



P E R S P E C T I V E

CARRYING BROKER
TD WATERHOUSE CANADA INC.

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C O N T E N T S

- The Five Keys to Portfolio Success
- Income Splitting: Part 2
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- Preparing for Tax Season

INSIDE:

Discover tax savings through income splitting strategies, the benefits of donating publicly listed securities and how to better prepare for tax season.



THE FIVE KEYS TO PORTFOLIO SUCCESS

Family and health. Career and relationships. Certain life areas present challenges that demand complex solutions. Your investment portfolio should not be one of them. Follow these five steps to simplify your investment experience and enhance your portfolio.

1. Know your objectives and risk constraints

Setting realistic portfolio objectives is the cornerstone of a satisfying investment experience. Many investors overestimate the returns they can expect from the stock market. A study of international capital market returns by three professors from the London Business School¹ has shown that the median equity return for 16 countries from 1900 to 2000 is 4.9% in excess of inflation. Adding 2.5% for expected inflation, you can look forward to a 7.4% expected return - arguably a fairly low number. That said, properly establishing your return objectives and risk constraints enables you to devise an effective action plan to achieve your financial goals within the realities of the marketplace.

2. Structure your portfolio effectively

Academics have demonstrated that a) the return and risk associated with portfolios are mostly determined by their structure, and b) returns can be enhanced by increasing the allocation of common stocks vs. bonds, small cap vs. large cap stocks, and value vs. growth stocks. Accordingly, index funds are much better investment vehicles than actively managed funds. You can depend on index funds to maintain their value or small cap mandate. Conversely, active funds will often venture outside their mandate with the excuse of pursuing other attractive opportunities - to mixed results.

3. Optimize the economics

Understanding that expected equity returns are well below 10% and that bond returns can be expected to be half that at best (10-year Federal bonds currently yield 4%), you may be inclined to seek more return through actively managed funds. However, active management does not add value compared to index solutions. The latest study of mutual funds by Standard and Poor's shows that more than 90% of actively

managed Canadian Equity mutual funds are actually underperforming the S&P/TSX Composite Index².

4. Choose the right supplier

In our industry the right suppliers can greatly contribute to your success. For example, over three years ago, PWL strategically decided to invest in the initial offering of Dimensional Fund Advisors (DFA) funds in Canada. Since then, DFA has upheld all of its original promises and even over-delivered in some cases. While 25% of Canadian Equity funds and 45% of U.S. Equity funds³ closed or merged during the last three years, DFA closed none. All of their funds have replicated their targeted asset classes correctly. Even better, management expense ratios, which were already low from the outset, have declined significantly for some funds.

5. Keep your emotions in check

There is no denying that investing can be entertaining. Picking a winning stock can be a thrilling experience and a confidence builder. But if you embrace the entertainment factor, your investment process becomes an emotional one - and that can be dangerous. Emotions often push investors towards self-sabotaging behavior like acting on false confidence and overtrading. When trading in and out, most investors experience lower returns than the market's rate of return. If your investments are delivering steady and "boring" results, don't worry: it's likely a sign that your investments are benefiting from a sound and rational management.

¹ Dimson, E., Marsh, P., Staunton, M., *Triumph of the Optimists*, Princeton University Press, 2002

^{2,3} Rive, S., *Index Versus Active Funds Scorecard for Canadian Funds*, Standard and Poor's, November 2006

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INCOME SPLITTING: PART 2

Splitting income with your family can help you save on your taxes. In our previous newsletter, we overviewed ways that you can benefit from splitting income with your children. In this article, we highlight strategies to split income between spouses.

Though there are strict rules about how you can split income between you and your spouse, there are still many possibilities. If the income generated from assets is earned by both spouses rather than one, the after-tax disposable income of your family will be greater. For example, a couple in Quebec with a household income of \$60,000 will have approximately \$43,000 in disposable income if only one spouse earns that income. If that same income is equally divided between spouses, disposable income rises to \$48,200.

