SVS GROUP LLP
CHARTERED ACCOUNTANTS

DEDUCTING EXPENSES AS AN EMPLOYEE

Employees are very limited in the expenses that they can deduct in calculating the tax they owe to the Canada Revenue Agency ("CRA"). Self-employed individuals have much more flexibility…they can basically deduct any reasonable expenses incurred to earn income from their business. However, there are ways for "regular" employees to reduce their tax bills by tax planning and structuring their employment arrangements appropriately.

This bulletin looks at the types of expenses you can deduct as an employee. Please note that it does not examine deductible expenses if you are a self-employed individual (independent contractor). There are differences in the rules for commission salespeople and the types of strategies they can use to maximize their deductible expenses, and this bulletin will address these issues. There are even special rules for artists, musicians and railway and transportation employees that we will examine briefly.

WHEN ARE EXPENSES DEDUCTIBLE?

Under Canadian tax rules, employees can only deduct expenses that are specifically allowed. Unlike individuals who run their own businesses, there is no general rule allowing them to deduct reasonable expenses to earn employment income. This can make tax minimization a challenge.

One basic test must always be met in order for <u>any</u> employee to be able to deduct expenses. An individual must be required BY THEIR CONTRACT OF EMPLOYMENT to pay their own expenses. This means that the employee needs to ensure that their employer signs **Form T2200 Declaration of Conditions of Employment** certifying that this requirement indeed exists. Fortunately, this is often not a problem. Employers are usually more than happy to certify that employees are required by the terms of their employment to pay certain expenses when this is the case and it enables the employee to deduct them for tax purposes.

The rules for commission salespeople are somewhat more generous. In addition to being allowed to deduct certain expenses, they can deduct any reasonable expenses incurred to earn income, such as commissions, which are based on the amount of sales they generate. To be able to deduct expenses as a salesperson, the following tests must be met:

- You must be required to pay your own expenses by virtue of your contract of employment;
- You must ordinarily be required to carry on the duties of your employment away from your employer's business location (e.g. at customer locations);
- Your remuneration must by wholly or partly based on commissions or other amounts, such as bonuses which are calculated by reference to the volume of sales made or contracts negotiated; and
- You are not in receipt of a tax-free travel allowance for your expenses or the allowance is insufficient.

If you are deducting expenses as a commission salesperson, there are a couple of points you should keep in mind. Firstly, you can only deduct expenses to the extent of your commission income. If your expenses exceed this income, any excess is lost and cannot be transferred to another year to deduct against income earned in that year. Secondly, you can always deduct certain expenses as a regular employee against your salary. You only need to use the rules that allow you to deduct certain expenses as a commission salesperson if you couldn't otherwise deduct them as a regular employee. A good example of an expense that is only deductible by a salesperson is meals and entertainment. Therefore, to minimize the likelihood that your expenses will exceed your commission income, you should always deduct expenses FIRST under the rules for regular employees, and then only use the rules for commission salespeople if the expense is not otherwise deductible.

WHAT IS DEDUCTIBLE?

The following chart outlines the various deductible expenses, comparing what is deductible as an employee with what is deductible as a commission salesperson. Additionally, we have included a column for self-employed individuals. Keep in mind that they have the greatest flexibility in deducting expenses, so at the end of this bullet, we will briefly discuss the possibility of rearranging your affairs to become an independent contractor.

Expense	**Regular Employee**	**Commission Salesperson**	**Independent Contractor**
Professional dues	Yes	Yes	Yes
Union dues	Yes	Yes	N/A
Salary paid to an assistant	Yes	Yes	Yes
Supplies consumed	Yes	Yes	Yes
Traveling expenses (Meals/lodging must be away > 12 hours)	Yes	Yes	Yes
Capital expenses (Automobile/aircraft)	Yes	Yes	Yes
Capital expenses (Equipment/furniture)	No	No	Yes
Rental costs of equipment/telephone	No	Yes	Yes
Interest expense	No	No	Yes
Meals and entertainment	No	Yes	Yes
Office rent/home office expenses	Limited	Limited	Yes

The following paragraphs explain many of the above expenses in more detail. Additionally, pay special note to the section on home office expenses…the rules for this area are complicated and the types of expenses that you can deduct vary depending on whether you are a regular employee, a commission salesperson or an independent contractor.

