SOBERMAN LLP

COMMENTS

Summary 2004 - 3

Renting Your Cottage?

By CLAUDIA KU, MBA, CA, Senior Tax Manager

IN THIS ISSUE

More and more people are flocking to "cottage country" to take advantage of the fresh country air, the cool lakes, the relaxed atmosphere and to get away from the hustle and bustle of urban life. The demand for recreational properties is far surpassing the supply and, as a consequence, real estate prices are increasing dramatically.

To ease the costly responsibility of a second home, some owners rent out their cottages. If you decide to rent your cottage to others, the rent you receive is taxable as income. We are assuming that any personal use you make of it thereafter, would be purely incidental.

Property Income or Business Income

Rental income is usually considered property income, but in some instances, such as with bed & breakfasts, business income could be generated. It would be property income if you provide basic services such as heat, light, etc. It would be business income if you provide extra services for the convenience and comfort of your renters such as cleaning services, linens, washroom supplies, dining facilities, etc. The income would still be considered business income if you hire an agent to provide the extra services.

Attribution Rules

Attribution rules to prevent the splitting of property income, deem that any income arising from property that you have transferred, either to your spouse or to a minor, is your income. However, these rules do not apply to attribute business income to you even if the business operates with some, or all, of the property originally obtained from you. Hence, if the rental operation of your cottage constituted a business operated by your lower-income spouse or a minor as a sole proprietorship, the rental income would be taxable in the hands of your lower-income spouse or the minor, and not in your hands. Note however, that the actual transfer of ownership requires careful planning and implementation.

Computation of Net Rental Income

You are allowed to deduct expenses associated with renting out your cottage such as advertising, insurance, interest, repairs, management fees, office expenses, legal and accounting fees, property taxes, wages, utilities, etc. Capital expenditures, such as the original cost of the cottage, furniture and appliances, are not deductible, but can be recovered through depreciation [Capital Cost Allowance (CCA)] claims. However, CCA

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2 St.Clair Avenue East Suite 1100 Toronto ON M4T 2T5
T 416 964 7633 F 416 964 6454 www.soberman.com
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We have a number of publications that may be of interest to you. If you would like a copy of any of the publications listed below, please send an email to comments@soberman.com, or visit our website at www.soberman.com.

- *(BKR) Doing Business in...* Informational brochures to help you understand the business environment in different countries around the world.
- *Tax Letters*
- *Tax Tips 2003*
- *The Ontario Small Business Guide* Useful for those establishing a new business in Ontario.

Visit www.carswell.com for the following publications:

- *Canadian Guide to Troubled Businesses and Bankruptcies* Provides comprehensive and up-to-date coverage of bankruptcy and corporate restructuring in Canada.
- *Identifying and Advising Troubled Small Businesses* Focuses on the concerns of stakeholders and their professional advisors, when the survival of a small business is at stake.
- *Restructuring and the Bankruptcy of Businesses* A technical consideration of the requirements for effectively restructuring businesses in Canada.

Individual Pension Plans

By SAM ZUK, BComm, CA, Partner

With more of us getting closer to retirement, we're spending more time trying to get our financial houses in order. Income tax rate reductions have stopped for the time being, and there is no indication that they will be reduced any further in the near future. RRSP contribution limits will cap this year at $15,500 and Canada Revenue Agency (CRA) seems to be attacking most income tax deferral or reduction plans with a vengeance. Without the benefit of a corporate pension plan, what is a hard working, self-employed entrepreneur to do?

Individual Pension Plan's (IPP's) have recently resurfaced as a real option to consider for tax-deferred savings as the costs associated with starting and maintaining these plans have been significantly reduced.

What Is An IPP?

An IPP is a defined benefit pension plan that enables a company to make regular pension contributions for the benefit of one or more of its employees, without making contributions for the benefit of all employees. The contribution amount is based on actuarial principals and is intended to provide a pension for a specified employee on his or her retirement. Where the company has a long-term employee who has earned over a number of years, a salary well in excess of $100,000 annually (often the owner), the company can usually make significant tax deductible contributions to this plan, often in the hundreds of thousands of dollars. In addition, the company can then effectively match the employee's annual contributions to this plan, the amounts of which are similar to what would be contributed to an RRSP. The benefit is that while the company gets to deduct the payment for tax purposes, the employee pays no tax on the company contribution until it is paid out of the plan over a number of years after retirement. Furthermore, the income earned in the plan is also tax deferred in the same manner as it is with an RRSP.

