

TAXTALK

Saving for Higher Education: The Power of RESPs in an Economic Recession

Theodore Roosevelt once said, “A man who has never gone to school may steal from a freight car; but if he has a university education he may steal the whole railroad.”

While that may be metaphorically true, “Teddy” overlooked one important factor: What if the person has to first steal the whole railroad in order to fund their university education?

Granted, post-secondary education in Canada does not necessarily cost as much as a railroad, but the truth may not be far from it. A recent study indicates the average annual tuition cost for a university undergraduate in Canada was \$5,138 in 2010-11 – a jump of 4.0% from the previous year and a catapult of 16.8% from five years ago.¹

Like generations before them, parents today make saving for their children’s post-secondary education a priority; however, never before has education in Canada been so expensive. With unprecedented increases in tuition costs and alarming amounts of government student loan debts² amidst the still-ongoing economic slowdown, parents’ concerns are legitimate and perhaps warranted.

Now may be the perfect time for parents to consider how a Registered Education Savings Plan (RESP) can help their children and themselves – especially in light of the recent legislative developments that have enhanced the attractiveness and functionality of RESPs.

CONTENTS

RESPs: What, Why, and How?	2
Contribution Limits	2
Types of RESPs.....	2
Government Grants	3
Educational Assistance Payments	4
Refund of Contributions	5
Accumulated Income Payments (AIPs).....	5
Other Payments	5
Death of Contributor or Subscriber	5
Impact of Recent Budget Changes	6
Other Tax Planning Strategies.....	6
In-Trust Accounts	6
Formal trusts	6
RRSP Withdrawals	6
Student Loans	6
Other Tax Incentives for Students	7
Conclusion	7
Terms of Reference	7

¹ Statistics Canada, “Undergraduate tuition fees for full time Canadian students”, September 24, 2010.

² Average debt was around \$25,000 in 2007. (Globe and Mail, October 27, 2007)

RESPs: What, Why, and How?

An RESP is a contract between an individual subscriber and a promoter, where:

- The subscriber names one or more beneficiaries;
- The subscriber contributes to fund future education costs for the beneficiaries; and
- The promoter pays contributions, and income earned on contributions (in the form of 'Educational Assistance Payments', or EAPs), to the beneficiaries.

The RESP is also a tax-deferral plan, where funds invested accumulate income on a tax-deferred basis until the beneficiaries enrol in a qualifying post-secondary education. However, subscribers cannot deduct their contributions from their income for tax purposes.

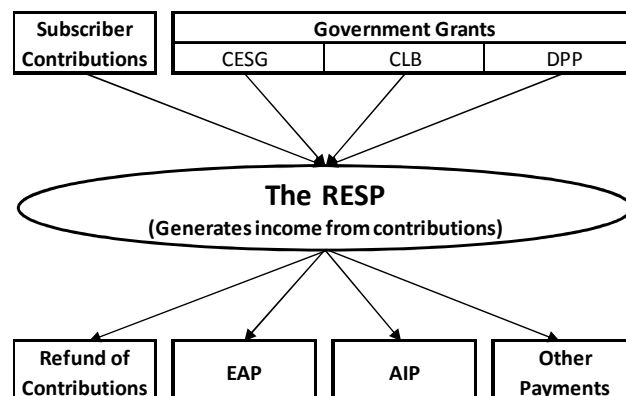
The accumulated income earned in the RESP, along with any government grants received, are withdrawn from the plan in the form of EAPs, and are taxed in the hands of the beneficiaries. The subscriber's (capital) contributions are not taxable to the beneficiaries. Since students normally have lower income, they would pay little or no income tax when funds are withdrawn from the RESP for their education. The subscriber may receive the original contributions on a tax-free basis and, under special circumstances, amounts earned from the RESP (in the form of 'Accumulated Income Payments', or AIPs).

Government grants include the Canada Education Savings Grant (CESG), Canada Learning Bond (CLB), and various designated provincial programs (DPPs), which make payments to the RESP where applicable.

Promoters are normally financial institutions, investment brokers and mutual fund companies. There are a number of different types of plans available with varying terms and conditions, with some being more restrictive than others.

Under current rules, both the subscriber and beneficiary must have a Social Insurance Number to open an RESP, and each beneficiary must be a Canadian resident. It has been proposed that under certain circumstances, the Social Insurance Number will not be required, and the designation of non-resident beneficiaries will be permitted.

The following diagram summarizes how an RESP generally works.



Contribution Limits

The lifetime contribution limit per beneficiary is \$50,000.

