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Registered Education Savings Plans (RESPs)

Part 2 — Savings Strategies and Special Circumstances

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Financial Advisory Support

The purpose of a registered education savings plan (RESP) is to assist you with saving funds for a beneficiary's education. This article is the second of a three-part series on RESPs and describes some of the best RESP saving strategies and other special circumstances you might encounter. The first article, "Establishing an RESP," addresses the basics of RESPs. Finally, the third article, "Withdrawing and Spending Savings," explains how you can withdraw and spend the accumulated RESP savings for educational purposes.

Making the Most of the Canada Education Savings Grant (CESG)

ACCUMULATING CESG CARRYFORWARD ROOM

Since 2007, $500 of CESG has been available each year for a qualifying beneficiary that is 15 years old or under. (Specific rules exist for children who are 16 and 17 years old, as discussed in part 1 of this series of articles.) Since the annual CESG is 20% of the RESP contribution made during the year, an RESP contribution of $2,500 for the year attracts the full $500 CESG annual limit.

Prior to 2007, the maximum CESG that was available for each qualifying beneficiary was $400 per year; thus annual RESP contributions of $2,000 attracted the full CESG.

If your RESP contribution for a particular beneficiary for the year is less than $2,500 ($2,000 for years prior to 2007) and does not attract the full CESG, the remaining CESG amount or unused grant room may be carried forward. This unused CESG creates a "pool" of carryforward room for the beneficiary, which is available for future years. Each beneficiary has their own pool, even if their contributions are combined in a family RESP.

USING UP THE CESG CARRYFORWARD ROOM

When a contribution to an RESP of more than $2,500 per year is made ($2,000 for years prior to 2007), the carryforward pool can be used. The maximum grant available in a year is limited to 20% of the first $5,000 of RESP contributions made ($2,500 for the maximum CESG of $500 and another $2,500 for the maximum CESG carryforward of $500)

For example, a child who is born in 2004 for which no RESP contributions have ever been made will have a total pool of $1,700 in 2008 in unused grant room ($400 for each of 2004, 2005, 2006 and $500 for 2007). A contribution of $5,000 in 2008 will trigger a grant of $1,000: $500 for the 2008 contribution and $500 from the CESG carryforward pool being used. The grant pool will then be reduced to $1,200.

As a second example, let's assume another child is born in 2006 and $900 of CESG carryforward exists in the pool. A contribution of $5,000 or more made in 2008 will trigger $1,000 in CESG: $500 for 2008 and $500 from the carryforward pool. $400 will remain in the pool. If a $5,000 contribution is made again in 2009, then a total of $900 in grant payments will be received: $500 for 2009 and $400 from the remaining amount in the pool. For 2010, there will no longer be an opportunity to catch up. The maximum CESG will be $500 for a contribution of $2,500 or more.

The following table illustrates the possible pool amounts for beneficiaries born in given years if a $5,000 contribution is made in 2008 and RESP contributions have not been made previously on their behalf in any RESP plan.

Year in which child was born	CESG carryforward pool*	Contribution made in 2008	Grant paid in 2008	Remaining carryforward pool
2003	$2,100	$5,000	$1,000	$1,600
2004	$1,700	$5,000	$1,000	$1,200
2005	$1,300	$5,000	$1,000	$800
2006	$900	$5,000	$1,000	$400
2007	$500	$5,000	$1,000	$0
2008	$0	$5,000	$500	$0

* If no prior RESP contributions have ever been made on behalf of the beneficiary in any RESP plan.

Making a large lump sum contribution and the impact on the CESG

Two of the most recent and substantial changes to RESPs have been the elimination of the annual $4,000 RESP contribution limit per beneficiary and an increase in the lifetime maximum RESP contribution from $42,000 per beneficiary to $50,000. As a result of the elimination of the annual limit, you may wonder if you should contribute $50,000 up front to your RESP in order to take full and immediate advantage of the tax-deferral opportunity.

The issue is that if you contribute the $50,000 up front, you will benefit from the tax deferral on the investment income; however, you will likely forfeit a substantial part of the CESG, which may otherwise be available if you make regular annual contributions. The CESG is paid based on 20% of the annual RESP contribution to a maximum of $500, or if there is a CESG carryforward pool, up to a maximum of $1,000. Thus if you make a one-time lump-sum contribution of $50,000 to the plan, the maximum CESG the plan could receive is $1,000. A lump-sum contribution in excess of $5,000 in any given year will attract CESG on only the first $2,500 ($5,000 if there is enough CESG in the carryforward pool). Grants are not paid to the plan in future years for past years' contributions.