Why Set Up An IPP?

The following advantages are cited as reasons to set up an IPP:

- It provides for retirement funds on a tax-deferred basis.
- Funds within the plan are typically creditor-proofed.
- It provides the company with an immediate tax-deduction for both the past-service contribution as well as the annual contributions, but is not taxable to the employee until receipt after retirement.
- The plan is a defined benefit plan. If the value of the plan drops below the actuarially determined amount needed for the retirement payment, because the investments in the plan have not fared as well as anticipated, the company can make a further tax deductible payment to top up the value.
- On death of the beneficiary, the plan benefits can pass to a surviving spouse, or to a designated beneficiary where there is no surviving spouse.

Disadvantages To An IPP

There are a few disadvantages associated with an IPP which include:

(Continued on page 4 . . .)

Welcome!

Our Assurance & Advisory Practice has grown with the addition of **Cecily Huang** and **Chad Tucker**. **Adel Aboulwafa** joins our Information Technology Department and **Kathy Kelly** joins our Administrative team.

INCOME SPLITTING - A TAX SAVING OPPORTUNITY

Many individuals have loaned money to their spouse, common-law partner or children with actual interest payable at the government's prescribed rate. Earnings in excess of this rate are taxed in the borrowers' hands.

From July 1, 2004 to September 30, 2004, the prescribed interest rate falls to a low 2%. This presents the opportunity to refinance - at 2% - loans made to family members that were made at higher rates in the past.

Thus, more income can be shifted to family members in lower tax brackets.

In order to ensure that your refinancing method of such loans is considered effective under tax rules, contact your Soberman LLP advisor for assistance.

Soberman news . . .

EVENTS

Jon Finkelstein attended the Carrie's Dream Fund Gala on May 11th. Funds went towards the Therapeutic Clown Program and Pediatric Research at the Hospital for Sick Children.

Daniel Edwards, **Kristin Matthews**, **Ron Schwartz**, **Michelle Silverberg** and **Kate Turoczi** represented Soberman LLP at the Canadian Defence Lawyers Annual Meeting and Conference on May 13th. The theme for the conference was "The Naked Lawyer: Recipes for a Successful Practice."

Eric Bornstein and **Jerry Cukier** attended the "Generation to Generation" event on June 9th in honour of Marvelle and Murray Koffler & Family. Proceeds went to fund Cancer Research Scientists and the purchase of a digital mammography unit with stereotactic biopsy for the Marvelle Koffler Breast Cancer Centre at Mount Sinai Hospital.

On June 17th, our **Claims Valuation & Litigation Support Group** co-hosted, along with Brown & Korte, Cameron & Associates and Merit Assessments, the 8th Annual Toronto Harbour Cruise. Over 200 individuals attended this networking event.

IN THE COMMUNITY

Soberman LLP sponsored a UJA breakfast program on Non-Cash Gifts to Charity on May 12th. **Dorete Drabinsky** and **Charlotte Haber** are involved with the UJA's Professional Advisory Committee. The event, held at the Estates of Sunnybrook, dealt with gifts of private company shares; gifts of publicly-traded shares; gifts of art; gifts of real estate; gifts of life insurance and annuities; and gifts of RRSPs and RIFFs.

Soberman LLP sponsored a table at JVS Toronto's "Second Annual Strictly Business Luncheon" on May 19th at the Fairmont Royal York Hotel. **Shalewa Adeniyi**, **Robert Brien**, **Jon Finkelstein**, **Ivan Lavine**, **Sharon Lee**, **Kristin Matthews**, **Soo-Ling Ng**, **Saverio Rigillo**, **Helen Sbeit** and **Alan Wainer** attended. JVS stands for Jobs/Vision/Success. The proceeds for this lunch went to Youth at Risk, Persons with Disabilities and Self Employment Initiatives.

