

INSIDE



Keeping your vacation property in the family 3

The family vacation property is a place where family comes together. But it can also become a source of family conflict, especially when it's time to pass along the property to the next generation. Whether you own property in Canada or the U.S., there are some key strategies that can help you maintain family harmony, while minimizing taxes at the same time.



The mystery of rising bond yields

By Jim Allworth

One interesting development in financial markets over the past several months has been the big jump in bond yields – 10-year U.S. Treasury yields rose from 4.45% in February to 5.3% in early June, while the 10-year Canada yield soared to 4.75% from below 4%.

The rhetoric accompanying this rapid increase in the price of longer-term credit has focused on a perceived build-up in inflationary pressures. The Bank of Canada has stated flat out that more interest rate increases are needed to head these off. The Bank stopped raising rates last spring, believing a forecast U.S. slowdown, an expected retreat in energy prices and an 85-cent Canadian dollar would moderate the economy and slow the rate of inflation, making further rate hikes unnecessary.

None of those factors have played out in a way envisioned by the Bank. Energy prices have not retreated appreciably. U.S. economic growth has moderated but that doesn't appear to be taking a big toll on trade. The strong Canadian dollar, however, has been a considerable hardship for the manufacturing sector, although the offset has been to dampen any inflation that might have come into Canada by way of imports. And core inflation remains above 2% – the top limit of the Bank's comfort zone.

Ditto for the U.S. Core inflation has been gradually easing but remains stubbornly above 2%. This has prompted a parade of U.S. Federal Reserve officials, including Chairman Ben Bernanke, to state that guarding against a build-up of inflationary pressure remains "job one" for the Fed. Unlike the Bank of Canada, the Fed has not suggested it's about to raise rates further, but it has implied rate cuts are not high on the current agenda.

So, is that it then? Have bond yields moved higher because investors have been persuaded by central bankers that inflation might be about to jump to a new, higher, more disturbing level?

Sorting through the evidence

We think there's evidence to suggest that's not the answer. Here's one piece. The Chicago branch of the Fed computes something called The National Activity Index. It takes the reading of many economic series that have had predictive ability regarding economic growth and inflation. When this index rises above a defined critical value, history suggests the U.S. is in for a bout of troublesome inflation. When it falls beneath a lower level, it signals an impending recession. These days, this index is at levels solidly in "Goldilocks" territory – that is, an outlook that features reasonable growth with contained inflation.

Continued on page 2

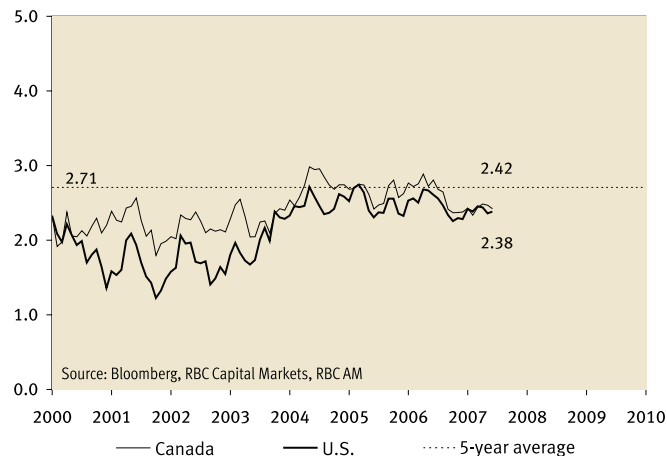
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A second indicator provides useful corroboration to this view because it answers the question, “What does the market think inflation will be in the future?” On any given day, a bond investor has two options. One is to buy a regular bond with a fixed coupon payable over a stated term. The coupon rate would usually be a couple of percentage points greater than the prevailing inflation rate but the investor would bear all the risk as to what inflation might turn out to be over the life of the bond.

The other option would be to purchase a “real return” or “inflation-adjusted” bond, which pays a much smaller annual coupon to start – usually only 1%-2% – but fully compensates the holder for whatever inflation turns out to be over the life of the bond. Since both types of bonds are always available, on any given day the difference in yield between them should represent the implied collective opinion of bond investors as to what inflation is going to average over the term of the bonds.

Today, in both the U.S. and Canada, the difference in yields between regular government bonds and “real return” bonds of a similar term (see chart) implies that inflation is going to average less than 2.5% per annum over the next 10 years. The spread between these two types of bonds has been remarkably steady over the past three or four years, even when reported inflation surged past 4% in the U.S. and 3% in Canada in the months following Hurricane Katrina. And while this number is still higher than what either central bank would like, it does not portend an “inflation breakout” that would require a much tighter monetary stance.

Implied long-term inflation premium



It's elementary

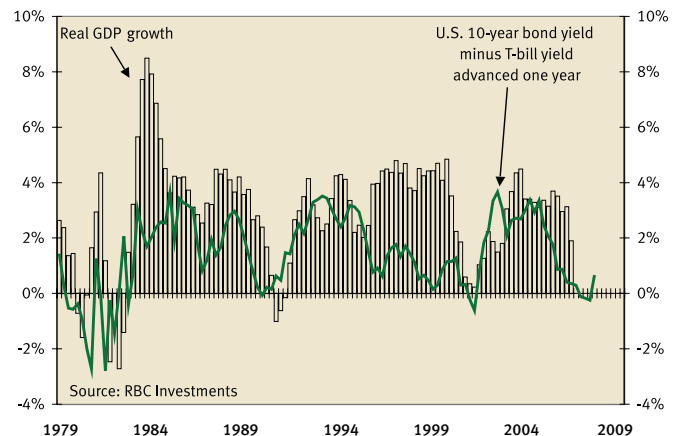
If inflation expectations aren't driving bond yields higher, what is it? We think a big part of the answer has to do with expectations for economic growth in North America and hence the demand for longer-term credit. The Bank of Canada has already noted that our economy, after slowing in the second half of last year has re-accelerated. In the U.S. the same pattern may be emerging. At least, the prospects of a recession have diminished greatly.

