



business meeting

CLAIMING BUSINESS EXPENSES – WHAT'S DEDUCTIBLE AND WHEN?

Every business incurs and pays a wide variety of business-related expenses on a day-to-day basis, ranging from employee payroll to advertising costs to utilities bills to the cost of new equipment. The general rule, for tax purposes, is that all reasonable current expenses which are incurred for the purpose of earning business income are deductible from that income. Effectively, a business doesn't pay income tax on income which has been used to pay expenses related to earning that income.

While the rule regarding the deduction of business expenses can be stated in simple terms there are, within that rule, myriad exceptions, qualifications, and restrictions. Most of those are the result of provisions in our tax law that limit, in one way or another, the amount of deduction which can be taken for a particular kind or class of expenses.

A. BERTUCCI

COMPTABLE PROFESSIONNEL AGRÉÉ - CHARTERED PROFESSIONAL ACCOUNTANT

Current vs. capital expenses

The first step to be taken in determining whether a business expense can be deducted from income in the year in which it is incurred is determining whether the expense is “current” or “capital” in nature.

Current expenses can, in most cases, be wholly deducted from income earned in the year in which the expense is incurred. A deduction can also be claimed for capital expenses, but those must be deducted over the course of a number of years, through the tax system’s capital cost allowance (CCA) regime.

The line between current and capital expenses isn’t always a clear and distinct one, and many disputes (and much tax litigation) have taken place over the years in the determination of which side of that line a particular expense falls. The general rule is that an expense is capital in nature (and therefore cannot be deducted in its entirety from current year income) where it brings into existence an asset of enduring benefit to the taxpayer. In this context, enduring benefit is taken to mean having a useful life of more than one year.

The application of that rule, and the difference between a capital and a current expenditure generally, is most easily illustrated by example. In its guide to the computation of business income, the Canada Revenue Agency (CRA) provides a series of examples illustrating the difference between a capital and a current expense. The examples and guidelines provided by the CRA are as follows:

- A capital expense generally gives a lasting benefit or advantage, while a current expense is one that usually recurs after a short period. For example, the cost of covering a wooden house with vinyl siding would be a capital expense, while the cost of painting the exterior of that wooden house would be deductible as a current expense.
- The cost of a repair that improves a property beyond its original condition is likely a capital expense, while an expenditure that simply restores it to its original condition is usually a current expense. For example, replacing wooden steps with concrete ones is a capital expense. The cost of repairing those wooden steps is a current expense.
- The cost of replacing a separate asset within a property is a capital expense, while the cost of repairing a property by replacing one of its parts is usually a current expense. For example,

the cost of buying a piece of equipment for use in a business is a capital expense, but the cost of upgrading electrical wiring in the business property is usually a current expense. While the electrical wiring is part of the building, the piece of equipment is not.

- Where the cost of the expense is high in relation to the overall value of the property, that cost is more likely to be a capital expense. The CRA cautions, however, that this test is not determinative. A business owner might well spend a large amount of money on deferred maintenance and repairs to the business property in a single year, but if the costs are entirely for required maintenance, they are current expenses and deductible in the year they are incurred.
- Where costs are incurred to repair used property that has been acquired, in order to make that property suitable for use in the business, the costs are capital in nature, but where those costs are incurred for the ordinary maintenance of property already owned by the business, they are current in nature.
- Finally, costs incurred to render an asset saleable (or as a condition of sale) are capital costs, but where the sale was negotiated during the course of or following the making of the repairs, the cost of the repairs is deductible as a current expense.

Where an expense is determined to be capital in nature, then it may or may not be deductible under the capital cost allowance system. In other words, not all capital expenditures are eligible for capital cost allowance treatment, and those which are not and which cannot qualify as a current expense are simply not deductible for tax purposes.

The capital cost allowance system separates assets into a number of pools, or classes. A prescribed percentage of the cost of the assets assigned to each class can be deducted (but is not required to be—the deduction is optional) each year on the annual tax return. Such deduction is usually taken on a declining balance basis (that is, deducted from the balance remaining after the previous year’s deduction was taken), but in some cases the deduction may be made on a straight-line basis (each year’s deduction is calculated as the applicable percentage of the original cost of the assets in the class). The method to be used for each particular class is also prescribed.