Sam Zuk has been appointed Chair of the Finance and Operations Committee of the Ontario Science Centre.

Neil Maisel has been appointed Treasurer of the Asthma Society of Canada.

Eric Bornstein has been appointed as Director serving on the BKR International Worldwide Board. BKR International is an association of independent accounting firms with presence in major centres in the US and around the world.

Gary Kopstick has been elected President at the Clanton Park Synagogue.

Jerry Colomby has been appointed Treasurer of the Beth Emeth Bais Yehuda Synagogue.

IN THE NEWS

Daniel Edward's article, "Testing Financial Dependency Requires Different Approach" and **Denise Osorio's** article, "Human Capital: A Smart Investment," were both published in the June edition of *The Bottom Line*.

Karen Slezak appeared on ROBTV's live call-in show, "Talking Tax with Kim Parlee" on June 22nd.

Alan Wainer and **Debby Stern's** article, "Family Council – The Key to Success(ion)," will appear in the August edition of the *Canadian Grocer* as part of the feature story titled "Where Will the Future Profiles of the Grocery Industry Come From?"

Frances Doria's article, "Home Ownership – The Ultimate Canadian Dream," will be published in an upcoming edition of *Real Estate News*. This magazine is the #1 real estate publication among both homebuyers and real estate agents in the Greater Toronto Area.

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Renting . . . (Continued from page 1)

cannot be claimed to create or increase a rental loss. Also, if you ever sell the cottage for more than the depreciated value, you will have to include prior CCA deductions in the income.

Only the portion of expenses relating to the rental operation can be deducted. If you have a net rental loss, the loss is deductible from your other income provided that you have reasonable expectation of profit.

Change In Use of Your Cottage

You are considered to have changed the use of your cottage when you stop using it personally and rent it out solely as an income-producing property. You will be considered to have sold your cottage at its fair market value (FMV) and to have immediately reacquired the property for the same FMV. To defer the potential capital gain resulting from the deemed disposition, a tax election can be filed to not have the change-in-use rules applied. However, if you make this election, you cannot claim CCA on your cottage to reduce the rental income.

This article just touches on some of the factors to consider when renting out your cottage. Contact your professional advisor for further information.

CLAUDIA KU

Claudia is a senior manager in our Tax Group. She has extensive corporate income and capital tax experience in dealing with multinational companies and both Canadian and foreign-based private and public corporations.

Claudia's practice areas include international tax, corporate reorganization, scientific research and experimental development. She also has experience in personal tax planning for executives and owner-managers.

You can contact Claudia at 416 963 7192 or cku@soberman.com.

IPPs (Continued from page 2)

- Cash flow is necessary to fund the payments and taxable income is required to enjoy the benefit of the tax deductibility.
- The annuitant cannot access the funds within the plan until retirement (anywhere from 50 to 69).
- The company has an obligation to fund the plan whether they are profitable or not.
- A portion of an individual's RRSP is transferred to the plan roughly equal to the amount which would have been in the plan had it been set up when employment had started. Since the funds within the plan are not accessible until retirement, this is somewhat less flexible than an RRSP.
- The plan must be accepted by CRA.
- There is a cost associated with administering and maintaining the plan.

This is a brief description of the advantages and disadvantages associated with IPP's. Contact your professional advisor for further information.

SAM ZUK

Sam is a partner in our Assurance & Advisory practice. He advises clients which include professionals, Canadian subsidiaries of foreign companies, estates, distributors and manufacturers, real estate and investment companies.

You can contact Sam at 416 963 7122 or szuk@soberman.com.

Dates to Remember

September 15

Third personal income tax instalment for 2003 is due.

Banking Costs – How Does A Consumer 'Win'?

By BRIAN McNICHOL, BComm, Insolvency Administrator

> **"When it comes to residential mortgages, the fixed 5-year interest rate has exceeded the variable rate virtually every year for the last 30 years in Canada."**

In recent years, Canadian banks, like most businesses, have been finding ways to increase profitability. It is good for the shareholders, but not so good for the customers. In today's world of limited competitiveness in the small Canadian banking market – there are fewer than ten banks for Canadians to choose from – consumers must be knowledgeable in order to minimize their costs.