Annual Professional Membership Dues

Suppose you are an engineer working for a large company. Every year, you must pay fees to the provincial Professional Engineers Association to maintain your professional status as a P.Eng. You may deduct these fees as an employment expense on your tax if you pay the fees yourself. If your employer pays the fees on your behalf, you cannot deduct them. This amount should be given as a non-taxable benefit to you, however if your employer does include the amount on your T4, then you can deduct this amount on your tax return.

Union Dues

Employees who are members of a union can deduct the annual dues they are required to pay.

Salary Paid to an Assistant

Sometimes, an employee can deduct the costs of hiring an assistant. This type of situation is quite unusual as most assistants are hired directly by their employer who will bear the costs. However, there are situations where it may make sense for an employee to hire an assistant. For example, a mutual fund salesperson who is an employee makes a small base salary, but earns commissions based on the dollar value of mutual funds sold in the year. The more time this person has to meet clients and make sales, the higher their commissions will be. In this case, an assistant to be invaluable in performing administrative duties, thereby freeing up the salesperson to make sales and earn higher commissions. If the employer won't hire the assistant, the salesperson could do so and deduct the costs of paying the assistant on their tax return, including CPP and EI premiums.

Supplies Consumed in Employment Duties

You may deduct supplies you have to pay for that are consumed in your employment duties such as:

- Paper
- Office supplies
- Long distance telephone charges
- Cellular phone airtime
- Internet charges based on usage

Some people think that they can deduct certain expenses, such as clothing, under this provision. You can't…not even special clothing such as uniforms. Items such as clothing are considered to be of a personal nature. However, if you are required to wear special clothing at your job and your employer provided it to you free of charge or at a reduced price, this is not considered to be a taxable benefit to you. In addition, if your employer provides you an allowance to pay for special clothing or footwear, or for the cost of maintaining the special clothing such as dry cleaning expenses, this is also considered a non-taxable benefit.

Planning Point: If you are required to wear special clothing for your job, such as a uniform or safety clothing, have your employer pay for it. This will <u>not</u> be a taxable benefit to you.

Travelling Expenses

Employees are allowed to deduct travelling expenses if they are required to pay these expenses under their contract of employment and they do not receive a tax-free allowance for these expenses. Remember, to claim meals and lodging, you must be away from your place of employment in excess of 12 hours. These rules also allow employees to deduct automobile expenses.

Please note, most allowances you receive from your employer will be taxable, except for reasonable automobile allowances that are calculated by reference to the kilometres you drive for employment purposes. In certain circumstances, other reasonable allowances can be considered tax-free, such as allowances paid to cover travel expenses for salespeople, clergy and for ordinary employees if they are required to travel away from the municipality in which they normally report to work. Keep in mind that if these allowances are reasonable and therefore not taxable, you cannot deduct any other the travelling expenses that you incur.

The most common travelling expenses are for your automobile. Many employers require their employees to have a car and do not reimburse them on a tax-free basis for their expenses.

Planning Point: Most employers are willing to pay you a reasonable amount per kilometre if you are required to use your car for employment purposes. What is reasonable is a question of fact, but the Canada Customs and Revenue Agency won't likely challenge a per-kilometre allowance of 47 and 53 (2012 rates) or of 54 and 48 (2013 rates). Compare the amount you receive as a per-kilometre allowance to the amount of deductible automobile expenses you have. If the allowance is higher, don't include it in your income and don't deduct automobile expenses. The excess amount of the allowance over the deductible expenses will be tax-free. This will usually be the case if you drive an inexpensive or older car and therefore the amounts you can deduct for tax depreciation on the car, as well as maintenance and fuel costs, are not very high.

Capital Expenses

Capital expenses include any amounts paid for a capital asset. For example, office furniture office equipment, such as computer, are capital assets. Businesses, including self-employed individuals, can deduct the cost of capital assets through a tax depreciation system call capital cost allowance ("CCA"). Generally, employees and commission salespeople cannot deduct expenses incurred for capital assets, with one main exception.