TAXES

A listing of the specific classes and the types of assets included in each is too lengthy for inclusion in this article. That information, can however, be found on the CRA Web site at www.cra-arc.gc.ca/tx/bsnss/tpcs/slprtnr/rprtng/cptl/clss-eng.html.

One cautionary note: the rules governing the capital cost allowance system are among the most frequently amended provisions in our tax system. For instance, the CCA system is frequently used to provide assistance to particular industries by providing incentives (for example, a 100% write-off of a particular asset in the year of acquisition) to taxpayers to acquire assets produced by those industries. As well, it's sometimes the case that the same asset could be assigned to a different class (with a different CCA rate) depending on the date on which it was acquired. Consequently, it's important to be sure that the version of the CCA regulations which is being consulted is the current one.

Current expenses —what's "reasonable"?

Where an expense has been determined, under the CRA guidelines, to be a current expense and therefore deductible in the year it was incurred, the next criterion which will apply is whether the expense was "reasonable". Reasonableness is, of course, often in the eye of the beholder, and there are undoubtedly many cases in which the CRA has disallowed a deduction for expenses which are, in

the taxpayer's view, reasonable in nature. Unfortunately, it's not really possible to provide a working definition of "reasonable" for tax purposes. There are, however, circumstances which are likely to lead the CRA to question the reasonableness of either the kind or amount of a deduction, as follows.

- **Expenses which are disproportionately high relative to overall business income.** A business owner who declares \$50,000 in business income and seeks to deduct \$48,000 in business expenses is likely, at the very least, to receive an inquiry from the CRA asking for documentation of those expenses. The CRA is prepared to accept that many businesses may, following their start-up, have expenses which are high relative to overall income, or even to exceed that income. However, if a situation like the one outlined above persists for an extended period of time, the CRA is likely to inquire further into the revenue/expense ratio of that particular business.
- **Claiming business expenses which are out of the ordinary for the industry in which the business operates.** Every business is different, of course, and no two businesses will have exactly the same revenue and expense picture. However, if expenses claimed are significantly at variance with the industry norm, the CRA may well have questions about whether those expenses are "reasonable".

- **Claiming business expenses which are significantly different than those incurred in previous years, for no apparent reason.** Here again, expenses incurred by a business will vary from year to year, but where that variance is extreme, the reasonableness of those expenses may well be at issue. In many cases, of course, the reasons will be obvious. Increases in the deductions claimed for fuel, delivery and freight costs won't be remarkable in a year in which fuel costs hit an all-time high. But where there is no such ready explanation, it may fall to the taxpayer to explain how the significant increase in costs remains "reasonable".

A final point—no matter what the kind or amount of costs or expenses claimed, it is up to the taxpayer, in all cases, to both justify the expense (in terms of it having been incurred to earn business income) and to document the cost. While receipts for business expenses claimed do not have to be filed with the annual return, the CRA has the right to ask to see those receipts. And, as with any expense claimed by a taxpayer, where the receipt or other proof of the expense cannot be produced, the CRA must assess on the basis that the expense was not incurred and the deduction will therefore be disallowed.

Once it has been determined that an expense is a current expense and the reasonableness standard is met, the next step is to determine whether the expense can be deducted in its entirety, or whether the tax system imposes limitations on either the timing or the amount of the deduction. What follows is a listing of those business expenses which are wholly deductible in the year they are incurred, followed by a listing of those to which special (usually limiting) treatment applies.

Expenses wholly deductible in the year

Bad debts

Every business runs into clients or customers who can't or won't pay their accounts on a timely basis or, sometimes, not at all. When a business finally decides that an account is uncollectible and writes it off, a deduction can be claimed in the year of the write-off, assuming that the receivable had previously been declared as business income on a previous tax return.

Business tax, fees, licences, dues, memberships, and subscriptions

There are business taxes, fees, and licences which must be maintained for just about every kind of business. As well, business owners who are members of a profession or trade are likely required to maintain membership in a professional organization or trade association. All such costs, to the extent that they relate to the business, are deductible in the year they are paid. Fees paid for memberships in groups or organizations whose main purpose is related not to business but to social, recreational, or sporting activities (like a golf and country club) are not deductible at all.

Office expenses

The cost of general office expenses for goods like paper, pens, pencils, etc. which will likely be used up during the year are deductible. However, office supplies like filing cabinets, desks, etc. are considered capital purchases, the cost of which must be deducted through the capital cost allowance system and not as a current year deduction.