Most consumers use their bank's services in two ways: to operate a chequing account, and to borrow money. It is not difficult to save money in both areas.

Chequing Account Charges

We have noticed that the banks want us to move money electronically more and more each year. From the bank's perspective, this is the most secure and cost-effective method, and the service charges reflect it.

It has been many years since I paid a service charge to my bank (one of the big 5). All my regular creditors (hydro, cable, phone, etc.) are set up and are paid electronically from my chequing account on my instructions via website or ATM. Other creditors – such as mortgage, car insurance, condo fees – are set up as pre-authorized electronic cheques and are paid automatically. I make liberal use of my debit card and use very little cash. The best part is that my monthly service charge is ZERO, because the bank waives the charges if a minimum balance of $1,500 (recently raised from $1,000) is maintained. If the bank was to pay 3% interest (which none do) on the $1500, I would receive $3.75 each month, and it would be taxable. The waived service charges on my chequing account activity come to $12 – $14.00 each month, so this is a deal not to be ignored. Even if you have to borrow the $1,500 on your line of credit, this is a money-saver!

Borrowing Money

The other area most of us spend money with the banks is in borrowing money. When it comes to residential mortgages, the fixed 5-year interest rate has exceeded the variable rate virtually every year for the last 30 years in Canada. It pays to negotiate with your bank at mortgage renewal time. Don't just accept the rate offered. Shop around, or just suggest to your banker that you intend to do so, and listen to their reply!

Car loans are another area to save a lot of money. The 'zero interest' loan offered by the carmaker is usually best left alone. There is always a 'cash back' alternative, and this is where you save money. (The cash-back is normally based on a conventional interest rate of about 10%.) Take the discount and borrow the money elsewhere. The cheapest source of money is a bank line of credit. If you have a good credit rating, your bank should offer an unsecured line at prime plus 1.5 to 2.5%, which is far lower than a conventional loan rate. If you have equity in your home or condo, you should ask for a secured line of credit, and the interest rate should be no more than prime.

There are not many bank choices in Canada, but there are ways to keep your banking costs to an absolute minimum.

BRIAN McNICHOL

Brian is a banking supervisor with the firm's Insolvency and Restructuring Department. He is responsible for managing million dollar trust accounts and is the department's liaison with its major bankers.

Brian is a Registered Insolvency Counsellor and has completed the Insolvency Adminstrator's Course.

Estate Executor? Here Is Your Job Description

By DORETE DRABINSKY, BComm (Honours), MAcc, CA, Tax Manager

> **"An executor is an individual or institution named in a will that is responsible for administrating the deceased's estate."**

An executor is an individual or institution named in a will who is responsible for administrating the deceased's estate. The executor carries out the deceased's wishes as stated in the will. The most significant responsibilities and duties of an executor can be grouped into five categories:

1. Familiarization With the Deceased's Personal and Financial Situation

This is often the most difficult stage, as the executor must deal with the emotional aspects of the death, offer support to family members and become familiar with the tasks that need to be done. If the executor is new to this role, it can be overwhelming. The immediate tasks include arranging for the funeral, reviewing and understanding the will and communicating with all beneficiaries.

2. Assembling and Protecting Estate Assets

One of the most important duties is to ensure that the deceased's assets are safeguarded. The executor gathers information about the deceased's financial affairs – both the assets and the liabilities. Notification of the death must be sent to financial institutions, the deceased's employer, potential creditors and others as required. In addition, the executor is responsible for changing legal title to assets such as bank accounts, canceling documents including credit cards and driver's licenses, and locating and filing claims for any life insurance benefits and company or government pension benefits.

3. Valuing Assets and Obtaining Probate

Once an inventory of assets and liabilities has been assembled, the next responsibility is to determine if probate is required. If it is, the executor will instruct the Estate's solicitor to file a probate application with the Court. It will be necessary to value the estate assets as at the date of death, as a probate fee based on the value of the assets is payable with the application. This valuation will also assist with the income tax return filings.

