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TAX LETTER

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STARTING A HOME BUSINESS — POINTS TO PONDER

Are you considering starting a home business? Here are some planning issues, tax rules and tips to keep in mind.

Incorporation

Many people are not clear on the difference between a business and a corporation, but the difference is extremely important, for both tax purposes and liability purposes.

You can carry on business without creating a corporation. Although you may give your business a name, it is simply you carrying on the business. You are a "sole proprietor".

If you create a corporation, it will have "Limited", "Inc." or "Corporation" as part of its name. The corporation is a **legally separate person** from you, and the corporation, not you, carries on the business. Although you control the corporation, the business is legally not "your" business. This means that **you are not liable for the corporation's debts**. (However, if the corporation needs to borrow money from a bank, the bank will insist on a personal guarantee from you, so you will be liable if the corporation cannot repay the bank loan. Also, as a director, you are liable for certain obligations of the corporation, such as an assessment of GST/HST or employee payroll deductions that the corporation fails to remit.)

If you create a corporation, then the corporation will have to file annual T2 corporate income tax returns and pay tax on its profits. After that tax has been paid, **you should not simply take the corporation's money for yourself**. When you want to extract profits from the corporation, you should either have the corporation pay you salary or bonus (which the corporation can deduct and is taxable to you as employment income), or have it pay you dividends (which are not deductible to the corporation but are taxed to you at a lower rate, due to the dividend tax credit). These steps require certain paperwork, and it is important to document properly what you are doing; otherwise the tax consequences can be serious if you or the corporation are audited. The corporation can also repay any money you have loaned to it, with no tax consequences.

Sole Proprietorship

In many cases, a home business is simply carried on as a sole proprietorship. There are no legal requirements for doing this; you are not required to have a separate business name, though you may wish to create one in order to appear more professional to your customers. (If your business will be visible, such as with customers regularly visiting you, then you should check whether you may run afoul of local zoning bylaws, or condominium or apartment rules if you live in a building.)

If you pick a business name that is not simply your own name (or perhaps your own name plus something like "Consulting Services"), then when you are paid by your customers, you will need a business account into which to deposit the cheques. For this purpose your bank will normally require that you obtain a **business name registration** from the province. This is usually a simple matter that requires a modest fee. Registering a business name in this way does not give you any special rights to that name if it violates someone else's trademark; it simply allows you to carry on business under that name, sue under that name, and open a bank account under that name.

GST or HST

Once your total sales exceed $30,000 per year (combined with those of any corporation you control), you must register for and collect the GST and HST. Until your sales top the $30,000 mark over four consecutive calendar quarters, you do not have to register or charge GST/HST.

Even if you are under $30,000 in sales, if your sales are to businesses rather than consumers, you may wish to register. You will then need to collect GST/HST from your customers, but they generally will not care since most businesses get back all GST or HST they pay. You in turn will be able to recover all GST/HST that you pay on your business expenses. (You may also be able to profit from the Quick Method of filing, which can allow you to make a little money out of the GST if you have relatively few taxable expenses.)

You may need to register for and collect provincial sales tax as well, depending on the nature of the goods and services you provide.

(The same rules apply to any corporation that you own: it may have to register for and charge GST/HST.)

Reporting Your Income

When you are carrying on a sole proprietorship, any income earned by the business is reported on your tax return under "Business income" (or Professional, Farming or Fishing income if you are engaged in one of those kinds of businesses).

The tax return requires you to show both gross revenues (total sales) and business income (after expenses). You will also need to file an income statement showing the details of your revenues and expenses (broken down by category — e.g. Advertising expenses, Office supplies, Meals & entertainment, Telephone, etc.). This is normally done on Form T2125, but is not required to be.

Your net business income is combined with your other sources of income on your return, like employment income and investment income, to reach "total income".

Deducting Business Expenses

When calculating your (net) business income, you can deduct the expenses of carrying on business. Here are some things to make sure you do not miss:

- Office supplies. This would include computer paper, toner cartridges, USB sticks, pens and similar items that you buy for use in the business. It may also include publications such as business magazines and journals. Keep your receipts!
- Telephone. If you have a separate business line, the cost is fully deductible. If you are using a personal line partly for business purposes, it probably falls within the "Home office expenses" category in the next heading. And don't forget to deduct your monthly Internet connection service fees, and cell phone costs to the extent you use your cell phone for your business.
- Equipment. For expensive, long-lasting "capital" items like computers and furniture, you cannot deduct the expense directly. Rather, you can claim depreciation, called "capital cost allowance" (CCA), applied to a declining balance over many years. The CCA rate depends on the kind of equipment; for example, it is 55% for computers and 20% for furniture.
- Automobile expenses. You will need to track your business use of your car as opposed to your personal use. It is advisable to keep a daily logbook recording business use, and note the odometer reading at beginning and end of the year. You can then figure out your business use proportion, and deduct that percentage of your gas, insurance, licence, car-washes, maintenance and repair costs. You can also deduct that percentage of capital cost allowance (which is 30% per year for cars). However, there is a dollar limit on a car's cost that can be used as your base for claiming CCA. The limit is reviewed each year, but for cars purchased in 2001 through 2018 it has remained at $30,000 (plus sales taxes).
- Meals and entertainment. You can claim restaurant meals and tickets to sports events, shows, etc. where the expense was required for your business — e.g., you take a prospective client to lunch or a hockey game. However, you can only claim 50% of the cost as a business expense (long-haul truck drivers can claim 80% of meals).