Supplies

All businesses require supplies of one kind or another in order to produce the goods they sell or render the services they provide. The cost of acquiring those supplies is deductible in the year they are purchased.

Legal, accounting, and other professional fees

At one time or another, a business will usually require the services of a lawyer or an accountant, even if it is only to prepare the business's annual tax return or to provide legal services relating to the start-up of the business. In most cases, the expense of those professional fees (including consulting fees) is deductible from income. That deduction is available as well for professional fees paid in relation to an assessment for income tax, Canada Pension Plan, Quebec Pension Plan contributions, or Employment Insurance premiums. No deduction is available, however, for legal or other fees paid in connection with the acquisition of a capital property. Instead, those fees are added to the cost of the property and claimed through the capital cost allowance system.

Insurance

Costs incurred to insure the business property (including buildings, machinery, and equipment), against loss through ordinary commercial insurance are deductible in the year they are paid.

Property taxes and rent

Whether the business premises are owned or rented by the business, property taxes or rent will be payable. Those costs are deductible, assuming that the premises and/or property to which they relate are used in the business. Here again, special rules apply to the use of one's home for business purposes and they are outlined below.

Maintenance and repairs

The cost of materials and labour used to effect minor repairs or do maintenance on a business property are fully deductible when incurred. Where work done on the property is more significant than minor repairs, it may be that the costs of that work must be treated as a capital expense and deducted over time under the capital cost allowance system.

Whether the cost of work done to property is current or capital in nature, no deduction is allowed for the cost or value of one's own labour.

Salaries, wages, and benefits

The cost of salaries, wages, and benefits paid to employees often constitutes one of a business owner's largest expenses. The gross amount of such wages and salaries are deductible from the business income. As well, the business owner can deduct the employer-paid portion of Canada Pension Plan and Quebec Pension Plan contributions and Employment Insurance premiums made on behalf of employees. No deduction is available, however, for salaries, wages, or drawings paid to the business owner.

Many businesses provide benefits to employees as part of their contract of employment. When the business pays insurance premiums for an employee for a sickness, accident, disability, or income insurance plan, the cost of those premiums is deductible in the year the payment is made.

Travel

The increased cost and difficulty of business travel as well as advances in communications technology have made travel for business purposes less frequent than it once was. Nonetheless, where travel is undertaken in order to earn business income, the cost of that travel (including public transportation fares, hotel accommodation, and meals) remains deductible from business income.

Note that a special rule, outlined below, imposes limitations on the amount of any deduction taken by the business for meals and entertainment expenses. Those limitations would also apply to such expenses incurred in the course of business travel.

Telephone and utilities

All costs of utilities, including telephone, gas, oil, electricity, and water incurred in order to earn business income are deductible when they are paid. Special rules apply where the business premises are located in one's home, and those rules are outlined below.

Delivery, freight, and expenses

Whether the costs are paid to Canada Post or to a private delivery or courier service, the costs of delivery, freight, and express services are deductible by the business in the year in which they are incurred.

Expenses partly deductible in year of expenditure

In some areas, the tax rules impose limitations on the deduction of expenses which would, under the general rules, be wholly deductible in the year in which they are incurred. In some cases, the amount of the deduction is limited or capped because the CRA is seeking to exclude a part of the cost which relates to personal use and enjoyment. In other cases, the tax rules require that part of the deduction be deferred to a later year to which it more properly relates.

Meals and entertainment

Where a business owner takes a client or prospective client out for lunch or dinner and picks up the tab, the cost would ordinarily be a fully deductible business expense. But, clearly, there is also an element of personal use and enjoyment of that expenditure on the part of the business owner. Strictly speaking, the best way to reflect that would be to limit the deduction to the cost of food and drink consumed by the client or prospective client and not by the business owner, such an approach is impractical, in addition to being nearly impossible to enforce. The CRA has settled, instead, on a "rough justice" approach in which the deduction available for the cost of business-related meals and entertainment is limited to the lesser of 50% of the actual cost or an amount which is reasonable in the circumstances. Practically speaking, this means that only one half of any business expenditures related to meals and entertainment may be deducted.

There is a fairly lengthy list of exceptions and qualifications to this rule, including meal and entertainment expenses relating to a special occasion party held for employees or similar expenses incurred for a fundraising event held for the benefit of a registered charity. A full listing of those exceptions and qualifications can be found on the CRA Web site at www.cra-arc.gc.ca/tx/bsnss/tpcs/slprtnr/rprtrng/cptl/clsss-eng.html.