An employee can deduct CCA within certain limits on their automobile if they are eligible to deduct automobile expenses using a prorated amount of actual expenses. Essentially, you cannot deduct CCA on any purchase price greater than $30,000 purchases, plus applicable GST and HST. If the cost of your automobile is less than these limits, it is considered a "Class 10" asset. Your purchase price including tax is added to a "pool" of costs with any other Class 10 assets you own. Each year, you are entitled to deduct of to 30% of the pool's balance as CCA, but only up to 15% in the year of purchase. Any amount claimed in one year reduces the pool's balance for next year's calculation. If the cost of your automobile exceeds the above limits, the maximum deductible amount will go into its own CCA class, or "Class 10.1" which is eligible for the same CCA deductions. If you sell a car in the year, you may have a gain or loss, depending on whether the proceeds are greater or less that the pool's remaining balance.

These rules do not apply to employees who receive reimbursement on a per kilometre basis

Rental Costs of Equipment/Telephone

Regular employees cannot deduct the cost of renting equipment, such as computer of office equipment. CCRA does not consider the rental payment to be a supply consumed in employment duties and therefore the cost is not deductible. The sale rationale also means that an employee cannot deduct the costs of renting a telephone line or purchasing cellular phone air time.

Planning Point - Regular Employees: Ordinary employees should avoid paying the cost of equipment that they need for employment purposes. Instead, you should have your employer purchase or rent the required equipment. Your employer can deduct these expenses and there will be no tax consequences to you as long as you do not use the equipment for personal purposes.

Planning Point – Commission Salespeople: A salesperson, if they need to provide their own equipment, should always lease it. If you buy the equipment you cannot deduct the cost as CCA. If you lease the equipment, however, you can deduct the lease payment as an expense incurred to earn your commissions.

Interest Expense

You cannot deduct interest expense if you are an ordinary employee or a commission salesperson, except interest on a car loan. You can deduct the "business" portion of the interest expense if you are eligible to deduct automobile expenses. These rules do not apply to employees who receive reimbursement on a per kilometre basis.

Planning Point: Never borrow to fund your employment expenses, unless you are borrowing to buy a car and you can deduct automobile expenses. Use cash for these expenses whenever possible and borrow if the interest is tax deductible. For example, you can deduct interest expense if you borrow to make an investment. However, keep in mind that interest on a loan to make an RRSP contribution is NOT deductible.

Meals and Entertainment

Ordinary employees cannot deduct expenses incurred for meals and entertainment. Commission salespeople, however, can deduct 50% of these expenses against their commission income.

Office Rent/Home Office Expenses

An employee can deduct the cost of renting an office IF their employer requires them to pay for their own office space. It is much more common, however, for individuals to work for their employers out of a home office. You can deduct the cost of a maintaining a home office, as long as you pass one of the following two tests:

1. *Your home office is the principle place of your employment*: Basically, this means that you work more than 50% of the time from home. This can be a difficult test to meet for some employees who have home offices. For example, a commission salesperson might use a home office to perform their administrative duties. However, since they are usually at customer sites, they likely won't meet the 50% test and are therefore not eligible to deduct home office expenses. If you meet the 50% test, the home office does not have to be used primarily for work. It can be combined with personal living space. You would have to prorate the expenses related to your home office between its use for employment and its use for personal living space.

2. *Your home office is used exclusively for employment 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 chiropractors, massage therapists and doctors – they might have an office where they usually work away from 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 in the employment duties (i.e. not part of their living space).

WHICH HOME OFFICE EXPENSES CAN YOU DEDUCT?

You can only deduct office in home expenses to the extent of your income (or commission income for commission salespersons). However, you can carry forward your home office expenses to a future year to reduce your income from that employment in that year.