VARIABLES TO CONSIDER

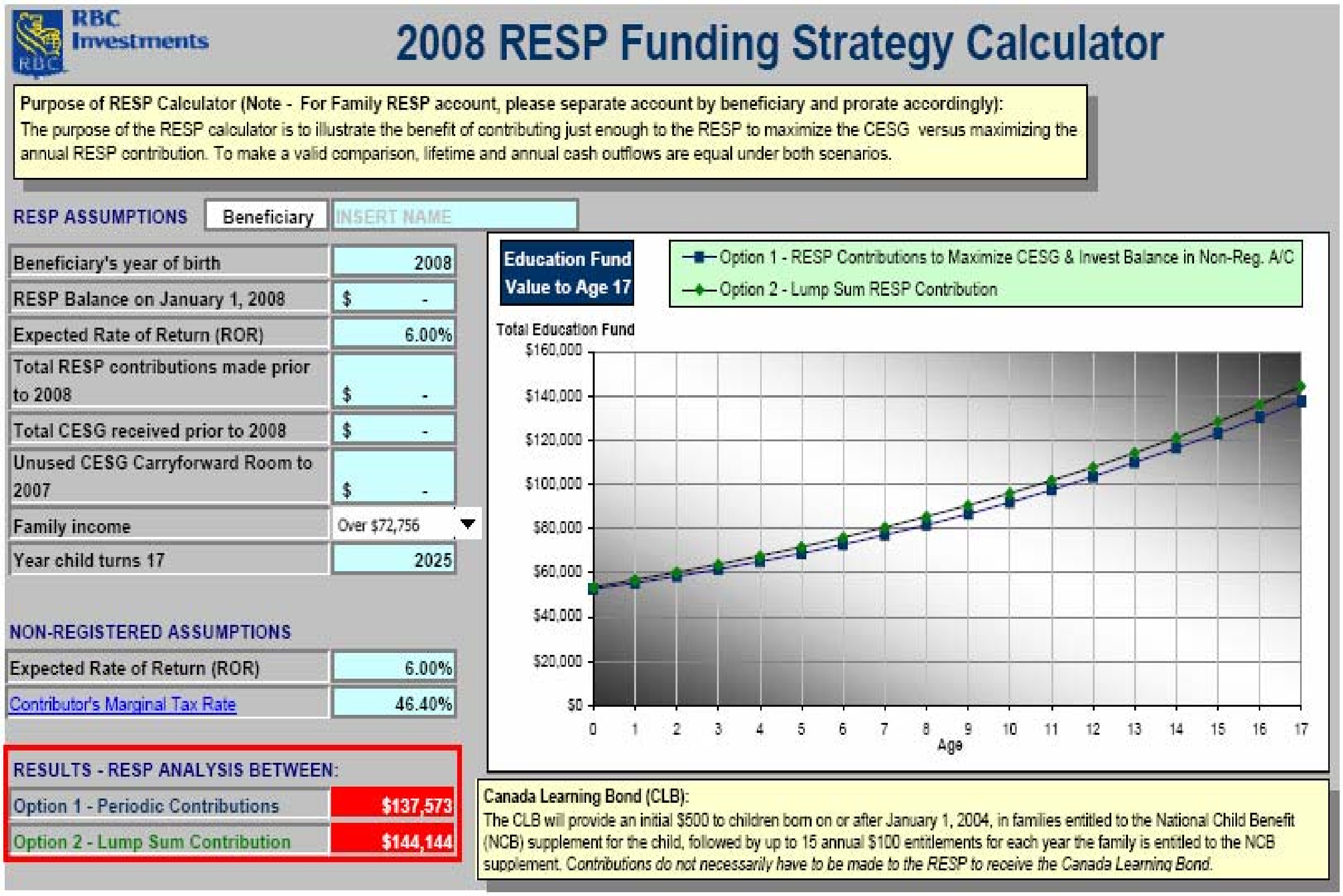
Whether it is it more advantageous to contribute a lump-sum amount of money up front or whether is it better to make several annual contributions to maximize the amount of CESG depends on several variables such as:

- Your ability to make a larger upfront contribution
- The age of the beneficiary, which is used to determine the balance in the CESG carryforward pool and the approximate timing of future withdrawals
- Your marginal tax rate on your non-registered assets
- Your expected rate of return on the investment income (inside the RESP and outside)
- Your beneficiary's expected marginal tax rate when the funds are withdrawn (often 0% given the basic personal exemption and other tax credits available to students)

ANALYZING THE NUMBERS

The following graph from the RESP funding strategy calculator illustrates an example where a $50,000 lump-sum contribution is made to an RESP instead of an annual contribution that maximizes the CESG payment. It is assumed that the contributor has the $50,000 in a non-registered account that may be used to fund the RESP. It is also assumed that the investment rate of return is 6%, net of fees.

In this example, the result is that with the lump-sum contribution, there is approximately $6,571 more in the plan when the beneficiary ultimately requires the funds.



Though the CESG is a boost to many families' education savings plans, generally, if you have the ability to make an upfront $50,000 lump sum, it will be more advantageous to do so and permanently forgo the full potential value of the CESG.

Also, with a larger plan balance from the very start, you may have access to a wider array of investment solutions than you would if you made smaller annual contributions.