Although a child can be a beneficiary of more than one RESP, the lifetime maximum contribution limits will still apply to that beneficiary. Hence, the contribution limits cannot be avoided by establishing more than one RESP, or by having different subscribers establish RESPs for the same beneficiary.

Over-contributions are subject to a monthly penalty tax of 1% until the excess is withdrawn from the RESP. The tax is payable within 90 days after the end of the year in which there is an over-contribution, and applies to any subscribers on a pro rata basis.

Interest paid on money borrowed to make RESP contributions is **not** tax deductible to the subscriber.

Types of RESPs

There are different RESPs, but they can be categorized into two general types: Self-directed, and group.

A **self-directed plan** can be set up as an individual or family plan, and is managed similar to a self-directed Registered Retirement Savings Plan (RRSP). It offers flexibility in terms of timing of contributions and investment options. Since there are no restrictions as to investment choices within a self-directed RESP, foreign stocks, bonds and other securities may be held in the plan.

An **individual** plan is set up for a sole beneficiary, who can be any age, does not have to be related to the subscriber, and can be the subscriber himself or herself. Contributions can be made up to 21 years after the plan is set up. Under certain conditions, an individual plan can be converted to a family plan.

A **family** plan has one or more beneficiaries, provided that the beneficiaries are related by blood or adoption to the subscriber.³ Most family plans are set up by parents for their children; however, parents and grandparents can be joint subscribers to a family RESP. The beneficiary must be under 21 years of age to be added to a family plan, and contributions can only be made until the beneficiary turns 21 years of age.

On the withdrawal of funds, EAPs do not need to be taken in the same proportion as the contributions withdrawn from the plan on behalf of a particular beneficiary. If one beneficiary decides not to pursue post-secondary education, the share of the accumulated earnings can be divided amongst the remaining beneficiaries, provided the contractual provisions of the RESP specifically allow for this division.

Group plans are more restrictive in terms of the timing of contributions and nature of investments. Such plans may have thousands of unrelated beneficiaries, and the subscriber does not need to be related to any one of them. The subscriber makes deposits for a stated period of time as per the savings program selected.

Group plans are often sold by non-profit scholarship companies, and can only invest in fixed income securities. The investments are selected by the plan administrator and are generally conservative, such as government bonds, treasury bills and guaranteed income certificates. The administrator determines the amount paid to beneficiaries and the timing thereof; the subscriber has no control over the RESP.

The terms of a group plan should be carefully considered. To benefit under a group plan, the beneficiary has until the age of 26 to attend a post-secondary institution. It is important to determine what recourse is available, if any, in the event the beneficiary does not pursue a post-secondary education.

³ A beneficiary is not related to an aunt, uncle or cousin under the Income Tax Act.

Government Grants

Three sources of government assistance are currently available, serving as a significant incentive to help parents save for their children's post-secondary education.

Under the **Canada Education Savings Grant (CESG)**, each child acquires CESG room commencing in the year of birth until the year in which the child reaches 17. The accumulating grant room per year is 20% of \$2,500 in RESP contributions, or \$500 per annum, for a maximum lifetime grant of \$7,200. The maximum CESG that a beneficiary can receive per year is \$1,000 or 20% of the unused CESG room, whichever is less.

The amount of any unused CESG contribution room can be carried forward and accessed in a subsequent year, subject to the \$1,000 maximum. If there is unused CESG room, a \$5,000 contribution creates a CESG of \$1,000.

Example:

Consider the situation of Carole and her newborn son, Adam. Carole had opened a RESP for her son at birth. Adam's \$500 grant room is established for each year to a maximum of \$7,200. If no contributions are made until four years after birth, CESG of \$2,000 would be available (on contributions of \$10,000 to the RESP). However, the maximum CESG that can be received in a particular year is \$1,000. Therefore, to maximize the CESG, Carole should contribute \$5,000 to the RESP in 2014, another \$5,000 in 2015, and another \$5,000 in 2016 (to account for the additional \$500 in grant room for each of 2015 and 2016). This would result in total CESG of \$3,000.

If instead Carole contributes \$50,000 in the year of birth, Adam would receive CESG of \$500 with no chance to realize further grants in a future year, since the life-time maximum of \$50,000 would have been contributed for him, precluding any further contributions.