Understandably, it is difficult to achieve any type of asset equalization when there is a great disparity in income between spouses. But there are some income splitting techniques and strategies that can ultimately reduce the tax bite.

Inter-spousal loans

The attribution rules of the Income Tax Act do not apply if a property is loaned to a spouse at the prescribed interest rate (currently 5%). As a high-income taxpayer, if you loan liquidities to your lower-income spouse for investment

purposes at the prescribed interest rate, any income generated from these investments will be taxed at your spouse's lower income tax rate.

It is important to note that your spouse will have to pay you interest owing on the loan within 30 days of the end of each year. If even one interest payment is missed or made after the deadline, the attribution rules will apply to all investment revenue for future years. As a lender, you will have to declare the interest on your tax return, though it will be deducted from your spouse's tax return as a borrower. For Quebec residents there is a caveat: the deductibility of the interest charge is limited to the investment income declared on the return. For this strategy to be worthwhile, the investment return must be greater than the prescribed interest rate.

Even if you are not interested in instituting an inter-spousal loan at the prescribed interest rate, you may still shift assets to your lower-income spouse by gifting or lending liquidities free of interest for investment purposes. Though income generated from the investment will still be attributed to you as a donor, any income earned on that income will belong to your spouse. Over time, your lower-income spouse will be able to build his/her own portfolio.

Overcoming the independence hurdle

Unfortunately, too many two-income families are unaware of the benefits of building investment assets in the lower-income spouse's name. Instead, it is more common practice to share expenses to preserve a sense of equality and independence. This presents a roadblock to building investments and the shifting of investment income to the lower-income spouse who invariably spends most of his or her income. A more beneficial scenario is to save the lower-earning spouse's income and have the higher-income partner pay for lifestyle expenses.

To get over this "independence hurdle", try depositing both of your pay cheques into a joint account. Transfer whatever monthly amount that is not needed for lifestyle expenses into an investment account for your lower-income spouse. In that you have concerns about a marriage breakdown, remember that the assets that you build

up during your marriage will be split in accordance with the family law rules of most, if not all, Canadian provinces.

Home ownership

If your family home is jointly owned and you have built up liquid assets as the higher-income spouse, you can buy your spouse's financial interest in the property and shift investment assets into his or her hands. Since the transaction is between spouses, there are usually no transfer taxes - though this should be verified with your municipality. Once again, family law rules allow that the value of the family residence will be split in the event of a marriage breakdown.

The federal government's new proposal for pension income splitting will also allow many retirees to reduce their tax burden. In effect a taxpayer who receives eligible pension income will be able to allocate up to 50% of his/her pension income to a resident spouse. For individuals aged 65 and over, eligible pension income includes payments from a registered pension, RRSP, DPSP or RRIF. For individuals under age 65, eligible pension includes income from a registered pension plan or similar payments pursuant to the death of a spouse.

Finding the perfect strategy for you

These are just some of the techniques for shifting capital and income to your lower-income spouse in order to build assets equally between you and reduce your tax burden prior to, and during, your retirement years. There are other more involved strategies for corporations or self-employed individuals who can pay a reasonable salary to their spouse.

Be aware that the implementation of any income splitting technique can have adverse tax consequences. To ensure that you benefit from a perfectly tailored strategy, consult with your PWL advisor before considering any of the recommendations overviewed in this article.



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PLANNED GIVING

FROM DISCIPLINED INVESTOR TO ASTUTE DONOR!

Here is an article published in UPBEAT (Fall 2006 bulletin of The Montreal Heart Institute Foundation) explaining the improvement in tax deductions for donations to charities of securities listed on the stock exchange.



Did you know that your next donation to the Montreal Heart Institute Foundation could generate additional tax savings for you? In fact, since May 2, 2006, when you donate publicly listed securities¹ to a charitable organization or public foundation, you will not pay income tax on the capital gain that is triggered by your donation.

Investors who have made a profit on the stock exchange in the past several years would do well to take a closer look at these new tax rules. They might even be able to kill two birds with one stone, that is, make a substantial donation for a lower net cost.

