



Wealth Management Services

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Year-End Tax Planning

Final Opportunities to Reduce Your 2006 Tax Bill

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As year-end approaches your thoughts may be turning to the holidays, winter sports, spending time with family and friends, and of course ... year-end tax planning! Well, to be fair, perhaps tax planning doesn't rank that high on your list of holiday priorities. But, taking a few minutes to review your financial affairs can yield significant tax savings. To ensure that you leave no stone unturned, we have summarized some popular year-end tax planning techniques. Prior to implementing any tax planning strategies, a qualified tax advisor should be consulted.

Tax Loss Selling

The strategy of selling securities at a loss to offset other capital gains realized during the year is probably the most popular year-end tax planning technique.

When disposing of an investment, you must remember that the sale for Canadian tax purposes will be deemed to have taken place on the "settlement date". Assuming the normal three-day settlement, in order to utilize this strategy for the 2006 tax year, transactions must be initiated by December 22, 2006 for Canadian transactions and by December 26, 2006 for U.S. transactions in order to actually settle during 2006. Canadian and U.S. option transactions have a one-day settlement, therefore option transactions must be initiated by December 28, 2006 to ensure 2006 settlements.

In order to ensure that the capital loss can be claimed, you must adhere to the "superficial loss" rules. A superficial loss will occur when a security is sold for a loss and **both** of the following occur:

- i) the identical property is acquired or re-acquired during the period beginning 30 days before the disposition and ending 30 days after the disposition of the original security; **and**
- ii) at the end of the above period, the identical property is still held.

Among other situations, the superficial loss rule also applies if an investment is sold at a loss and acquired by your spouse OR a corporation controlled by you and/or your spouse during this time period. Triggering the superficial loss rule will result in the denial of the capital loss. The denied loss amount will then be added to the cost base of the substituted investment effectively resulting in the original cost base being transferred to the newly repurchased shares. However, if you delay the repurchase until after the 30-day period, the capital loss can be claimed.

Note that the 30-day waiting period is counted from settlement day of sale to settlement day of repurchase and includes all holidays and weekends. Furthermore, the superficial loss rules also apply to mutual funds sold at a loss.

Selling the loss security in a non-registered account and repurchasing the identical security in an RSP/RIF within 30 days and owning it on the 30th day after the sale will also deny the

use of the capital loss. Furthermore, a direct transfer or swap of the loss security to an RSP/RIF will result in the capital loss being lost.

However, gifting the loss security in-kind to a non-spouse individual (like a minor or adult child) will allow you to claim the capital loss as this gift is a disposition at market value and does not trigger the superficial loss rules.

Any capital losses generated that cannot be used in the current year can be carried back three years to be applied against capital gains of prior years (i.e. 2003, 2004 or 2005) or carried forward indefinitely.

In order to increase the effectiveness of tax loss selling, portfolios should be reviewed with your advisor to determine which investments are in a loss position and no longer meet your investment objective. Hence, if the investment still has strong fundamentals and meets your investment objectives, consider all costs, including transaction costs before selling investments solely for the purpose of triggering the tax loss.

Defer Realizing Capital Gains

You may be aware that deferring to realize a capital gain is a popular tax planning strategy. As we approach the end of 2006, if you currently have unrealized capital gains you may want to consider deferring the realization of capital gains until year 2007 for the following tax motivated reasons:

- a) Your marginal tax rate may be lower in 2007 compared to 2006;
- b) Realizing capital gains at the end of the year means that any tax payable would have to be remitted by April 30, 2007. Realizing capital gains at the beginning of 2007 means that any tax payable would not have to be paid until April 30, 2008 (unless there are installment payment issues) and,
- c) If you have net capital losses in 2006, you can carry back those losses against previously realized capital gains in 2003, 2004 and/or 2005. However, before losses can be carried back, they must first be used to offset capital gains in the current year. Therefore realizing capital gains at the end of this year means that there are less capital losses to be carried back, if any.

As always, the investment merits of deferring a sale of a security to the following year for the purpose of deferring the realization of a capital gain must be considered first before looking at the tax issues.