Certain families enjoy additional CESG rates. In 2011, the CESG could increase by \$100 to \$600 if the net family income is \$41,544 or less, or by \$50 to \$550 if the net family income is between \$41,544 and \$83,088.⁴

⁴ The CESG rate on the first \$500 of RESP contributions is doubled from 20% to 40% where net family income is \$41,544 or less, and increased to 30% where net family income is between \$41,544 and \$83,088.

The CESG is directly provided by the federal government to be invested in the same plan chosen by the contributor, and paid to students when they enrol in a qualifying post-secondary education or training program. The grant is included in the EAPs when paid out of the RESP, and is taxable to the beneficiary.

The RESP trustee will be required to repay a CESG amount if any of the following events were to occur:

- The plan is terminated;
- The payment of the *RESP* income is made for non-educational purposes;
- A beneficiary under the plan is replaced by another beneficiary who is not related to the contributor by blood or adoption; or
- Where there is a transfer to another RESP involving beneficiary changes or partial fund transfers.

If the RESP is invested in a group plan, the CESG can be reallocated to other RESPs within the group, and the \$7,200 CESG limit paid to any beneficiary under the group plan. In a family plan, the lifetime limit of \$7,200 will apply to each beneficiary. If one beneficiary chooses not to enrol in a post-secondary education program, only siblings may receive their CESG grant.

There are additional restrictions for beneficiaries who are 16 or 17 years of age to be eligible to receive the CESG. In order for a child to be eligible for CESG's on RESP contributions in their 16th and 17th years, at least \$100 per year must have been contributed for the four preceding years, **or** a total of at least \$2,000 must have been contributed by the year in which the child turned 15.

The **Canada Learning Bond (CLB)** is available to children born after December 31, 2003 if the parent receives the National Child Benefit Supplement as part of the Canada Child Tax Benefit. For a qualifying child, the government will contribute \$500 to the RESP. If the parent continues to receive the supplement, an additional \$100 per annum can be received for up to 15 years. A contribution from a subscriber is not necessary to be eligible to receive the CLB in an RESP established for an eligible child. If the beneficiary does not pursue post-secondary education, the CLB must be repaid to the government.

Currently, **designated provincial programs (DPPs)** include the Alberta Centennial Education Savings Plan Grant and the Quebec Education Savings Incentive.

Educational Assistance Payments

Generally, income earned and CESG received in the plan can only be paid to the beneficiaries as EAPs and are taxable to the beneficiaries on receipt. EAPs can be used for tuition, books, lab fees, equipment, accommodation and transportation relating to full-time attendance at most post-secondary educational institutions.

A beneficiary cannot receive EAPs from an RESP if he or she receives any allowance, grants or reimbursements for the program – other than a scholarship, fellowship, bursary or a benefit because of a loan made to the beneficiary under the *Canada Student Loans Act*. In addition, a beneficiary cannot receive EAPs from an RESP if, during a time when the program is taken, the beneficiary receives employment income while on a temporary education-related leave.

The maximum amount of EAPs that a beneficiary can receive depends on the program that he/she enrolls in.

Not all academic programs qualify for the RESP. Specifically, a **'qualifying educational program'** is a post-secondary course of study that lasts at least three weeks in a row, with at least 10 hours of instruction or work each week. A program at a foreign educational institution must last at least 13 consecutive weeks.

Students who study in a qualifying educational program can receive up to \$5,000 for the first 13 consecutive weeks. Thereafter, there is generally no limit on the amount to be received, provided the student continues to qualify to receive them.

Qualifying educational programs include apprenticeships and programs offered by a trade, CEGEP, college or university. They may also be offered by other institutions certified by the Minister of Human Resources and Skills Development.

Those enrolled in a **specified education program** can receive up to \$2,500 for the 13-week period. This route is for part-time and other programs that do not meet the 10 hour-per-week requirement. Under this rule, students must be 16 or over in order to receive the EAPs.

Refund of Contributions

Subscribers can withdraw their capital contributions to an RESP on a tax-free basis at any time, subject to the terms of the particular plan.

Accumulated Income Payments (AIPs)

Under certain conditions, the **subscriber** may also receive AIPs, which are payments of income earned from the RESP. The AIP is available if the subscriber is a Canadian-resident subscriber and payment is made to only one subscriber, and one of the following is true:

- The RESP has been set up for at least 10 years, and each beneficiary has reached 21 years old and is not currently eligible to receive an EAP;
- The RESP has been set up for at least 36 years (or, in certain situations, 41 years); **or**
- All beneficiaries are deceased.

The AIP is taxed to the subscriber at the regular graduated income tax rate plus an additional combined federal-provincial 20% penalty tax (12% for Quebec residents).