The difference between the yield on short-term instruments and longer-term bonds, plotted over time, has done a good job as a leading indicator of the direction of future economic growth (see chart). This indicator suggests while there may still be a couple of bumpy quarters ahead, by early 2008 the U.S. economy should be gathering forward momentum.

As we've suggested here before, if central bankers turn out to have successfully engineered a “soft landing” for the North American economy, then the global economic expansion probably has legs out to the end of this decade, an outlook that is unequivocally good for equities. All the usual caveats apply and big, sometimes unsettling, corrections are business-as-usual for equity investors. We're likely to experience at least one such setback over the next couple of years. That notwithstanding, we expect equity portfolios will deliver attractive all-in returns over the same period.

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

U.S. real GDP growth and the yield curve



The family vacation property

Strategies to reduce taxes

By Prashant Patel, ASA, CFP, TEP

Whether you already own a family vacation property — or you are just thinking about it — there are many tax-related issues to consider. Following are some strategies to help you reduce the taxes associated with owning vacation property — and passing it on to family members.

Succession planning

In straightforward situations, a person often acquires ownership of a vacation property either solely or jointly with their spouse for the control and simplicity. As people get older and no longer actively use the vacation home, they sometimes decide to transfer the property to their children. However, if the transfer of the property is not structured correctly, disharmony amongst family members can occur.

Here are some succession planning strategies to consider related to a family vacation home:

- › **If your children will inherit the property** and you expect it to significantly appreciate in value, consider gifting the property to the children today either directly or to an inter vivos family trust if you wish to maintain control. Although this results in a disposition at market value, triggering accrued capital gains to you today, the future capital gain tax is deferred and probate taxes are avoided. If the property is sold to the children, your capital gain can be spread over five years in some cases.
- › **For additional tax deferral**, you may want to consider the potential advantages and disadvantages of transferring the property to a Canadian corporation or to a non-profit corporation.
- › **If the property value is high** and you are over age 65, consider the cost/benefit of rolling it into an alter-ego or joint partner trust today in order to avoid probate taxes related to the property at death (particularly in provinces with high probate taxes).
- › **You may leave the vacation home to** one or more family members under the terms of your Will. Some of the options include granting one or more children the option to purchase the property, allowing a child to take the property as part of his or her share in the estate, or creating a trust to hold the vacation home under the terms of your Will. In this case, the capital gains taxes can be payable upon death of the last spouse.



- › **Life insurance can be used** to pay any capital gains taxes triggered by the disposition of the property when your estate is settled. It also creates a pool of funds to pay children who are not interested in inheriting the property (alternatively, children who are interested in the property can take out a mortgage to buy out siblings who are not interested). In addition, life insurance can be used to provide the children with the money necessary to pay for the maintenance and expenses related to the property. Since your children will benefit from this insurance coverage, consider asking them to pay the premiums.
- › **If more than one child will own the property**, they can enter a co-ownership agreement to determine when and how they can use it, as well as how expenses will be paid.

Regardless of the succession planning strategy chosen, you can minimize capital gains tax on the disposition or deemed disposition of your vacation home, either during your lifetime or at death by:

1. Ensuring that any vacation home renovation costs are tracked as these costs add to the cost of the property for tax purposes and will reduce any future capital gain.
2. Using your principal residence exemption to reduce or eliminate the capital gains tax on the property. However, only one principal residence can be designated per family unit for years after 1981. So if the principal residence exemption is

Continued on page 4



Continued from page 3

used for the vacation property to minimize the capital gains tax, then it cannot also be used to reduce tax on the disposition of the city home related to years after 1981.

U.S. real estate

The U.S. government has an estate tax on the fair market value of property located in the U.S., even if it is owned by a non-resident. U.S. Estate Tax ranges from 18 – 45% of

the fair market value of the U.S. assets. However, there are generous U.S. tax exemptions that are available to minimize or potentially eliminate the U.S. Estate Tax.

If your U.S. assets (typically U.S. real estate and U.S. stocks) are US \$60,000 or less on death then there would be no U.S. Estate Tax payable regardless of the value of your worldwide assets. If your worldwide estate is US \$2 million or less upon death then there would be no U.S. Estate Tax payable regardless of the value of your U.S. assets. If your worldwide estate is greater than US \$2 million upon death then there could be U.S. Estate Tax on the value of your U.S. assets.

There are legitimate strategies to reduce or eliminate U.S. Estate Tax, including taking out a “non-recourse” mortgage against your U.S. real estate. This special type of mortgage reduces the value of U.S. real estate subject to U.S. Estate Tax dollar for dollar.

This article appears in our recently published guidebook, *Family Wealth Management – Ten Strategies to Build and Protect Your Family’s Wealth*. Please contact your Investment Advisor for more information.

Before taking any action on any of the strategies discussed in this article, make sure you consult with a qualified tax professional.

INTEREST RATES APPLIED TO ACCOUNT BALANCES*

As of May 22, 2007 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 May 22, 2007.

\$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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