

INSIDE


› FAMILY INCOME SPLITTING 3

Families can save substantial taxes every year through income-splitting strategies recognized by the Canada Revenue Agency.

› TAX SLIPS 4

Before filing your taxes, make sure you have all of your tax slips. T5 mailings start on February 13, while T3/T5013-related mailings start in March.

Bumpy landing

By Jim Allworth

It's one thing to confidently forecast a soft landing for the U.S. economy when you're at 10,000 feet and 60 miles from touchdown. However, it is quite another matter when you are down to 100 feet, the landscape is rushing by and you can now make out that there are some potholes on the runway.

Well we're there or, that is, the U.S. economy is. The fourth quarter is in the books and all indications are it will have featured a further deceleration in overall activity.

Housing continues to subtract from growth – a fact that's not likely to change soon. Consumers, crimped by surging fuel costs and concerned by bad vibes from the housing and financial markets, haven't exactly refused to show up at the mall but it's taken blow-out sale prices to get them there. Business investment looks like it slowed in the fourth quarter but from a fairly robust 5%-plus rate in the third.

Two wheels on the ground...

The two bright spots for the U.S. economy will likely have been government and trade. Government spending (some 20% of GDP) is growing at a very reliable rate of better than 2% per annum, driven by defence and health

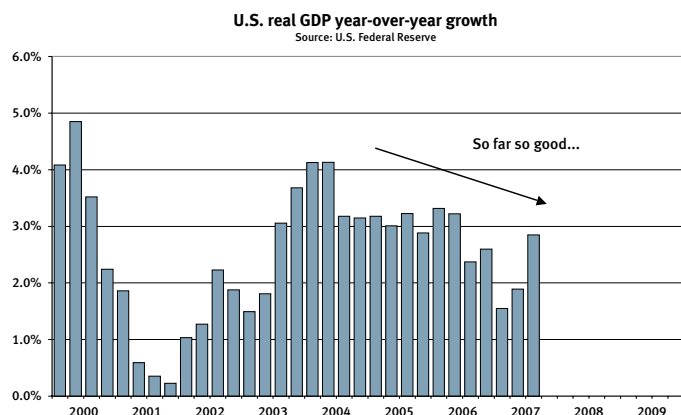
care. Neither of these very large budget items is sensitive to interest rates or to the business cycle. That makes government an important bulwark against the effects of weakness elsewhere in the economy.

Trade is noteworthy because it is so often overlooked as a potential source of strength and because the mechanics of how it fits into the growth equation are not well understood. Because the U.S. runs a trade deficit – i.e., it buys more from abroad than it sells – when one adds up all the components of the economy to arrive at GDP, trade turns out to be a subtraction from the total.

But whether trade is adding to the growth rate of the economy – or subtracting from it – is determined by whether exports are growing faster or slower than imports. The persistent weakness of the U.S. dollar over the past several years has eventually acted, as one would expect, to constrain the growth of imports into that country while stimulating the growth of exports. So much so that for all of 2007 foreign trade added just about as much to the U.S. economy as the housing slump cost it. Importantly, it has also added to jobs growth.

Continued on page 2

Continued from cover



...one wheel coming down hard

But it's the consumer at 70% of GDP who counts most and for 2007 it was more subdued household spending that slowed economic growth to an estimated 2.7% from 2.9% in 2006. And leading indicators suggest 2008 will be slower still. The U.S. Federal Reserve recently lowered its growth forecast for the coming year by one-half a percentage point to just 2.2%.

The first half is likely to feature even slower growth than the full year, so the "landing" is well and truly upon us. If these first two quarters do indeed mark the low point then they will undoubtedly make bad reading for data watchers. Economic data is likely to be appreciably worse than it has been with many of the factors that have allowed a mood of cautious optimism to prevail becoming much more problematic – employment chief among them.

But that's what soft landings are like – almost always bumpy, never pretty.

Three key questions

However, even if this view turns out to be correct – i.e., that having passed its low point in the first half, the U.S. economy reaccelerates in the second half in response to the rate cutting the Fed has already undertaken or will likely undertake in response to a weak first half – new questions will arise. Two big ones that come to mind are:

"Does the fact the U.S. banking industry will have written off a significant portion of its capital mean that future lending could be constrained to a degree that makes any economic reacceleration more tentative and fragile and harder to get off the ground in the first place?" and...