Trigger Capital Gains in an In-Trust Account

Typically minor children have no taxable income. If this is the case, the minor child can realize gross annual capital gains of up to \$18,000 and pay no tax due to their basic personal exemption. The attribution rules generally do not apply on capital gains earned by a minor child. Therefore, if the minor child has no other income, capital gains of up to \$18,000 per year could be purposely triggered in the minor's In-Trust account with no taxes payable. If the security is still favoured, it can be bought back immediately thereby increasing the Adjusted Cost Base (ACB) of the security. The higher ACB going forward will mean less tax payable in the future. Of course, the disadvantage of this strategy is potential commission charges. Also note that even though there may be no tax payable on the sale, a tax return must still be filed for the minor child to report the sale.

Charitable Donations

In addition to RSP contributions and investment tax shelters (discussed later), charitable donations are one of the few remaining ways that you can significantly reduce the personal tax you pay. The final day to make contributions to a registered charity in order to claim the donation tax receipt on your 2006 income tax return is December 31, 2006. Due to the calculation of the donation tax credit, donations above \$200 can result in a tax savings equal to the top marginal tax rate in your province of residence. For example, a donation of \$10,000 can result in tax savings of approximately \$4,300 for residents of B.C.

Effective May 2, 2006, you can now donate publicly listed securities in-kind to qualified charities and not be subject to tax on any capital gain. In addition, you will receive a donation tax receipt equal to the fair market value of the security at the time of the donation, which can help reduce tax on other income.

Speak to your advisor on the investment merits of donating securities in-kind to a charity prior to year-end. If you plan on donating securities in-kind before year-end, then due to the administration involved in processing an in-kind donation, ensure that you start this process well in advance of December 31, 2006 to ensure that the in-kind donation is recorded as a 2006 donation. If you have thought about leaving a legacy but are unsure the best way to accomplish this, then speak to your advisor on the benefits of donating cash or securities in-kind to your own charitable foundation.

Turning 69 in 2006?

If you are turning age 69 in 2006, you must convert your RSP (or LIRA) to one of the many RSP (or LIRA) maturity options that are available by the end of this year. As well, you must make your 2006 RSP contribution to use any unused RSP contribution room by the end of this year. That is, individuals who turned 69 in 2006 DON'T have the extra 60 days after 2006 to make an RSP contribution to their own RSP in order to receive a tax deduction on their 2006 income tax return.

In addition, if you are turning age 69 in 2006, you should consider making your year 2007 RSP contribution in 2006 before converting to an RIF. Why? If you have 2006 earned income, your 2007 RSP contribution room would not be created until January 1, 2007. Since those individuals turning age 69 in 2006 cannot have an RSP after December 31, 2006, you should consider making your expected year 2007 RSP contribution in December 2006 before converting your RSP. This early contribution (sometimes called the "Forgotten RSP Contribution") will allow you to claim the RSP deduction on your 2007 income tax return. Although you have overcontributed to your RSP now, the tax savings realized should easily outweigh the overcontribution penalty of 1% per month. For instance, the overcontribution penalty on a \$19,000 RSP contribution for 2007 would only be a maximum of \$190 (1% of \$19,000) if you made this 2007 RSP contribution in December 2006. However the tax savings on the \$19,000 RSP deduction in 2007 could be as high as \$9,200.

If you have a younger spouse, you could always consider making your RSP contributions to a spousal RSP until the year your spouse turns age 69, thereby avoiding the overcontribution penalty.

Low-income Year

If you are expected to be in the lowest marginal tax bracket in 2006 (i.e. less than approximately \$36,000 of taxable income) but expect to be in a much higher marginal tax bracket in retirement then you may want to consider making an early withdrawal from your RSP before year-end to bring your taxable income up to approximately \$36,000. In general, this strategy only makes sense for those individuals who are primarily growth investors outside their RSP and are nearing retirement. The advantage of this strategy is that you can avoid a higher income tax rate on these RSP funds if withdrawn in the future when your marginal tax rate may be higher. Furthermore, if

the RSP funds withdrawn are reinvested in a non-registered account, you can now take advantage of the preferred income tax treatment on capital gains, Canadian dividends and return of capital. The drawback of this strategy is a prepayment of income tax and lost tax deferral on the RSP funds withdrawn. For more information on this strategy ask your advisor for a copy of the article "Early RSP/RIF Withdrawal".