You may also decide to do a combination of a lump-sum upfront amount of less than $50,000 and future contributions to maximize the CESG.

Speak to your Advisor about analyzing and illustrating the various strategies that may be available to you.

Opportunities and constraints for grandparents

Grandparents may have the financial means and desire to contribute to an RESP for their grandchildren. It is a wonderful way for them to provide for their grandchildren in a meaningful way.

If you are a grandparent, you are able to establish an RESP yourself (i.e., be the "subscriber") and become the contributor to the RESP for your grandchildren; however, you may also want to consider a slightly different approach. You may want to consider gifting the funds to your son or daughter who in turn will establish the RESP for your grandchildren. In both cases you are providing the financial gift and your grandchildren are the beneficiaries of the RESP. The difference is that, in the latter case, your child is the subscriber of the plan.

The advantage of the second approach is that if one of the beneficiaries doesn't go to post-secondary school, there are opportunities for the subscriber to transfer the earnings from the RESP to their own RSP, within certain limits (as discussed further in part 3 of this series of articles). In order to do this, the subscriber must be 71 years of age or less. RESP plans have a potential life span of 25 years (which the February 26, 2008, federal budget proposes to increase to 35 years). This opportunity, which may not exist for you if you are 71 years of age by the time it is known that one of your grandchildren will not attend school, may exist for your son or daughter at that time.

The disadvantage of this approach is that you have little or no legal control over the funds. When you gift the amount to your son or daughter, they have control over the funds and there is no guarantee that they will follow your wishes. Even if the funds are contributed to an RESP, as the subscribers, they will always have the ability to withdraw the funds.

As there is ambiguity with respect to who actually owns the funds within an RESP, in the case of divorce or creditors trying to access RESP funds, it may be up to the courts to assign ownership of the funds. Before gifting money to your son and daughter to set up an RESP for a grandchild, you should be aware of these potential problems.

Investment options

As with any other investment, you must determine your own risk tolerance, your investment objectives, the time horizon for the use of the funds and any investment bias when determining the appropriate investment asset allocation of the RESP funds.

ELIGIBLE INVESTMENTS AND ALLOCATION OF ASSETS

The same investments that are eligible for a Registered Retirement Savings Plan (RSP) are also eligible for an RESP.

Since RESPs enjoy tax-deferred growth, many contributors would rather hold their investments that generate capital gains in their non-registered accounts and hold their assets that predominantly produce dividends and interest in their RESPs. However, as RESPs are generally long-term investments (depending on the age of the beneficiaries), other contributors may choose to invest in equity-based securities that generally produce capital gains rather than dividends or interest income.

Both of these strategies have their merits. Speak to your Advisor about determining the best approach for you based on your circumstances and your risk tolerance.

Special circumstances

DEATH OF A BENEFICIARY

In the unfortunate event that the beneficiary of the RESP account you established should pass away before depleting all the funds within the account, you may designate a replacement beneficiary. Due to contribution and CESG limits, please be cautious in naming a replacement beneficiary that is already a beneficiary under another RESP.

In a family plan with multiple beneficiaries, the CESG can be shared amongst the beneficiaries. In the unfortunate event that one of the beneficiaries passes away, their share of the RESP assets may be reallocated to other beneficiaries. However, each beneficiary is able to receive a maximum CESG of $7,200. Any CESG remaining in the plan after the plan has been wound up has to be returned to the government.

If you decide you do not wish to designate a replacement beneficiary, then you may wind up the plan.

DEATH OF THE CONTRIBUTOR

Given that the maximum life span of an RESP is 25 years (which the 2008 federal budget proposes to increase to 35 years), this is a potential issue that should be considered.

If you pass away prior to the RESP funds being fully utilized by the beneficiaries, a successor subscriber may be named. If your RESP is established with you and your spouse acting as joint subscribers and either one of you passes away, the surviving spouse becomes the sole subscriber. You may also designate a replacement subscriber in your Will. If you do not designate a replacement subscriber in your Will, your executor or liquidator may designate someone as a replacement subscriber.

A successor subscriber assumes responsibility for the management of the account and may also continue making contributions to the plan. A successor subscriber can be an individual, an estate or a company.

Your successor subscriber will have the same rights as you do as the original subscriber with the exception that only your spouse or common-law partner as your successor subscriber will be able to reduce the accumulated income payments (AIPs) subject to tax by transferring up to $50,000 of income to their RSP. (AIPs and educational assistance payments (EAPs) are discussed in part 3 in this series of articles.)

If you pass away and do not have a spouse as a joint subscriber or a Will that names a successor subscriber, or your plan (if permitted) does not say who will be the successor subscriber and your beneficiaries are not able to all agree on a successor subscriber, your executor may be compelled to wind up the RESP (but only under specific circumstances).

Depending on the situation, an RESP will require probate on the death of a subscriber. The executor or successor subscriber will likely have to provide a death certificate of the original subscriber and inform RBC who will be the new subscriber. As well, the value of the asset will likely be included in calculating probate taxes.