WEALTH MANAGEMENT review

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Five key strategies that can help reduce your tax bill, including:

- Tax-loss selling
- Deferring capital gains
- Waiting until the new year to purchase mutual funds
- Making your last two Registered Retirement Savings Plan contributions
- Contributing to Registered Education Savings Plans

The road ahead

By Jim Allworth

By our reckoning the U.S. Federal Reserve and the Bank of Canada have both finished raising interest rates. This brings to a close, at least for now, a programme of tightening that began more than two years ago. Rates have come up from 2% to 4.25% in Canada and from 1% to 5.25% in the U.S. Now, apparently, bad things are supposed to happen.

Slower growth? Yes. Recession? We don't expect one. Why? Because it's hard to get there from here when two big components of the economy – government spending and business investment, between them more than a third of GDP – are showing few signs of flagging.

SPENDING SPREE

U.S. government spending is growing at a solid 2% per annum fueled by the start-up of new health-care entitlements together with the demands of national defence. And neither Congress nor the executive branch has even floated a plan to slow spending. In a political world where control of both houses of Congress are at stake this fall and again in 2008 along with the White House, it seems likely government outlays will accelerate from here.

Capital spending, meanwhile, tends to depend on three factors. The first is profits, which are at record levels and still forecast to grow at above-trend rates through 2007 at least. The second is the ability of companies to undertake project spending as measured by the state of corporate balance sheets. There too the picture is startlingly good – corporate treasuries are awash with excess cash. What debt they have is for the most part manageable and interest charges on the whole are generously covered by cash flows.

And finally, companies need projects to undertake that are likely to earn an economic return. With capacity utilization decisively above 80% for the first time this cycle, a growing number of businesses find themselves with opportunities for outright expansion.

Between them government and business account for about 35% of U.S. GDP. It is very hard to sink into recession – which, after all, is a broad-based decline in the economy – when one-third of it is growing at a combined rate in excess of 4%. Especially when that third is largely insensitive to the level of interest rates.

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CONFIDENT CONSUMERS

That leaves the job of pushing the U.S. economy into the ditch up to the consumer who accounts for most of what's left. Are there any signs suggesting consumers are about to go into reverse and spend less in the coming quarters than they have been?

Today the answer would seem to be no. There have usually been two factors which needed to occur simultaneously to have that happen – fear of imminent job loss by some significant fraction of the work force as well as the drying up of new credit and the demand for repayment of existing loans. Neither is anywhere in evidence.

Job growth remains steady if unspectacular – the U.S. economy goes on adding in excess of 100,000 new workers to the payroll every 30 days. On top of that, the average number of hours worked by each employee has been creeping up while compensation per hour has been growing at better than a 3% annual real rate. Put them all together – more people working for longer hours at higher hourly wage rates – and you get solid growth in real disposable household incomes.

On the credit front, there is an urban myth out there that portrays the average American as an irresponsible, debt-ridden profligate who keeps refinancing his house to take out cash to buy yet another, bigger SUV or scrape together the entry fee for a poker tournament – a picaresque portrayal hard to find in the data.

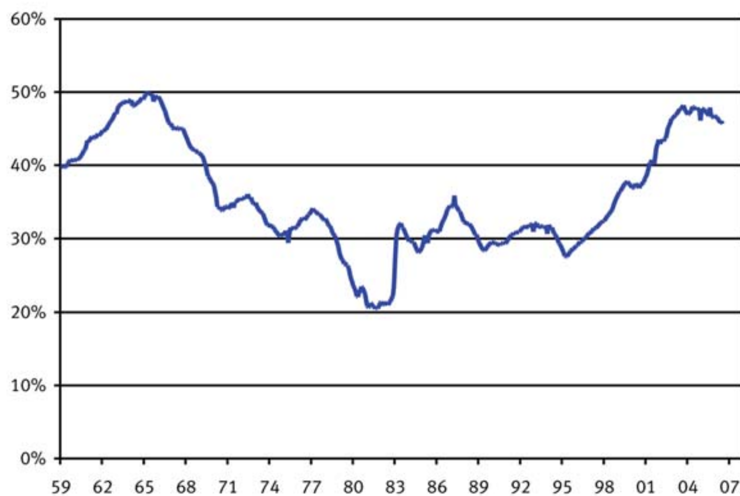
HEALTHY HOUSEHOLD FINANCES

American households have used the availability of the lowest interest rates in 50 years to refinance two huge liabilities – their mortgages and their credit cards. Rather than simply take money they may have borrowed on home equity loans and "blow" it, as is usually assumed, most of it went to pay down high-cost debt, buy real estate, or to buy financial assets.

