Starting Your Own Business: The Tax Benefits of Self-Employment

Since the unofficial start of the current recession last fall, hundreds of thousands of jobs have been lost across Canada, and the only employment category to show consistent signs of growth this year is that of self-employment. While some intrepid individuals may be choosing to start a business in less than ideal economic conditions, many of the newly self employed are likely former employees who have turned to self-employment when a job search hasn't produced a job offer. For most of them, self-employment will be a new experience.

There are a many differences between working for someone else and being self-employed. While there are downsides to self-employment — no paid vacation, statutory holidays, or sick days; no extended health care coverage; no administrative or technical support supplied (and paid for) by the employer; and, if the business should fail, no severance payments or eligibility for Employment Insurance — the benefits, from a purely tax point of view, can be significant.

First of all, it's important to note that the tax rates and income tax brackets that apply to individual taxpayers are the same, whether income is received from an employer or generated by self-employment. There are no special tax rates or brackets for self-employed individuals, and all of the rules regarding eligibility for personal tax credits are the same, whether you're an employee or self-employed. That said, it's also true that self-employed taxpayers have access to a much broader range of deductions from income than employees do, and in some cases, deductions are available for costs that the taxpayer is already incurring and would continue to incur in any case.

The general rule when calculating income from self-employment is that income from all sources earned during the year is totalled, and then money expended to earn that income is deducted to arrive at net business income for the year. Unlike employment income, where the types of available deductions are specifically identified and enumerated by the tax authorities, a deduction can generally be taken from self-employment income for any reasonable costs that are incurred in order to earn that income. And, while the list isn't comprehensive, the Canada Revenue Agency (CRA) income tax form on which business income is calculated (the T2125, available on the CRA's Web site at http://www.cra-arc.gc.ca/E/pbg/tf/t2125/README.html) lists such costs as salaries, office expenses, legal and accounting fees, telephone and utilities, travel costs, and advertising as possible deductions in the computation of net business income for the year.

Former employees who choose to become self-employed often start out by working out of their home, saving the cost of office rent at least until the business is on a firmer financial footing. Where a business is being operated from a home office, a further set of deductions becomes available to the taxpayer in the calculation of income from that business. Essentially, the business owner will be able to deduct a percentage of most operating costs of the home, such as heat, hydro, property taxes, telephone, and mortgage interest (but not mortgage principal) costs. The percentage of costs deductible is generally equal to the proportion that the home office is of the square footage of the entire house. So, where the size of the home office represents 15% of the square footage of the entire home, and the allowable operating costs of the home for the year are $5,000, a deduction of $750 ($5,000 times 15%) can be claimed on the T2125 for the year.

Self-employed taxpayers who pay a salary to someone else working in the business can also deduct that salary from their income from the business. In many cases where a new business has an employee, that employee is another family member — for example, a spouse who takes phone calls, books appointments, prepares billings, and helps out generally in an administrative capacity. And as long as the family member/employee has the skills to do that work, is actually doing it, and is receiving compensation comparable to what would be paid to an unrelated party, the policy of the CRA is to allow a deduction for the salary paid to him or her.

There's a lot involved in the decision to start a business and join the ranks of the self-employed. From a tax perspective, what's outlined here is just an overview of some of the bigger differences between receiving a salary and earning income from your own business. The first step to be taken by taxpayers who decide to take the leap into self-employment should be to consult a lawyer or accountant who can provide the expertise needed on how to set the business up properly and operate it in compliance with all the applicable federal and provincial laws, leaving the new business owner free to focus on growing the business itself.