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TAXSTRATEGY

RESPs

More Than a Tax Advantage

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June is here and with it comes a school calendar full of end-of-year events, with the biggest being our kids' graduation. Whether your children are graduating from kindergarten or high school, the same question is on most parents' minds: How to pay for university or college?

So what about a savings program that has some extra bonus points in the form of tax-deferred growth?

One such tax-saving vehicle, which has been quite popular over the years, is the Registered Education Savings Plan (RESP). While contributions to RESPs are not tax-deductible (so not as good as an RRSP), they are invested in a special fund in which earnings accumulate tax-free until they are distributed as payments for post-secondary education to children, grandchildren or other designated beneficiaries.

There are, however, no relationship requirements between the contributor and beneficiary, so that you may set up an RESP for any relative or deserving beneficiary (as long as they are a Canadian resident who can provide a Canadian Social Insurance Number (SIN)).

There are three types of RESPs:

1. Individual RESP plans: This plan is simple - anyone can open an individual RESP for a particular beneficiary and contribute to it. This can be a parent, a grandparent, or anyone who wants to benefit the child.

2. Family RESP plans: In a family plan, you can have one or more beneficiaries, although they all have to be related to the contributor (this includes nieces and nephews). The beneficiaries also have to be under 21 when they're added to the plan.

3. Group RESP plans: In a group plan, one single child is the beneficiary, and that child does not have to be related to you, but many people are contributing to this plan. So essentially, the beneficiary shares the pooled earnings of investors with children of the same age. Group plans tend to have more restrictions and rules than other plans.

The benefits of an RESP arise through three mechanisms:

☛ Tax deferral: income earned on the (non-deductible) contributions you make to the plan is not subject to tax; accordingly income accumulates more rapidly in the plan than it would in the hands of the contributor;

☛ Income splitting: when amounts are paid out of the plan for the post-secondary education of a beneficiary they will be taxed to the beneficiary. This can result in little or no tax being ultimately paid on the earnings, since a taxpayer (i.e. the child) with no other income can earn at least (approximately) $14,000 (for 2022) annually completely tax

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free, by virtue of the basic personal tax credit, with additional tuition and education tax credits being available to also increase the effective tax-free amount. Even if these tax-shelter sources are exhausted, then the lowest tax bracket would then apply.; and

☛ Incentive grant: The government will actually match contributions under the "Canadian Education Savings Grant" (CESG) with 20 per cent grants paid to the plan on contributions of up to $2,500 per year (see further discussion below).

As a contributor (subscriber) to an RESP, you are not entitled to a deduction in respect of your contribution; however, the interest income (or other investment income) earned in the plan on your contribution is not taxed in your hands. Rather, the investment income earned in the plan is accumulated free of tax and will be taxed in the student's (child's) hands only when the child receives funds from the plan.

While there is no annual limit for contributions to RESPs (as of 2007), the lifetime limit on the amounts that can be contributed to all RESPs for a particular beneficiary is $50,000.

Excess contributions

A penalty tax of 1 per cent per month of any excess contributions is assigned pro rata to each contributor's contributions. This means that the lifetime limit cannot be avoided by establishing more than one RESP or by having different subscribers establish RESPs. Note: payments made to an RESP under the Canada Education Savings Program (CESP) or any Provincial Education Savings Programs are not considered for the $50,000 lifetime limit.

The tax is payable within 90 days after the end of the year in which there is an excess contribution. An excess contribution exists until it is withdrawn (so yes, you can withdraw the excess). However, you have to inform the CRA of your share of the excess contribution to all RESPs for a beneficiary.

In general, the rules ensure that plans must provide that education benefits are only paid to bona fide students in full-time attendance in qualifying educational programs at post-secondary educational institutions.

Withdrawals

Funds accumulated in an RESP and used as intended for full-time education are subject to few restrictions. The amount of educational assistance payments withdrawn is limited to $5,000 until the student has completed 13 consecutive weeks in a qualifying educational program. Although normally, payments must be in support of qualifying full time post-secondary education, payments in support of part-time education are permitted for students who cannot enroll full time due to physical or mental impairment.

It is possible under these plans for the original capital contributions to be returned to the contributor, tax-free, typically in the event that no related beneficiary qualifies by taking post-secondary education within the required time frame. However, withdrawals of RESP earnings to a contributor will be taxable income to the contributor (but not earned income for RRSP purposes). A good planning tip would be to ensure that the returned plan earnings are contributed to an RRSP of the contributor or the contributor's spouse or common-law partner to the extent that the contributor has adequate RRSP contribution room, as such transfers can be done on a tax-deferred basis.

Plan earnings received by the contributor which are not contributed to an RRSP (whether because they exceed RRSP contribution room or otherwise) are subject to a special tax of 20 per cent in addition to regular income tax payable.

Most transfers from one RESP to another RESP will have no tax implications. This is the case when the transferring RESP and the receiving RESP have the same beneficiary. There are also no tax implications when a beneficiary under the transferring RESP has a brother or sister (under 21 years of age before the transfer is made, unless the receiving plan is a family plan) who is a beneficiary under the receiving RESP. In any other case, transfers can result in an excess contribution. This is because the RESP contribution history for each beneficiary under the transferring RESP is assumed by each beneficiary under the receiving RESP.

Canadian Education Savings Grant

The government also provides additional RESP assistance of up to $500 per year for beneficiaries under 18 by providing the CESG to RESPs, based on 20 per cent of annual contributions to a $2,500 ceiling (the payments are made directly to the RESP trustee).

Beneficiaries who are 16 or 17 in the year will receive a grant only where at least $2,000 of RESP contributions were made in respect of the beneficiary, or at least $100 in annual RESP contributions were made in any four years before the year in which the beneficiary reaches age 15.

The maximum total of grants per individual is $7,200 (this cannot be avoided by setting up multiple plans).

CESGs paid into family plans (i.e., plans with multiple beneficiaries, all of whom are related) on contributions made in respect of a particular beneficiary can be used for the education of other beneficiaries under the plan. However, the $7,200 ceiling applies to each beneficiary.

Withdrawals of contributions from an RESP for non-educational purposes, or a transfer from one RESP to another, will result in restrictions on future CESG payments in respect of beneficiaries under the plan. This is to prevent the "recycling" of RESP contributions to obtain grants under the new system.

Generally, RESPs may retain CESG funding until it is used to assist in the beneficiary's post-secondary education or it has been determined that it will not be used for that purpose. When contributions are withdrawn for non-educational purposes from an RESP which has received a grant, the RESP trustee will be required to make a CESG repayment to the government equal to 20 per cent of the withdrawal.

However, repayments will generally not be required for group plans which operate on the basis of "age cohorts" (i.e., traditional-type plans, discussed earlier). In this case, the grants can be reallocated to other RESPs in the group arrangement.

Final thoughts

The benefits of RESPs must be weighed carefully, not simply in tax terms, but with an understanding of plan provisions in the event that beneficiaries do not ultimately attend designated schools within the anticipated time frame.

Planning Points

☛ RESP rules in general make these plans far more attractive as an income splitting vehicle for setting aside savings for the higher education of your children, grandchildren, or other young relatives.

☛ If you have invested in a RESP and it begins to appear that no beneficiary will use the plan before its mandatory 25 year expiration, you should consider foregoing RRSP contributions if necessary, to ensure adequate contribution room to cover a return of plan earnings. ❏

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