4. Administering the Estate

Estate administration includes opening estate bank accounts and paying liabilities, determining if estate assets should be sold, managing investments and keeping administrative records of the estate's assets, income and expenses. Consulting with a tax professional is important to determine the filing obligations (including tax returns and potential Clearance Certificate requirements for the deceased for the year of death, and the estate for the period from the date of death), and to consider tax-saving opportunities and post-mortem tax planning strategies.

5. Distributing the Estate

Once Tax Clearance Certificates have been obtained from the Canada Revenue Agency, and the estate records have been approved by the beneficiaries (or the Courts in a formal Passing of Accounts), the executor's final role is to distribute the estate assets to the beneficiaries in accordance with the will.

DORETE DRABINSKY

Dorete is actively involved in all tax practice areas, and her experience has covered a variety of broad-ranging issues for both public and private corporations. Her specific interests include estate and succession planning, corporate reorganizations, and real estate planning.

You can contact Dorete at 416 963 7212 or ddrabinsky@soberman.com.

COMMENTS
is a quarterly publication of
Soberman LLP
1100 - 2 St. Clair Avenue East
Toronto, ON M4T 2T5
T 416 964 7633
F 416 964 6454
info@soberman.com

Assurance & Advisory
Eric Bornstein 416 963 7100
Don Borts 416 963 7101
Jerry Cukier 416 963 7104
Roy Flax 416 963 7131
Dirk Joustra 416 963 7110
Sam Kaner 416 963 7111
Harvey Klein 416 963 7112
Ivan Lavine 416 963 7114
Des Levin 416 963 7115
Paul Pethick 416 963 7117
Martin Starr 416 963 7119
Deborah E. Stern 416 963 7103
Alan Wainer 416 963 7121
Sam Zuk 416 963 7122

Business Valuation
Neil Maisel 416 963 7116

Claims Valuation & Litigation Suppport
Daniel M. Edwards 416 963 7221

Due Diligence & Forensic Investigation
Sam Kaner 416 963 7111
Ron Schwartz 416 963 7184

Insolvency & Reorganization
Ken Tessis 416 963 7120

Litigation Support
Neil Maisel 416 963 7116
Ron Schwartz 416 963 7184

Mergers & Acquisitions
Eric Bornstein 416 963 7100
Larry Maker 416 963 7216
(Soberman Maker & Associates, Inc.)

Tax
Gary Kopstick 416 963 7113
Karyn Lipman 416 963 7159
Adam Rubinoff 416 963 7178
Karen Slezak 416 963 7109

Does Your Business Have the Right Commercial Insurance Coverage?

By DANIEL M. EDWARDS, MA, CAïIFA, CAïCBV, CFE
Partner Claims Valuation & Litigation Support Group

Regrettably, many business owners do not fully understand their insurance coverage until a claim occurs. Once a claim occurs, if they do not have sufficient coverage, or if they have the wrong type of coverage, they may not receive adequate compensation for the losses suffered.

Accountants often assist insured businesses in the determination of the amount of a loss. For example, a business which suffers a fire may have claims for loss of earnings; extra expenses; clean-up costs; loss of inventory; and damage to property and equipment. The amount recoverable will depend on (a) the type of coverage purchased, and (b) the amount of the insurance coverage.

Property Damage

Coverage for property damage may be based on either replacement cost or actual cash value. Where the coverage is for actual cash value only, a deduction for depreciation (of capital property) will be made (or, in the case of inventory, there will be a deduction for inventory obsolescence). In either case, the amount payable may not be sufficient to replace the items lost or damaged. Further, in many policies with replacement cost coverage, the insured must replace the lost or damaged property, or the basis of settlement will revert to actual cash value.

Business Interruption

Coverage for business interruption loss is more complex. In Canada, there are two primary types of coverage for business interruption loss: (1) coverage for loss of Gross Earnings; and (2) coverage for loss of Profits. Be careful – in insurance policies, these terms have specific definitions which differ from the corresponding accounting definitions. The term “Gross Earnings” means net sales (or, for a manufacturer, net sales value of production) minus the cost of materials and supplies. The term “Profits” means net profit before tax plus insured standing charges (generally fixed or semi-fixed expenses). The policy forms are generally referred to as a Gross Earnings form or a Profits form respectively.