Tax planning should be considered to reduce the amount of AIPs subject to tax. Generally, the subscriber may transfer a portion of the AIPs to his or her own RRSP, or a spousal RRSP. The amount that can be contributed to a RRSP is limited to \$50,000 of AIPs received in the year (or in the first 60 days of the following year). Where both parents are joint subscribers to a self-directed plan, the transfer can be made to either parent's RRSP, based on the limits noted above, effectively doubling the limit as long as available RRSP contribution room exists. Once income is withdrawn from an RESP by the contributor, the plan must be terminated by February 28th of the following year.

Income withdrawals in excess of the limit are subject to a combined federal-provincial 20% penalty tax, which serves to prevent abuse where the ultimate intention is not to use the RESP to fund the post-secondary education but rather to defer tax on investment income for several years. In other words, the penalty tax is a proxy of the tax that would have been paid on investment earnings within a RESP.

In addition, the RESP must repay to the government any remaining CESG at the time accumulated earnings are withdrawn for non-educational purposes.

Other Payments

In addition to paying a refund of contributions, EAPs and AIPs, the promoter of the RESP can also make the following payments, where appropriate:

- Pay to a designated educational institution in Canada;
- Repay amounts under the *Canada Educational Savings Act*; or
- Pay to a trust to accommodate the transfer of property between two or more RESPs.

Death of a Subscriber

A common misconception is that an RESP is a trust, and that upon the death of a subscriber, the assets comprising the RESP are held in trust subject to the RESP.

Properly, an RESP is a contract. Upon the death of the subscriber (or the surviving joint subscriber), the RESP becomes an asset of the estate and is subject to the terms of the deceased subscriber's will. If the subscriber provides in the will for the estate to continue the RESP after his or her death, the beneficiary can still receive payments from the RESP while attending post-secondary school. However, depending on the terms of the contract, further steps may be required in order for the succeeding subscriber to acquire full rights.

Also, the subscriber may be able to name another individual as a succeeding subscriber who will assume responsibility for the RESP and has the authority to name new beneficiaries. The RESP may allow for the distribution of accumulated income to any person resident in Canada. However, where income is returned to an individual other than the spouse or former spouse of the deceased contributor, the 20% additional tax will apply on the amounts received.

There are two ways to name a successor subscriber:

- Certain RESPs allow the subscriber to name a succeeding subscriber in the contract; or
- A succeeding subscriber can be named in the subscriber's will, if none have been so named in the RESP contact.

If the subscriber and the spouse are joint subscribers, then the surviving spouse becomes the sole subscriber upon the death of the first-to-die.

Impact of Recent Budget Changes

When RESPs were first introduced in 1974, they received little popularity. Fortunately, legislative changes over the years have made RESPs an attractive method to accumulate funds to pay for higher education.

To provide flexibility to subscribers of separate individual RESPs, the 2011 federal budget proposed to allow, in certain circumstances, the transfer of plan assets between individual RESPs for siblings without triggering CESG repayment. This measure is to create a level playing field relative to family plans, which currently offer additional flexibility by allowing the allocation of plan assets among siblings (subject to certain restrictions).

Other Tax Planning Strategies

In addition to the RESP, there are other tax planning opportunities for parents who wish to save for a higher education for their children.

In-Trust Accounts

One alternative is an in-trust investment account (also known as an 'informal trust') held by a parent *in trust* for a minor child. An in-trust account can be set up by anyone for the child through most financial institutions, mutual fund companies and investment brokers.

From a legal standpoint, there is no such entity as an 'informal trust'; there either exists a formal trust arrangement or there is none. However, where there is *intent* to set up a trust, all the formalities must be respected: separate tax returns must be filed, and separate records must be kept. Where such formalities are not respected, Canada Revenue Agency may find that there is no trust and the funds still belong to the parents, meaning that they will be taxed on all income earned on the funds maintained in an in-trust account.

In-trust accounts are more flexible than RESPs, as funds can be used by the child for any purpose, and not just for education, when they turn 18 years of age. However, the fact that both the initial capital contribution (assuming the contributions were gifts) and income is the child's property once they turn 18 years of age can be a critical drawback of using an in-trust account, since the child is free to use the funds as desired. The contributor to the account cannot withdraw the funds for his or her own use, even while the account is still held in-trust. In contrast, the capital of an RESP can be returned to the contributor if the child does not pursue higher education.