Home office expenses

Home office expenses are deductible only if you fall into one of two categories:

- Your home is your principal place of business — that is, you do not have an office elsewhere in which you conduct more business than your home office. Note that even if you have a major client that provides you with an office on its premises, it is still the client's premises and it will not necessarily disentitle you to your claim for a home office.

  or

- The home office is used exclusively for your business, and is used "on a regular and continuous basis for meeting clients, customers or patients".

  You can only claim the expenses against your income from the business. You therefore cannot use home office expenses to produce an overall business loss that is applied against other income.

  However, losses disallowed because of this rule can be carried forward and used in any later year against income generated from the same business (you will need to bring them in on each year's return to carry them forward).

  The allowable expenses will normally be based on the fraction of the home that is used for your office. When making this calculation, you can normally exclude common areas, such as hallways and bathrooms, from both the numerator and the denominator. You can choose any calculation that is reasonable; for example, calculations based on square footage or number of rooms are usually considered reasonable.

The expenses you can claim include:

- rent, if your home is rented
- mortgage interest (but not the principal portion of blended mortgage payments)
- home insurance
- property taxes
- utilities: electricity, heat, water, gas
- telephone, if your personal line is used partly for business
- home maintenance and repairs, as well as supplies (e.g., light bulbs).

  You may also claim CCA (at 4% of the declining balance of the cost of the building) on the appropriate fraction of your home, but this is often not advisable.

THE GST/HST NEW HOUSING REBATE

If you are buying a new home or condominium, a GST or HST (and in Quebec, QST) New Housing Rebate may be available to you — but there are a number of traps and pitfalls that can cause you to lose the rebate.

Amount of rebate

The **federal** rebate, offsetting in part the 5% GST on the new home, is **1.8% of the purchase price**, or 36% of the GST. However, the full rebate is available only up to a purchase price of $350,000, where the maximum rebate is $6,300. After that the rebate is phased out, and **disappears entirely once the home price exceeds $450,000**.

In **Quebec**, an additional rebate is available of **4.9875% of the purchase price** (50% of the 9.975% Quebec Sales Tax — QST). However, the full rebate is available only up to a purchase price of $200,000, so the maximum rebate is $9,975. After that the rebate is phased out, and **disappears entirely once the home price exceeds $300,000**.

In **Ontario**, an additional rebate is available of **6% of the purchase price**, or 75% of the 8% Ontario portion of the HST. However, the full rebate is available only up to a purchase price of $400,000, so the maximum rebate is $24,000. After that level, the **rebate remains at $24,000** to matter how expensive the home.

No other province provides an additional rebate, although Nova Scotia offers a rebate to "first-time buyers" (persons who have not owned a home in the past 5 years) which is not part of, or based on, the GST/HST rebate system.

The rebate is normally credited to you by the builder on closing, though you can also apply for it directly to the Canada Revenue Agency (or in Quebec, to Revenu Québec).

Most new home builders price their homes to include the GST/HST or QST, net of the rebate, but also provide in their standard Agreement of Purchase and Sale that they will credit you the rebate and that you will in turn pay or transfer the amount of the rebate back to the builder. In these cases, calculating the rebate using the above percentages does not quite work, because the technical purchase price on which the rebate is calculated includes the rebate itself.

Conditions for rebate

If you are **purchasing** a new home or condominium from a builder, you can normally claim a rebate if you meet the following conditions:

- The sale of the home is subject to GST or HST.
- At the time you sign the agreement of purchase and sale, you are acquiring it with the **intention** of using it as your (or a close family member's) "**primary place of residence**". (If instead you are intending to rent out the property for at least a year, there is normally a parallel "landlord's rebate".)
- You pay all the GST/HST on the purchase.
- The construction is "substantially complete" by the time ownership is transferred to you.
- The home **has not yet been lived in** (if it has, the builder should have paid the GST/HST on it and there should be no GST/HST when you buy the home). However, occupancy of a condominium unit under an agreement of purchase and sale before closing is allowed — often this happens as a temporary rental before the condominium project is registered and ready to be transferred.
- Either you (or a close family member) are the **first person to live in the home** after substantial completion, OR you re-sell the home without GST/HST before anyone moves in.

What happens if someone else helps you with the financing?

Beware of what can happen if you get help from a friend, or a relative who is not a close family member (e.g., an uncle), with your financing.