Prepaid expenses

It is sometimes the case that a business will pay for services or goods which are to be provided to it throughout the current year and into the next one. The example used by the CRA in its guide is that of a business which, on June 30, 2015, prepays its rent for a full year (from July 1, 2015 to June 30, 2016). In such circumstances, the rule is that one half of the rent is deductible as an expense on the business's return for the 2015 taxation year, while the other half is deducted as an expense in 2016.

Motor vehicle expense

The rules relating to the taxation of automobile benefits expenses received by employees and the deduction of motor vehicle expenses incurred by employers are both detailed and subject to frequent revision. The general rule for businesses, however, is that where a vehicle is used for business purposes, the following types of expenses are deductible:

- licence and registration fees;
- fuel costs;
- insurance;
- interest on money borrowed to buy the motor vehicle;
- maintenance and repair costs; and
- leasing costs.

It's often the case that a small business owner will use his or her own vehicle for both personal and business-related purposes. In that situation, the business owner is required to keep records which document the use of the vehicle for business purposes, as only that portion of the motor vehicle costs will be deductible.

The types of cost which are deductible, listed above, are the same whether the vehicle is used full-time for business

purposes or its use is divided between business and personal purposes. But, in either case, there are limitations placed on deductible lease costs where a vehicle is leased and on the amount of any interest payments which can be deducted where money is borrowed to purchase a vehicle. While the rules outlining those limitations can be complex, in general terms, taxpayers are entitled to claim such costs only up to a prescribed maximum set annually by the CRA. More details of the limitations and how they apply can be found on the CRA Web site at www.cra-arc.gc.ca/tx/bsnss/tpcs/slprtnr/bsnssxpns/mtr/menu-eng.html.

Business use-of-home expenses— a special case

It's always been the case that some businesses get their start as a home-based operation and grow from there. However, in recent years, the operation of a business from one's home on a long-term basis has become quite common. In many instances, a homeowner will create a dedicated space in the home for the business



and is able, with the use of communications technology, to operate the entire business from home.

Where part of a home is used for business purposes, some of the expenses related to that home become, in effect, business expenses, and may be deducted from business income.

In order to deduct such expenses, it is necessary that the business space in the home be either the principal place of business or that it be used only to earn business income and be used on a regular and ongoing basis to meet clients, customers or patients. Once either of those criteria are satisfied,

the business can deduct a portion of heating, home insurance, and electricity costs, as well as a part of property taxes, mortgage interest (but not mortgage principal), and, sometimes, capital cost allowance.

To determine what portion of such costs will be deductible as business expenses, the home/business owner will need to determine what percentage of the home is used for the business. The simplest way to do so is to calculate the overall square footage of the home and square footage of the room or rooms used for business purposes. For example, if a 200 square-foot room in a 2000 square-foot house is used for the business, then the business owner would be entitled to deduct 10 percent of the eligible costs related to running the house ($2000 \times 10 \text{ per cent} = 200$).

While a claim for capital cost allowance for the portion of the house used for business purposes may be allowable, it may not be in the homeowner's best long-term interests to make that claim. Where an owner-occupied home (a "principal residence", in tax parlance) is sold, the gain made on that sale is, effectively, received free of tax—a benefit known as the principal residence exemption. However, if capital cost allowance is claimed on the "business"

portion of the house, the part of any gain attributable to that portion will be disqualified from the principal residence exemption at the time of sale. In most cases, the cost of forgoing that portion of the principal residence exemption will be greater than the benefit which could have been received from making the available capital cost allowance claim.

Conclusion

The kinds of expenses incurred by Canadian businesses are as many and as varied as the businesses themselves. The CRA issues a guide to the computation of Business and Professional Income (T4002(E)), which summarizes the tax treatment of all of the types of expenses outlined above, and many more, and that guide is available on the CRA Web site at www.cra-arc.gc.ca/E/pub/tg/t4002/t4002-15e.pdf. There is also a portion of the CRA Web site devoted to the tax treatment of business expenses, and that can be found at www.cra-arc.gc.ca/tx/bsnss/tpcs/slprtnr/bsnssxpns/menu-eng.html. If neither of those sources can provide an answer to a particular question, taxpayers can always contact the CRA's business enquiries line at 1-800-959-5525.