Let's take the example of a \$100,000 donation. In the first scenario, the gift is made by selling a publicly listed security and then donating it to a charity. In the second scenario, the security is transferred directly to the charitable organization.

The Answer to Concentration Risk?

When a share represents 10 percent or more of the market value of an investor's portfolio, there is concentration. This can occur, for instance, if a person regularly purchases company shares through a workplace incentive program. In such a case, strong market

EXAMPLE

	Sale and Donation	Direct Donation
Market value of shares	\$100,000	\$100,000
Cost of shares	\$40,000	\$40,000
Capital gain	\$60,000	\$60,000
Taxable capital gain	\$30,000	\$0
Taxes payable*	\$15,000	\$0
Charitable donation tax credit*	\$50,000	\$50,000
Net tax savings*	<u>\$35,000</u>	<u>\$50,000</u>
NET COST OF DONATION	\$65,000	\$50,000

**Figures rounded off based on the maximum marginal tax rate in Quebec. Donations are limited to 75 percent of a person's net income during that year. Additional amounts can be carried forward to the next five years. This limit increases to 100 percent the year an individual dies and any excess amount can be applied to the previous year.*

performance combined with the share's accrued value may eventually create concentration. Unfortunately, this is a major risk that is often overlooked when managing investment portfolios. Because donating publicly listed securities entails tax incentives, it is an interesting option for investors who want to reduce this type of risk.

One last tip

Don't wait until the end of the year to talk with an advisor about donating publicly listed securities. Remember that a disciplined

investor knows how to generate profits, but an astute donor knows how to maximize tax savings.

¹ For example: publicly traded stocks, bonds, units of mutual investment funds, segregated funds and exchange-traded funds.



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THE FINANCIAL KNOWLEDGE TEAM

Portfolio Management

Financial Planning

Insurance and Estate Planning

Research

PREPARING FOR TAX SEASON

Taxes are an unfortunate reality and April 30th will soon be upon us. This list of tips will help you to get organized for tax time and make your preparation tasks easier.

Stock list

List all the stock sales for the year and match the proceeds with the price you paid for the stock. If the transaction is in U.S. or another currency, you will need the date of purchase and the date of sale so that your tax preparer can record the relevant foreign exchange rates.

Charitable donations

Match all of your charitable donations with provided tax receipts (ideally by comparing cheque stubs with your receipts). Try to do this in January or February so that you have time to contact any charitable organizations that failed to send you a receipt.

Parents with students

Those with children in post secondary institutions should ensure that each student obtains form T2202A/Relevé8 from their school. Many institutions now provide these receipts on-line for easy access and printing.

Public transport

As of July 2006, you can deduct public transport fees (cost of passes) for yourself and your family members. You need proper receipts to support deductions and they must have the commuter's name on it. Credit card receipts are the most appropriate.

Medical expenses

When tabulating medical receipts, choose a 12-month period that affords you the most deduction. Note that the 12-month period must end in the taxation year in question. Even if you think there are insufficient expenses to justify a deduction, you should still send them to your tax preparer. There could be a taxable benefit on your T4/Relevé1 that may qualify as a medical expense.

Self-employed and rental income

If you are self-employed or earn rental income, provide your tax preparer with income and expense summaries and supporting documentation. Submitting organized information will reduce the tax return preparation time and possibly fees as well.

New tax preparer

If you have changed tax preparers or are using a tax preparation service for the first time, provide the preparer with your last notice of assessment (Federal and Provincial). This should have your RRSP contribution limit and a record of any capital loss to be carried forward.

A WORD FROM PWL'S PRESIDENT

In 2006, PWL proudly celebrated a decade of helping private investors to reach their financial goals and enhance the quality of their lives.

As we begin this new year of success and growth, we do so with a renewed strength and commitment to providing you with the industry's best financial advice, services and wealth management offering.

On behalf of the PWL team, I would like to wish you our very best for a prosperous New Year.



Sincerely,

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