Three important facts about RESPs that Canadians need to know

theglobeandmail.com/investing/globe-advisor/advisor-news/article-three-important-facts-about-resps-that-canadians-need-to-know

Helen Burnett-Nichols

2 September 2020

Open this photo in gallery

For many RESP subscribers, understanding that there are three notional pots of money within the RESP is the most significant area in which they could improve their own experience and use of the plan, one advisor suggests.
Andrii Dodonov/iStockPhoto / Getty Images

The registered education savings plan (RESP) remains a popular and flexible tool for Canadians looking to supercharge their children's savings for post-secondary schooling. While many are moderately versed in how this plan works, the parameters and practical uses of the RESP still cause some confusion and can lead investors to ask their financial advisors for some clarity.

"Most people I come into contact with know about RESPs and have some grasp of the basic mechanics – and then there are some complexities that would benefit them knowing," says Sandi Martin, partner, chief operating officer and financial planner at Spring Planning Inc.

Here are three important facts about the RESP that advisors say Canadians need to know:

1. Contributing $2,500 annually won't maximize the plan

Most RESP subscribers are aware that in order to receive the maximum $500 annual Canada Education Savings Grant (CESG) from the federal government, they need to contribute $2,500 a year to their child's plan, starting in their first year. With this method, they would reach the maximum lifetime CESG of $7,200 in the child's 14th year.

"They know that part," Ms. Martin says. "But then, the question is almost always, 'Why would I put in any more than that?'"

The reason, she says, is that this approach will leave subscribers with $36,000 of contributions, which is shy of reaching the RESP's lifetime contribution limit of $50,000.

"If you start putting $2,500 in a year when your child is [born], then you have additional $14,000 [in contribution room] available [after maxing out the CESG] to bring it up to that $50,000 lifetime contribution maximum. [Those extra contributions] don't attract a grant, but still could go into the account and grow on a tax-deferred or tax-transferred basis," Ms. Martin says.

"The idea that you could even do that is often one piece that people don't realize is an option," she adds.

To take further advantage of the parameters, one possibility is to contribute the extra $14,000 in the child's first year, says Peter Guay, portfolio manager at PWL Capital Inc. in Montreal.

This strategy would enable the money to grow effectively tax-free for 18 years, he says.

2. All money within the RESP is not treated equally

For many RESP subscribers, understanding that there are three notional pots of money within the RESP is the most significant area in which they could improve their own experience and use of the plan, Ms. Martin says .

From a tax perspective, each category – the investor's contribution, the government grant and any growth and income earned in the account – is treated differently.

When withdrawing the assets held in an RESP for educational purposes, an individual's contributions – called Post-Secondary Education Payments – come out tax-free. The grant portion as well as any growth, referred to as Educational Assistance Payments, will be taxed in the beneficiary's name.

Individuals should brush up on these rules regularly during the contribution years, Ms. Martin says. They will likely benefit from them when it comes time to map out how to withdraw the funds in a way that works best for their situations.

Generally, Mr. Guay says students will not be earning enough income to be taxed on the growth and grant portion of the RESP if withdrawals are spread out evenly over the course of their degree. But in some situations, it may make sense to withdraw this portion earlier.

"Depending on what you're studying, you can make more in the later years in your summer jobs, so taking more of that grant money and earnings money sooner is often the better way to do it so that at the very least, when they've finished university, all that's left is contributed capital," he says.

One area in which Canadians can easily run afoul of the rules is in not using all of the funds in the plan before winding it up, Mr. Guay says. In these cases, the RESP subscriber will be taxed on any growth left behind and unused grant money will go back to the government. As such, he says, it's important to have a plan in place to spend it down during the post-secondary years.

"Even if you don't intend to spend it all on the child, remember that the contributions can come back out, tax-free, in your own name. So, you could always spend the grant money and the growth on the child's education and then take out the contributions and put that in your own RRSP down the road," he says.

3. The complexity of the family RESP

For those who have more than one child, family RESPs can provide flexibility to reallocate funds among the beneficiaries to a maximum of $7,200 CESG per individual.

But some subscribers may not realize there's some added complexity to these plans, says James Schofield, vice-president and senior financial planning advisor at Assante Capital Management Ltd. in Ottawa.

Individuals and advisors need to ensure monthly contributions are redistributed properly to younger beneficiaries as the oldest children start to withdraw the assets and are no longer eligible for grants, he says.

Families also need to plan ahead, in terms of knowing their children and how the money is likely to be allocated, particularly in situations in which beneficiaries don't all attend four-year post-secondary programs.

“Having an advisor is really important because we know our clients,” Mr. Schofield says. “[For example], the first child is going to go to a one-year trade school that’s going to cost $10,000, so let’s get all their $7,200 CESG and as much of their growth [in the plan] out and leave the contributions for the other two children who are going to go to four-year programs.”