Gross Earnings and Profits Forms

Gross Earnings are calculated before deducting the payroll cost (“Ordinary Payroll”) of “ordinary” workers who would be laid off during a disruption. Therefore, unless excluded by endorsement, Ordinary Payroll is insured under a Gross Earnings form. In other words, during an interruption, the policy will respond to the cost of maintaining and paying the ordinary employees. This may be necessary if, for example, the employees would be difficult to replace (due to specialized skills), or if they must be paid pursuant to a collective agreement.

Profits are determined before adding back Ordinary Payroll to the bottom line. Therefore, unless included by endorsement, Ordinary Payroll is not insured under a Profits form. During an interruption, the policy would not respond to the cost of maintaining

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Insurance Coverage (continued from page 7)

idle employees. This is sufficient if, should a disruption occur, the employees would be immediately laid-off, without pay. Alternatively, a business may purchase limited Ordinary Payroll coverage, for (say) the first 90 days following an insured event.

In a manufacturing plant, an example of the Ordinary Payroll would be the plant labour, generally paid on an hourly basis. Management staff, along with salaried employees (for example, involved in administration or sales) would usually not be Ordinary Payroll – they would be fixed expenses (to be considered when calculating the amount of coverage required).

There is another important difference between the Gross Earnings form and the Profits form. The Gross Earnings form normally covers the business interruption loss until the replacement or repair of the damaged property can be completed with due diligence and dispatch. On the other hand, the Profits form covers the business interruption loss until sales return to normal. The type of coverage required depends upon the nature of the business, and, in particular, the extent to which the business depends upon customer relationships. For example, a gas station at a busy city intersection would return to normal almost immediately, whereas a manufacturer with a few major customers may lose some customers to its competitors.

"The type of coverage required depends upon the nature of the business, and in particular, the extent to which the business depends on customer relationships."

Sufficient Coverage is Essential

Aside from the type of earnings loss coverage required, the business owner must ensure that sufficient coverage is purchased. This may involve a number of considerations. Firstly, the amount of the coverage will be compared with the amount required for the 12 months following the date of loss. Secondly, one must be careful to correctly determine the amount of coverage required. Many business owners may assume that if the business has traditionally generated annual profits (before tax) of $100,000, then coverage in the amount of $100,000 would be sufficient. However, this is not the case, because the definitions of Gross Earnings and Profits are not based on "the bottom line."

The responsibility for ensuring that a business has the right type of coverage for business interruption loss, and the required amount of business interruption loss coverage, lies with the business owner and his/her insurance broker or other insurance professional. However, we at Soberman LLP have the experience to provide informal guidance in this regard.

DANIEL M. EDWARDS

We are pleased to announce that **Daniel M. Edwards** joined our firm as partner in our Claims Valuation & Litigation Support Group on April 1st.

A designated specialist in Investigative and Forensic Accounting and Business Valuation, Daniel has 14 years experience in the quantification of losses or payments in insurance and litigation claims.

Our Claims Valuation & Litigation Support Group advises both plaintiffs and defendants, and both insurers and insured persons or businesses in connection with insurance or litigation claims. Our professionals have the experience necessary to provide a fair and appropriate recommendation regarding the amount payable or the damages suffered.

Daniel is joined by **Kristin Matthews, Helen Sbeit** and **Michelle Silverberg**.

The contact information for our Claims Valuation & Litigation Support team is as follows:

- Daniel Edwards, 416 963 7221, dedwards@soberman.com
- Kristin Matthews, 416 963 7239, kmatthews@soberman.com
- Helen Sbeit, 416 963 7199, hsbeit@soberman.com
- Michelle Silverberg, 416 963 7200, msilverberg@soberman.com

Thank You!

We would like to thank you – our clients and professional referral sources – for your significant contribution to our continued growth and success by referring your friends and associates to us.

It is always a pleasure to work with you, and we appreciate your vote of confidence.