Year-end Bonus Planning

There are pros and cons of receiving a bonus at year-end versus deferring the bonus (if the employer allows) to early 2007. Receiving a bonus prior to year-end allows you to earn RSP deduction room for 2007 assuming you did not have adequate other 2006 earned income to reach your maximum 2007 RSP deduction limit already. Furthermore, receiving a bonus prior to year-end may also allow greater employee/employer pension and/or employee profit sharing plan contributions for 2007 if these contributions are based on the prior year's total compensation.

If you are expected to be in a lower tax bracket in 2007, then there may be a tax benefit of deferring the bonus to 2007. However, if the bonus is paid directly to you there will still be withholding taxes at source on the bonus payment.

If the employer permits, some or all of the withholding taxes on the bonus can be avoided if it is transferred directly to an RSP. You must have adequate unused RSP deduction room in the year of transfer.

Note that if the employer's year-end is after June 30, then paying the bonus in December 2006 or early January 2007 will still allow the employer to deduct the bonus payment in their same corporate tax year. That is, our tax rules allow a corporation to deduct a bonus paid to an employee on the corporation's previous year's tax return as long as the bonus is paid within 179 days after their corporate year-end.

Defer Mutual Fund Purchases

The purchase of mutual funds near year-end can result in an unexpected tax liability next April.

If you purchase these funds near year-end, the year-end distribution received may include taxable income or capital gains even though the overall value of their holdings may not have changed.

For example, the year-end distribution may represent the cumulative capital gains recognized during the year by the fund. However, most if not all of this distribution was recognized prior to your purchase. Once the distribution is made, the Net Asset Value of the fund is reduced by the amount of the distribution. You have received no benefit from the distribution since you will simply hold additional units with a lower unit price having the same total value (we have assumed that distributions have been reinvested which will increase your ACB). However, we must not overlook the fact that the distribution received will be taxable.

To avoid this premature tax payment, consider waiting until January to make a mutual fund purchase. Alternatively, another potential solution is to sell the fund prior to the distribution date to avoid receipt of the distribution and then buy back the same fund after the distribution is paid. For recent purchases, this would likely result in little or no tax liability since the cost base will likely be close to the sale price. The potential capital gain should be determined prior to implementing this strategy. Furthermore, the sale could trigger redemption fees that may exceed the tax liability of the distribution. However, transfers within the same family of funds using this strategy may trigger a capital gain/loss without incurring redemption fees, but the previously mentioned superficial loss rules may apply.

Note that if a fund makes regular distributions (monthly or quarterly) then selling would only avoid any remaining distributions during the year-end and may not save as much tax as selling a fund that makes one large year-end distribution.

Of course the year-end mutual fund purchase dilemma described above is only an issue in non-registered accounts and not an issue in registered accounts.

Get Next Year's Tax Refund Early

If you normally get a tax refund when you file your tax return, you should consider applying to the Canada Revenue Agency (CRA) for a waiver to have your employer reduce your tax withheld at source from your paycheques. Why allow the CRA to use your tax refund interest free during the year?! Among others, the CRA will normally approve the tax waiver for individuals who expect the following types of deductions: RSP contributions, alimony payments, carrying charges, childcare expenses, and employment expenses.

You must apply for the tax waiver (CRA Form T1213) on an annual basis. Approval of the tax waiver by the CRA usually takes about six weeks; therefore for the year 2007 tax year you should start applying in late October/early November of year 2006.