"Isn't it likely a U.S. slowdown will take a toll on the economic performance of Asia and, to a lesser extent, Europe?"

And to these we could add a third question:

"What does slower growth for the U.S. and perhaps for much of the world outside the U.S. mean for the Canadian economy?"

The answer to the first two is "probably." And clearly a less-dynamic-than-normal recovery for the U.S., coupled with other industrialized countries shifting down to a lower gear, points to a more challenging environment for some parts of the Canadian economy.

Challenges for Canada

It's the export sector (which includes tourism) that will face challenges if global growth slows. It already is. Manufacturing orders, both new and unfilled, have been softening for some time. Although the Canadian dollar is well off its peak, it is nonetheless some 15% above where it was a year ago. The full cost of this to manufacturers in lost orders and lost markets won't be tallied for some time.

In the resource sector, where most costs are borne in Canadian dollars but goods sold in U.S. dollars, the surging loonie has lowered profit margins, in some cases dramatically. This, together with higher costs for and shortages of labour and equipment, has caused several major expansion and development projects to be re-evaluated and one or two deferred. Were slower global economic growth to weaken commodity prices from this point then capital investment in this sector, an important contributor to economic and employment growth in this cycle, could be scaled back or postponed.

However, the good news is that Canada's domestic economy is on a solid footing: employment, wage rates, consumer spending, and housing are all firm. Core inflation is well below 2% and the overheated resource economy, especially in Western Canada, has come off the boil, giving the Bank of Canada the room to lower interest rates further if it deems it advisable.

And there's more than just monetary policy available. Canada's fiscal position is extraordinarily strong: government has the capacity to compensate for any cyclical weakness the economy may encounter.

So fasten your seatbelt – some decisive quarters lie immediately ahead for the economy and investors. For further discussion of our outlook for the economy and financial markets ask for a copy of the Winter 2008 edition of *Portfolio Strategy Quarterly*.

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

Family income splitting

Strategies to reduce your family's tax bill

By Prashant Patel, ASA, CFP, TEP

Income splitting is one of the most effective, yet often overlooked, opportunities for high-income families to reduce their taxes. In a family of four, annual tax savings of up to \$45,000 can be realized through income splitting.

Income splitting involves transferring income from a family member with a high income to a family member with little or no income. This can reduce a family's taxes for two key reasons:

- 1 Every family member has a \$9,000 basic personal tax exemption.
- 2 Canada's graduated tax system means that the higher your income, the higher your tax rate.

If you are a higher-income family member, and you can transfer some of your income to a lower-income family member, you can potentially drop into a lower tax bracket. Furthermore, if the income you transfer doesn't bump your family member above their basic exemption, it's tax-free. Even if it does bump them over the threshold, they would still most likely pay taxes at a much lower rate than you.

Taking advantage of income-splitting strategies

There are several different income-splitting strategies which, when properly implemented, are recognized by the Canada Revenue Agency (CRA). The primary types of income that can be legally split with lower-income family members are:

- › Reasonable salaries for work performed in a family business
- › Investment income such as interest, dividends and capital gains
- › Income from a spousal Registered Retirement Savings Plan (spousal RSP)
- › Eligible pension income

One of the most common income-splitting strategies is splitting retirement income between spouses. Traditionally, this has been done through a spousal RSP. The higher-income spouse contributes to the spousal RSP and claims the tax deductions, as they would with a normal RSP. But it's the lower-income spouse that eventually draws income from the spousal RSP and pays the taxes. The goal of this strategy is to even out the income between the two spouses, so that their combined tax rate is lower than it would be if one spouse earned most of the income.



With recent tax rule changes, a higher-income spouse can split up to 50% of eligible pension income (e.g. employer pension, Registered Retirement Income Fund payments if at least 65, etc.) with their spouse. This would seem to reduce or even eliminate the usefulness of the spousal RSP. However, a spousal RSP still has an important role in situations where the higher-income spouse also has income generated by non-pension investments, because there is no 50% limit with a spousal RSP.

