction to income earned from another employer. He has to carry forward the deduction and apply it to employment income he earned from the employer in the next taxable year.

Takeaway: Use Questionnaire to Avoid T2200 Headaches

Click here for a Questionnaire that boils down these rules and lays them out in a series of Yes/No questions that employees can use to determine if they’re entitled to a home office deduction. The goal is not simply to explain the tax laws but to discourage employees from asking you to complete Form T2200 for home office deductions that they’re not entitled to claim. Hopefully, this technique will relieve you of an administrative burden and employees of the risk of denials and audits.