RESP Contributions

A Registered Education Savings Plan (RESP) is not only an excellent way to save for a child's post-secondary education costs – it's also a good income splitting strategy. The official deadline to contribute to an RESP for the 2006 tax year is December 31, 2006 (this day falls on a Sunday so make your contribution by December 29, 2006). You DO NOT have 60 days after the end of the tax year to contribute to an RESP like you normally do for RSP contributions. Furthermore, RESP contribution room that is not used by the annual deadline is lost forever. That is, unused RESP contribution room does not carryforward like unused RSP deduction room.

However, unused government grant room (i.e. the Canada Education Savings Grant (CESG)) can be carried forward until the year the child turns age 17, subject to annual maximums.

Business Owners

- a) If you own your own business then consider paying salaries to yourself and family members before year-end. This year-end payment will give the family member earned income so they can make an RSP contribution the following year and will give the business a tax deduction in the current year. Note that the salary paid before year-end must be reasonable and based on the services performed by the family member in the business. For example, paying a child \$30,000 per year for sweeping the office floor every weekend is not reasonable.
- b) If you intend on purchasing assets for the business (i.e. computer, furniture, equipment, etc) you should consider making this purchase before year-end. This year-end purchase will allow the business to claim depreciation on the asset for tax purposes. However, only half of the regular allowable depreciation can be claimed for tax purposes in the first year.
- c) If your company is incorporated and looking for year-end corporate tax deductions and you are looking for a structured retirement savings plan, then the company can consider setting up an Individual Pension Plan (IPP) for you. An IPP is an employer sponsored registered pension plan that allows greater tax-deductible contributions than an RRSP for those employees in their forties and older. Speak to your advisor if you require more information on the pros and cons of an IPP.

Tax Shelters

Many high-income earners will consider purchasing a tax shelter (i.e. limited partnership, flow-through shares, etc) before year-end in order to receive significant tax deductions. A tax shelter is generally structured so that the expenses incurred by the tax shelter in the first few years are flowed directly to the individual investor that the individual can deduct against any other taxable income. However, as the saying goes "a good tax shelter that is a bad investment is really a bad tax shelter". In other words, the investment potential of the tax shelter and not the initial tax

savings, should be the prime consideration when deciding whether to invest in a tax shelter or not. Before making any investment in a tax shelter, you should consider the following questions:

- What is the promoter's track record?
- Has the tax shelter received an Advanced Income Tax Ruling from the CRA?
- Is there a reasonable expectation of profit?
- Is future financing required (i.e. additional future installment payment)?
- When will the tax deductions be available?
- Will the tax deductions trigger Alternative Minimum Tax?
- How liquid is my initial investment?
- How does the tax shelter investment affect my overall asset allocation strategy?
- How long do I plan to hold the investment and what are the tax implications on disposition?

You should be comfortable with the answers to the above questions before jumping in. Although the temptation may be high to invest in a tax shelter solely for the immediate tax benefits, you should ensure that there is a reasonable expectation of profit after taking the tax benefits into account. In addition, the opportunity cost of investing in a particular tax shelter should outweigh other investment alternatives at that time.

Moving Within Canada

Individuals pay provincial tax rates on their taxable income based on their province of residence on December 31st. Since marginal tax rates vary from province to province (e.g. top rate in Alberta is 39% and the top rate in Newfoundland and Labrador is about 49%) if you are moving to a province with a lower tax rate, you may consider moving prior to year-end. If you are moving to a province with higher tax rates, you may consider delaying your permanent move until early 2007.

Tax Installments

If you are required to make quarterly tax instalment payments to the CRA, you should make your final payment on or before December 15, 2006 to avoid late interest charges. If you missed an earlier instalment payment deadline, then you may want to consider making a larger final instalment payment or make your final instalment payment earlier than the December 15, 2006 deadline to minimize late interest charges.

And Finally...

You should remember to pay all investment management fees, tuition fees, safety deposit box fees, accounting and legal fees if deductible, childcare expenses, alimony, and medical expenses by year-end if the intent is to deduct them on your 2006 tax return.

Note: The above information is based on the current and proposed tax law in effect as of the date of this article. The article is for information purposes only and should not be construed as offering tax or legal advice. Individuals should consult with qualified tax and/or legal advisors before taking any action based upon the information contained in this article.

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