Today, the average American household is sitting on just shy of half a year's income in the bank in cash. That's twice what it had in relation to income a decade ago. And monthly payments look manageable too. The Fed does a calculation designed to stress test the state of household finances. It takes all the major periodic payments that have to be made or an American will lose a significant asset like their home or car – i.e., all mortgage payments, rent, lease payments, property taxes, and property insurance. It adds all these together and calculates the total as a percentage of household disposable income.

Twenty-five years ago the average American household spent not quite 16% of their disposable income on these payments. By 2001, that had drifted up to 19%, where it is today. That is not a startling additional burden. In fact former chairman Alan Greenspan said repeatedly that there was no sign of undue stress on household balance sheets.

U.S. household liquid assets as a % of disposable income



Source: RBC Capital Markets

A BUMP IN THE ROAD

But won't falling house prices send the consumer running for cover? Possibly, but without the prospect of widespread forced liquidations we doubt it. We do expect that a weaker housing environment will act to slow consumer spending, especially on big-ticket purchases, to some extent. In fact, that's our forecast – a slower rate of growth in consumer spending acts to moderate the growth profile of the overall economy, say from the 3.5%-4% range where it's been down to the 2.5%-3% range by later next year.

More moderate growth is likely to keep inflation contained and the Fed on the sidelines. Indeed the Fed could be cutting rates as early as the first quarter of next year if the history of tightening/easing cycles is any guide.

Moderating but positive growth in the U.S. could provide a bumpy ride for parts of the Canadian economy but is fundamentally good news for the projected longevity of the global commodity cycle, for the Canadian stock market, and for markets elsewhere. We expect the Canadian economy will continue to grow at rates close to 3% this year and next.

For a fuller discussion of our outlook for the Canadian and global economies and financial markets ask for the latest issue of Portfolio Strategy Quarterly.

Jim Allworth is Vice Chair of the RBC Investment Strategy Committee.

Five strategies to reduce your 2006 tax bill

By Prashant Patel, ASA, CFP, TEP

Reviewing your tax situation before year-end can yield some significant tax savings. Following are five popular year-end tax-planning strategies.

STRATEGY 1 – TAX-LOSS SELLING

One of the most popular year-end tax-planning strategies is tax-loss selling, which can help you reduce your capital gains tax.

Particularly with the recent strong performance in the Canadian stock market, you may have significant taxable capital gains, triggered by selling stocks at a profit. Half of your net capital gain is taxable at your marginal rate.

However, you can offset your capital gains with capital losses. While no one likes selling a stock at a loss, it can make sense when the stock no longer meets your investment objectives – and you can use the loss to reduce your taxes. Your advisor can help you identify which stocks are suitable candidates for tax-loss selling.

Key dates

For Canadian tax purposes, a sale takes place on the "settlement date" – normally three days after you initiate the sale. If you are considering a tax-loss sale, make sure you allow enough time for the transaction to settle in 2006.

Transaction	Initiate sale by
Canadian	Dec. 22, 2006
U.S.	Dec. 26, 2006
Options	Dec. 28, 2006

Offsetting gains in past or future years

Capital losses have to be used to offset capital gains in the current year first. If the losses exceed the gains, then you can apply the excess amount against capital gains in the three previous years (2003, 2004, or 2005) or you can carry it forward indefinitely.

Superficial losses

Simply selling a stock to trigger a loss, then buying it back within a certain timeframe is considered a "superficial loss" by Canada Revenue Agency, meaning the loss will be denied, but added to the cost of the repurchased security. A superficial loss occurs when:

1. You sell a security, including stocks and mutual funds, at a loss
2. You either purchase or repurchase the same security in the 30 days before or after the sale, counting from the settlement date
3. You still hold the security 30 days after the sale

The superficial loss rule also applies, among other situations, when your spouse or a corporation controlled by either you or your spouse acquires or reacquires the same security 30 days before or after the sale.

STRATEGY 2 – DEFER REALIZING CAPITAL GAINS

By waiting until the new year to realize capital gains, you can delay paying the capital gains tax until April 30, 2008, unless you have to pay tax installments. If you sold a security for a capital gain at the end of the year, you would have to pay the tax by April 30, 2007.

Waiting until the new year can also potentially reduce your capital gains tax, if you expect your marginal tax rate to be lower in 2007 compared to 2006.

It can also help you make the most of tax-loss selling, in situations where you have paid capital gains tax in 2003, 2004 or 2005. If you have capital losses in 2006, those losses have to be applied against gains realized in 2006 before they can be carried back to the three previous years. By waiting to realize capital gains, you can now

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utilize more 2006 losses against capital gains in the prior years.