Continued on page 4

Establishing a family trust

Another popular income-splitting strategy is giving assets to children and earning capital gains in their name. Only 50% of capital gains are taxable, so each child or grandchild can earn about \$18,000 of capital gains tax-free every year because of their \$9,000 basic tax exemption (assuming they have no other income). But what if the children are minor – or you are concerned about giving up control of these assets? One alternative is to establish a family trust.

With this strategy, you can loan cash to a trust established for the benefit of your children or grandchildren – interest-free. This way, you can call back the loan capital at any time. The capital gains earned in the trust can be taxed to your low-income children or grandchildren. In addition, the income generated within the trust can be used to cover expenses directly benefiting your children or grandchildren, such as lessons or private school.

We recently introduced a new solution to assist our clients with establishing family trusts. For more information on the RBC Dominion Securities Family Trust, please contact your Investment Advisor.

Continued from page 3

Dividend sprinkling

One strategy you should consider if you own an active Canadian corporation is “dividend sprinkling” with your spouse and adult children. The first step is to reorganize the ownership of your corporation by adding your spouse and adult children as shareholders, either directly or through a family trust. Then, provided they have no other income, the corporation can pay each of them approximately \$30,000 – \$50,000 in tax-free dividends (varies by province).

Income attribution rules

The CRA will attribute income back to the high-income family member if the income-splitting arrangement is considered abusive or is not properly structured, thus preventing any tax savings. Before putting any income-splitting strategy into action, you should consult with a qualified tax advisor.

These are just a few of the many income-splitting strategies that can help reduce taxes. Please contact your Investment Advisor for more information.

Before you file your income taxes...

Make sure you have all of your tax slips

Soon you will receive your 2007 tax slips and other related materials needed to file your income taxes:

- › T5 income-related slips and materials will be mailed starting February 13.
- › The mailing of all other tax slips is contingent on the release of tax information by external issuers. As soon as we receive this information, we begin printing your tax slips immediately. Depending on when we receive this information, tax slips will be mailed in March and, in some cases, early April.

We strongly advise you not to file your taxes until you receive all outstanding slips.



INTEREST RATES APPLIED TO ACCOUNT BALANCES*

As of December 22, 2007 our interest rates are as follows:

Credit balances	Canadian dollar accounts	US dollar accounts
Under \$10,000	1.25%	1.50%
\$10,000 – \$24,999	1.50%	1.60%
\$25,000 – \$49,999	1.75%	2.10%
\$50,000 – \$59,999	2.25%	2.35%
\$60,000 – \$99,999	2.50%	2.75%
\$100,000 and over	3.00%	3.00%

Debit balances	Canadian dollar accounts	US dollar accounts
Under \$10,000	8.00%	9.50%
\$10,000 – \$24,999	7.75%	9.25%
\$25,000 – \$49,999	7.50%	9.00%
\$50,000 – \$99,999	7.25%	8.75%
\$100,000 and over	7.00%	8.50%

Registered accounts

All credit balances 0.75% 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 December 22, 2007.

\$CDN Prime= 6.00% and \$USD Prime= 7.25%. 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.



This newsletter is not intended as nor does it constitute tax or legal advice. Readers should consult their own lawyer, accountant or other professional advisor when planning to implement a strategy. The information contained herein has been obtained from sources believed to be reliable at the time obtained but neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers can guarantee its accuracy or completeness. This report is not and under no circumstances is to be construed as an offer to sell or the solicitation of an offer to buy any securities. This report is furnished on the basis and understanding that neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers is to be under any responsibility or liability whatsoever in respect thereof. The inventories of RBC

Dominion Securities Inc. may from time to time include securities mentioned herein. Using borrowed money to finance the purchase of securities involves greater risk than a purchase using cash resources only. Should you borrow money to purchase securities, your responsibility to repay the loan as required by its terms remains the same even if the value of the securities purchased declines. RBC Dominion Securities Inc.* and Royal Bank of Canada are separate corporate entities which are affiliated. *Member CIPE. ® Registered trademark of Royal Bank of Canada. Used under licence. RBC Dominion Securities is a registered trademark of Royal Bank of Canada. Used under licence. © Copyright 2008. All rights reserved. vps 44250 WMR DSE036 (01/2008)