Formal trusts

Another source of funding post-secondary education is through the use of a formal trust. While more costly to set up and maintain, formal trusts exhibit several advantages. For instance, they can be structured in a flexible manner with discretionary characteristics. In addition, parents as trustees can maintain control of the trust capital and income even after the child turns 18 years of age. However, they must consider the "21-year rule" whereby a trust is potentially subject to tax every 21 years on certain of its assets that have increased in value.

RRSP Withdrawals

Under the Lifelong Learning Plan, individuals can borrow funds from their RRSPs on an **interest-free** basis to finance full time post-secondary or vocational education.

These non-taxable withdrawals must be repaid over a ten year period, in equal instalments, beginning after five years. Total withdrawals cannot exceed \$10,000 per year, or \$20,000 in total over a four year period.

Qualifying post-secondary programs are similar to those required for RESP purposes: the program must be at least three months in duration, and the student must spend at least ten hours a week on courses. Certain programs in foreign educational institutions will still qualify.

Failure to make repayments to the RRSP results in an income inclusion in the year the repayment is missed. An RRSP deduction will not be available if contributions are made less than 90 days before a withdrawal is made from the RRSP to finance higher education. In addition, the RRSP Lifelong Learning Plan rules are similar to those applicable to the RRSP Home Buyer's Plan rules in the event of death, emigration, or failure of repayment.

Student Loans

Canada and most provinces have programs to underwrite certain student loans such that the government pays interest on the loan while a student is enrolled in post-secondary school, and payments are deferred until the completion of studies. For six months after graduation, interest continues to accrue but payments are not required. In cases of financial hardship, this six-month period may be extended. For graduates still facing financial hardship five years after the completion of studies, further relief may be available in the form of debt reduction.

Other Tax Incentives for Students

Individuals repaying student loans are entitled to claim a tax credit on the interest portion of the amount paid. The tax credit is calculated at the lowest federal marginal tax rate (i.e. 15% in 2011), plus the provincial component (e.g. 5.05% for Ontario in 2011).

Tuition, education and textbook credits are available to full-time and part-time students. Any unused credits in any year may be carried forward by the student or transferred to a supporting individual, within certain limits.

When child care expenses have been paid for periods during which one parent is enrolled in an educational program, qualifying child care expenses would be able to be claimed either by a single parent student, or in the case of two parents, by the higher income earning parent. This is available to both full-time and part-time students.

For 2006 and later years, the full amount of certain scholarships, fellowships, or bursaries are no longer taxable and are no longer reported as income on the student's tax return. This exemption applies to scholarships, fellowships and bursaries received by the student with respect to their enrolment in a program that entitles them to claim the education amount. In the case that the student is not eligible for the education amount, report as income only the amount that is more than \$500.

Conclusion

Children today need a significant amount of funds to complete post-secondary education. The funding of education is becoming more of a private matter as direct government funding continues to be tightened. In response to the rising concerns with respect to the prohibitive costs of higher education, the federal government has responded with new and enhanced incentives. For Canadians beginning to save for their children's education, RESPs rules have become more flexible. However, it is recommended that tax advice be consulted as many other factors will have an impact.

Terms of Reference

AIP	Accumulated Income Payment
CESG	Canada Education Savings Grant
CLB	Canada Learning Bond
DPP	Designated Provincial Program
EAP	Educational Assistance Payment
RESP	Registered Education Savings Plan
RRSP	Registered Retirement Savings Plan

The above discussion is strictly of a summary nature and is based on the current *Income Tax Act (Canada)* and proposals to change it, and our understanding of the current administrative policies of the Canada Revenue Agency. No other changes to the Act in this area are anticipated, and our comments could change if the Act, or draft legislation to implement the proposals, were to be changed.

A memorandum of this nature cannot be all encompassing and is not intended to replace professional advice. Its purpose is to highlight tax planning possibilities and identify areas of possible concern. The content of this TaxTalk is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

Anyone wishing to discuss the contents or to make any comments or suggestions about this TaxTalk is invited to contact one of our offices.

Offices: 10 Bay Street, Suite 600
(Bay Street and Queens Quay)
Toronto, Ontario, M5J 2R8

Phone: (416) 362-0515
Fax: (416) 362-0539

8501 Mississauga Road, Suite 100
(North of Steeles Avenue)
Brampton, Ontario, L6Y 5G8

Phone: (905) 451-4788
Fax: (905) 451-3299

TaxTalk is prepared by our Tax Group (taxtalk@mgca.com)

Please visit our website at www.mgca.com

McCarney Greenwood LLP is an independent member of Morison International.