STRATEGY 3 – WAIT TO PURCHASE MUTUAL FUNDS

Purchasing mutual funds near year-end can result in an unexpected tax liability. Many mutual funds make annual year-end distributions that may include taxable income or capital gains accumulated over the year, which are already recognized in the value of the fund. You receive no benefit from this distribution, yet you still have to pay taxes on it. If it makes sense from an investment standpoint, consider waiting until January to make your mutual fund purchases to avoid this premature tax liability.

STRATEGY 4 – REMEMBER YOUR FINAL RSP CONTRIBUTIONS IF YOU'RE TURNING 69

If you are turning 69 in 2006, you must convert your Registered Retirement Savings Plan (RSP) to an RSP maturity option such as a Registered Retirement Income Fund (RIF) by the end of the year.

Because of this, you also have to make your 2006 RSP contribution by the end of the year in order to receive a tax deduction on your 2006 income tax return. You don't have the extra 60 days after year-end to make your RSP contribution that you had in previous years, unless you make a spousal RSP contribution and your spouse is under 69.

You can also make an early 2007 RSP contribution – before converting your RSP – if you have earned income in 2006. Often overlooked, this "forgotten RSP contribution" results in a small over-contribution penalty, but the tax savings should more than compensate for that.

For example, say you contribute $19,000 to your RSP in December for your expected 2007 RSP contribution, in addition to your 2006 contribution. You have to pay a 1% penalty per month on the over-contribution – up to $190 in this case, since you're only early by one month. Compare this to the 2007 tax savings, which could be as high as $9,200. You can avoid the 1% penalty by making your 2007 contribution in 2007 to a spousal RSP, assuming your spouse is under 69.

STRATEGY 5 – MAKE YOUR RESP CONTRIBUTIONS BEFORE THE END OF THE YEAR

Unlike RSPs, you don't have an extra 60 days after the end of the year to make your Registered Education Savings Plan (RESP) contributions. Also, the annual RESP contribution amount doesn't carry forward to future years if you don't use it, like it does with an RSP. The deadline for 2006 RESP contributions is Dec. 31, 2006. This day falls on a Sunday, so consider making your contribution by Friday, Dec. 29, 2006.

FOR MORE INFORMATION

Before considering any tax-planning strategies, make sure you consult with a qualified tax advisor. For more information, please contact your Investment Advisor.

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INTEREST RATES APPLIED TO ACCOUNT BALANCES*

As of September 22, 2006 our interest rates are as follows:

Credit balances	Canadian dollar accounts	US dollar accounts
Under $10,000	1.25%	2.50%
$10,000 – $24,999	1.50%	2.60%
$25,000 – $49,999	1.75%	3.10%
$50,000 – $59,999	2.25%	3.35%
$60,000 – $99,999	2.50%	3.75%
$100,000 and over	3.00%	4.00%
Debit balances	**Canadian dollar accounts**	**US dollar accounts**
Under $10,000	8.00%	10.50%
$10,000 – $24,999	7.75%	10.25%
$25,000 – $49,999	7.50%	10.00%
$50,000 – $99,999	7.25%	9.75%
$100,000 and over	7.00%	9.50%

Registered accounts

All credit balances 0.50% All debit balances 8.00%

The interest rates that will be in effect for debit balances in cash and margin accounts fluctuate with prime as follows:

Debit balances	Canadian dollar rates†	US dollar rates†
Under $10,000	$CDN Prime + 2.00%	$USD Prime + 2.25%
$10,000 – $24,999	$CDN Prime + 1.75%	$USD Prime + 2.00%
$25,000 – $49,999	$CDN Prime + 1.50%	$USD Prime + 1.75%
$50,000 – $99,999	$CDN Prime + 1.25%	$USD Prime + 1.50%
$100,000 and over	$CDN Prime + 1.00%	$USD Prime + 1.25%

†Based on prime rates as of September 22, 2006.
$CDN Prime= 6.00% and $USD Prime= 8.25%. Rates are subject to change.

*RBC Financial Group retains the right to change interest rates on a discretionary basis. A committee comprised of individuals representing various authorities within RBC Dominion Securities administers these interest rates. These rates are adjusted from time to time based on various factors, including, but not limited to, competitive analysis, Bank of Canada and other bellwether rates, and/ or cash rates. Interest amounts less than $5 are neither charged nor paid on regular accounts and interest amounts less than $1 are neither charged nor paid on special product accounts. Rate changes of less than 1% will be processed on the 22nd of the month. The average daily cash balance for the month determines the tier that will be used to establish the rate.

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