If you rent your living space and it contains a home office, you will be able to deduct a portion of your rent, utilities and minor repairs as a cost of renting an office. For example, you rent an apartment for $900 per month, pay $100 per month for utilities and you use one of the bedrooms as an office. The bedroom is 25% of the total apartment and you use it 80% of the time for work. You will be able to deduct $200 a month for home office expenses calculated as follows:

Rent	$	900
Utilities		100
	$	1,000
Office portion - 25%	$	250
Time used for employment – 80%	$	200

If you own a house in which you have a home office, you can deduct a portion of the utilities and maintenance costs that relate to the business use of your home office as supplies consumed in your employment. However, the deductible portion of these expenses is probably not significant.

Ordinary employees cannot deduct property taxes, insurance and mortgage interest. Commission salespeople CAN deduct and reasonable expenses that they incur to earn commission income and can therefore deduct a portion of their property taxes and insurance, but none of their mortgage interest. From the following chart, you can see that independent contractors have the most flexibility in deducting home office expenses.

Expense	Regular Employee	Commission Salesperson	Independent Contractor
Rent	Yes	Yes	Yes
Utilities	Yes	Yes	Yes
Repairs and maintenance	Yes	Yes	Yes
Insurance	No	Yes	Yes
Property taxes	No	Yes	Yes
Mortgage interest	No	No	Yes
Capital cost allowance	No	No	Yes

PLANNING TO MAXIMIZE TAX BREAKS - As an employee, you are limited in what you can do to maximize your tax breaks. However, there are some measures you should consider:

Become a Salesperson

Are you involved in sales? Do you often negotiate contracts on your employer's behalf? If yes, consider negotiating your salary package so that at least some of your income is based in the revenue you produce. This could be as simple as receiving a year end bonus which is based on the sales that you are responsible for. If you can rearrange your affairs, you will be eligible to deduct expenses as a commission salesperson. Make sure that your employer reports your commission or bonus separately as commission on your T4, otherwise CCRA will likely question you expense deductions as a commission salesperson.

Consider the risks however. Are you willing to accept the risk that part of your remuneration package will be based on the sales you produce? Consider the amount of expenses you currently pay which would become deductible as a commission salesperson…if they are minimal, it is probably not worthwhile to renegotiate your employment contract.

Become an Independent Contractor

Self-employed individuals have the most flexibility in deducting expenses. It may be possible to rearrange your work arrangement so that you will be considered to be self-employed, rather than an employee.

A few words of caution, however. You can't simply state that you are an independent contractor to be treated that way for tax purposes. There is a series of tests that are used by CCRA in determining whether you are self-employed or an employee. For example, they look at a series of questions relating to factors such as control, ownership of tools, chance of profit/risk of loss and integration.

Consider a few things…Will you have significant expenses that will now be deductible? Are you prepared to give up the perks of employment, such as pension, health and dental plans? Do you want the protection of employment insurance, which is only available to employees and not independent contractors? Is it even possible to change your relationship with your current employer?

SPECIAL SITUATIONS

Musicians

Musicians usually have to buy their own musical instruments. They can deduct the cost of these instruments using CCA. Most instruments are considered Class 8 assets which allows for up to a 20% deduction of the pool's balance per year (10% in year of purchase).

Artists

Artists who earn employment income from an artistic activity can deduct additional expenses from the employment income. Artistic activities include:

- Creating paintings, prints, etchings, drawings, sculptures, or similar works of art;
- Composing a dramatic, musical or literary work;
- Performing a dramatic or musical work as an actor, dancer, singer or musician; and
- Carrying out an artistic activity of which the taxpayer is a member of a professional artists association certified by the Minister of Canadian Heritage.

The expenses that can be deducted are limited to the lesser of:

- $1,000; and
- 20% of employment income from artistic activities, less any amounts claimed as CCA on automobiles or musical instruments.

Amounts exceeding this limitation can be carried forward and applied against future artistic employment income.

Employees of a transport business

Individuals who work for employers whose principal business is the transport of passengers, goods or both, can deduct reasonable expenses for meals and lodging (including showers), less any reimbursements received from their employer if they meet the following four conditions:

- You work for an airline, railway, bus, or trucking company, or for any other employer whose main business is transporting goods, passengers, or both.

- You travel in vehicles your employer uses to transport goods or passengers.

- You **regularly** have to travel away from the municipality and the metropolitan area (if there is one) where your employer's relevant establishment (home terminal) is located.