Some mortgage lenders insist that a person who wants to co-sign or guarantee a home purchase loan must sign onto the Agreement of Purchase and Sale as a co-purchaser. If this happens, and the person is not "related" to you as defined in the *Income Tax Act*, **you will lose the rebate**. The reason is that *every* person who signs the purchase agreement must meet all of the conditions above, and your friend or uncle is not intending to live in the home.

Even if the other person signs a bare trust agreement confirming they have no real interest in the home, the rebate will be lost. This was determined by the Federal Court of Appeal in February 2018 in the *Cheema* case (2018 FCA 45).

What's included in the purchase price?

If your new home costs under $350,000, you can increase your GST rebate by having "extras" included in your contract as part of the new home price. For example, the CRA's administrative policy permits appliances sold with a new home to be considered part of the purchase price in certain cases. Other extras, such as landscaping, can also become 1.8% cheaper when included in the price this way.

On the other hand, if your new home costs *over* $350,000 but less than $450,000, you will want to exclude such "extras" from the purchase price and contract for them separately, so as to stop the erosion of the rebate that happens once the purchase price exceeds $350,000.

If you are in Ontario or Quebec, these calculations need to also take into account the Ontario or Quebec rebate.

Co-operatives

Co-operative housing corporations are similar to condominiums, but you don't actually buy a unit as you do with a condominium. Instead, you buy a share in the corporation, which gives you a right to occupy a particular unit.

For GST/HST purposes, the share is exempt — you pay no tax on it (just as when buying any shares of a corporation — this is an exempt "financial service"). However, the housing corporation will have paid GST or HST in constructing the building. You can therefore claim a rebate from the CRA when buying a new co-op unit. The rebate is 1.71% of the value of the co-op share up to $367,500. Above that level, the rebate is again capped at $6,300 and gradually phased out for more expensive shares. For Ontario and Quebec, similar adjustments are made to the provincial rebate.

The numbers are different than for houses and condominiums because the price you pay for the co-op is already a "GST-included" price, reflecting the GST the housing corporation paid on the construction.

Owner-built homes

If you **build your own home**, you can claim the new housing rebate directly from the CRA. The rebate is **36%** of the GST you pay on construction costs (trades, materials, etc.).

If the completed value of the home (including the land) is over $350,000, the rebate is capped at $6,300 and then phased out so that it disappears once the value of the home reaches $450,000, using the same formula as above for purchased homes. For this purpose, the value of *both* the house and the land are counted.

The additional Ontario and Quebec amounts are also available for the owner-built home rebate.

Conclusion

If you are buying a new home, condominium or co-op or building yourself a house, be aware of the availability of the new housing rebate, and of all the conditions that must be met for you to be entitled to the rebate. The CRA actively reviews new housing rebate applications, and will check to make sure the conditions are met by every purchaser or co-purchaser. If they are not, the CRA will assess you to recover the rebate, plus interest, even if the builder credited it to you on closing. If you are in Ontario, this can easily cost you $25,000 or more; in Quebec, $17,000 or more, and in other provinces, $6,500 or more.

"WORKING INCOME TAX BENEFIT" SCAMS

The CRA recently issued a warning to taxpayers not to "be fooled by the working income tax benefit tax scheme".

The WITB (which will be renamed the Canada Workers Benefit starting 2019) is a refundable tax credit intended to help low-income individuals and families who are currently in the workforce. It also encourages Canadians to enter the workforce. You can only claim the WITB if you are earning income from working in Canada.

The scheme involves the promoter preparing a T4 employment income slip in your name, listing an income amount in Box 14 that will maximize your tax refund. Because the WITB is a refundable credit, earning such income can keep you below the level of paying tax and yet generate a WITB for you.

The promoter will tell you that you must pay them the tax deductions they noted on the T4 slip as well as a fee for them completing your tax return. A legitimate tax preparer will never ask you to pay back deductions and will not prepare a T4 for you when you did not earn income in Canada.

If you suspect someone of promoting or participating in an abusive tax scheme, you can report it at canada.ca/taxes-leads or by calling the Leads program at 1-866-809-6841. You may give information anonymously. See also canada.ca/tax-schemes.

AROUND THE COURTS

Mortgage lender lost out to borrower's pre-existing GST debt

In *The Queen v. Toronto-Dominion Bank*, 2018 FC 538, a Mr. Weisflock was in the landscaping business as a sole proprietor. In 2007-2008, he accumulated some $68,000 of unremitted GST, which he had collected but did not remit.

In 2010, Weisflock and his wife took a line of credit from TD Bank, secured by their home, which was registered in his name. A year later he sold the home and repaid the loan to the bank, discharging the mortgage.

The CRA then sued the bank in Federal Court for the $68,000 that the bank received back from Weisflock. This was because section 222 of the *Excise Tax Act* (the GST/HST legislation) imposes a deemed trust on Weisflock's property despite any security interest, and required "proceeds" of the property to be paid to CRA "in priority to all security interests".

The Court agreed with the CRA, and ordered the bank to pay the $68,000 to the CRA, along with pre- and post-judgment interest.

The bank has appealed this decision to the Federal Court of Appeal, so this issue is not yet finally resolved.

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