- You **regularly** incur meal **and** lodging expenses while travelling away from the municipality and the metropolitan area (if there is one) where your employer's relevant establishment (home terminal) is located. This means that you must generally be away from home overnight to do your job.

Meals

The most you can deduct for meal expenses is **50%** of your claim (unless you are a long-haul truck driver claiming meals for an eligible trip, as explained in Meal expenses of long-haul truck drivers). For example, if you use the simplified method, which is based on a daily meal rate of $17 per meal, the most you can deduct is $8.50 ($17 x 50%) for each meal.

Under either the simplified or detailed method, you can claim one meal after every four hours from the departure time, to a maximum of three meals per day. For the purposes of calculating the maximum number of meals allowed, a day is considered to be a 24-hour period that begins at the departure time.

Lodging and Showers

You can deduct your lodging expenses. The costs of showers are also considered to be deductible as part of lodging expenses for transportation employees who may have slept in the cab of their trucks rather than at hotels. You need to keep your receipts to support the amount you deduct.

Keep in mind that time and travel logs are required.

For more detailed information regarding transport employees refer to the following CRA website.

http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/ncm-tx/rtrn/cmpltng/ddctns/lns206-236/229/trnsprttn/mp-trnsprt-eng.html

Meal expenses of long-haul truck drivers

Meal and beverage expenses of long-haul truck drivers are deductible at a higher rate than the 50% permitted for other transportation employees. During eligible travel periods in 2012, meal and beverage expenses are deductible at **80**%.

You are a **long-haul truck driver** if you are an employee whose main duty of employment is transporting goods by way of driving a long-haul truck, whether or not your employer's main business is transporting goods, passengers, or both.

A **long-haul truck** is a truck or tractor that is designed for hauling freight, and has a gross vehicle weight rating of more than 11,788 kg.

An **eligible travel period** is a period during which you are away from your municipality or metropolitan area for at least 24 hours for the purpose of driving a long-haul truck that transports goods at least 160 kilometres from the employer's establishment to which you regularly report to work.

Railway Employees

Individuals who are employees of a railway company can deduct expenses for meals and lodging to the extent that are not reimbursed by their employer.

You can claim the cost of meals and lodging when you meet **one** of the following conditions:

- You work away from home for a railway company as a telegrapher or station agent in a relief capacity, or carrying out maintenance and repair work for the railway company.
- You are a railway employee who works away from the municipality and the metropolitan area (if there is one) where your employer's relevant establishment (home terminal) is located. You also work at such a distant location that it is unreasonable for you to return daily to your home, where you support a spouse or common-law partner, or a dependant related to you.

Only costs incurred while traveling away from the municipality where the individual reports to work can be deducted. Again, an employee may deduct 50% of their actual meals costs (supported by receipts), or use CRA's flat rate of $17/meal which is 50% deductible. Keep in mind that time and travel logs are required.

DOCUMENTATION OF EXPENSES

Receipts are crucial for all of your expenses. For example, if you are a salesperson deducting meals and entertainment, it is a good idea to write on the receipt who you took to lunch and why. Automobile expenses have to be documented as well…it is extremely important to keep a logbook of your driving to support the number of kilometres you drive for business purposes.

GST REBATES

When you incur expenses, you also pay GST on some of these expenses. If your employer reimburses you and is registered for GST, they are eligible to recover the GST. If you do not get reimbursed and are eligible to deduct the expenses for tax purposes, it only makes sense that you can recover the GST as well! You do this by requesting a GST rebate when you file your personal tax return. The rebate if 5/105^{ths} of your deductible expenses, less expenses on which you did not incur GST (i.e. insurance, car loan interest). The rebate is claimed by filing Form GST 370 with your personal income tax return. Note that you do not qualify for a GST rebate if your employer is not a GST registrant or if you work for a listed financial institution.

SUMMARY

Employees are very limited in what they can deduct for tax purposes. However, with a little imagination, they can take advantage of the deductions that are available to them.

This is provided for general information only.
For more detailed information and exact requirements, refer to CRA guide T4044