MoneySense

4 things to get right when tapping RESP savings

Invest wisely, minimize clawbacks

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When your kids are on the cusp of starting university and you're eyeing a hefty tuition bill, you are no doubt thankful for a sizeable balance in your Registered Education Savings Plan (RESP). Sure, it's a sweet program—but now you have to master the complexities of taking the money out.

Here are four key things you should do with your kids' RESP when they approach university or college age: Stop contributions when it makes sense; adjust your asset allocation; structure withdrawals to minimize tax; and deplete your RESP at the right time.

By now you probably know the RESP basics. You can earn up to 20% in "core" grants (termed "Canada Education Savings Grants" or CESGs) on your contributions to a maximum lifetime CESG grant total of $7,200 per child. (There are additional grants for low-income families and in certain provinces.) The grants, contributions and investment income are all tax-sheltered until you take the money out.

If you withdraw the money while your kids (the "beneficiaries") are in post-secondary education, then "grants" and "income" are taxable in your kids' hands, which generally means little or no tax if you do it right. Withdrawal of "contributions" is tax-free.

More onerous rules (including possible grant clawbacks) apply to taking money out after they finish their post-secondary schooling, or if they never attend. So your objective should be to invest wisely while your funds are in the RESP, then minimize potential taxes and clawbacks when you take the money out.

Three buckets

However, the program is complex, so making the most of these rules isn't easy. For starters, you will need to track your RESP balances according to their source as “grants”, or “contributions” or “income” (which is interest, dividends, and capital gains earned from the grants and contributions).

“There are three different buckets and they’re calculated in the background,” explains Dawn Tam, regional financial planning consultant with Royal Bank. But tracking them can be tricky because the balances in each bucket are often not shown on your statements.

To get these numbers, you may have to keep asking your advisor or financial institution at key points. Armed with the right information, here are four key things you should do:

1. Maximize grants without over-contributing

One thing you need to figure out is when to stop making contributions. The contribution limit is $50,000 per kid and the penalties are 1% of the excess per month if you exceed that amount, so that’s a “hard stop.” Be sure to track it, or have a reliable advisor do it for you.

However, in practice, you should generally only contribute enough to maximize the grant money. Total contributions of $36,000 per kid will earn you the maximum $7,200 CESG grant if you structure the contributions in the optimal manner. The rules for realizing the full CESG grant rate of 20% are complicated, but generally you have to contribute a bit at a time rather than in big lumps.

You can max out the CESG grants if you contribute $2,500 a year for 14.4 years by the year the kid turns 17, although there are also limited provisions to catch up with larger contributions if you fall behind.

For most people there isn’t much point in contributing more money than is necessary to max out the grants. Without the sweetener of RESP grants, you’re generally better off doing something else with the money if you have any debts, or unused TFSA or RRSP contribution room. You’re always better off contributing to a TFSA than making grant-less RESP contributions because the TFSA is more flexible and withdrawals are never taxable.

RRSP contributions are also generally the better option if you fit the classic RRSP profile of saving for retirement while being in a fairly high bracket now and a lower tax bracket in retirement. On the other hand, if you’re debt-free and have used up better tax-sheltering opportunities, then it might be mildly advantageous to put extra contributions into the RESP (up to the $50,000 limit) for a few years until your kids need it for schooling.

2. Adjust the asset mix as you get close to drawing the funds

You need to find the right balance for your RESP investments between earning an attractive return, but protecting yourself from the risk of losing money just before you need the funds. After all, you don't want your kids' education funding imperilled by the possibility of a big market meltdown just before paying their next tuition bill. But at the same time, you also probably don't want to invest heavily in low-yielding GICs or bonds when your kid is 15 years away from university, given that there would be plenty of time to recover from a market setback.

While you will need to find the right mix that suits you, experts generally recommend that you should invest more in equities than fixed income in the early years of an RESP, then gradually up the fixed income and cash proportion as your kids get closer to using the funds.

3. Get the money out tax-effectively

When your kids start needing the money, you should structure the withdrawals to minimize taxes. While your kids are in school, withdrawals from the "grants" and "income" part of your funds are lumped together and called "Educational Assistance Payments" (EAPs), which are taxable in the hands of the beneficiaries. Meanwhile, withdrawals of "contributions" are not taxable. If you do this properly, "typically the amount of tax the child is paying is minimal or none," says Tam.

Start drawing EAPs early to help ensure they get used, but also try to spread them out over enough years so that they are offset by tax credits and little or no tax is paid. "We want to take EAPs fast, but taking them too fast could have a tax impact," says Tam. Each year you can top up the remainder of your kids' funding needs with withdrawals from contributions, which have no tax consequences.

When you make a withdrawal, you need to tell your advisor or financial institution how much of it comes from EAP and how much comes from "contributions" (which is also called "capital"). (The allocation of the EAP withdrawal to "grants" and "income" is proportional to the current balances in each category.

You can only withdraw $5,000 in EAP money in the first 13 weeks of post-secondary schooling, but generally there is little restriction after that while your kid is in school.

You need to show proof of enrolment but no receipts, although you could possibly be asked to demonstrate that very large EAP withdrawals over $20,000 in a year are being used broadly to further your kids' education.

Here’s how to figure out roughly how much EAP money you can withdraw each year without federal and provincial income tax, using 2017 figures. Start with the basic personal tax credit that everyone gets ($11,635 for federal taxes). Then add a tax credit for tuition paid (we’ll assume $9,000 for a full-year at school). Then subtract income (we’ll assume $7,000 from a summer job), offset partly by job-related tax credits for EI, CPP, and employment ($1,465 federally in this example).

In this case you should be able to withdraw roughly $15,100 in EAP money in 2017 without your kid having to pay any significant amount of income tax ($11,635+$9,000-$7,000+$1,465). (If your kid’s gross income is relatively low, you can also transfer up to $5,000 of unused federal tuition credit to a parent.) In this example you would pay no federal tax but would pay a small amount of provincial tax in some provinces because of differences in provincial tax practices.

If you take out a few thousand dollars in EAP above that threshold, expect that your kid would pay income tax on the excess in the lowest income tax bracket (about 20% in Ontario and B.C., as examples). To do your own calculations, I recommend the income tax calculator at taxtips.ca.

4. Deplete the RESPs near the end of university

RESPs are designed to provide funding only while your kids are in school, which probably fits your needs anyway. However, if the RESP continues on after they leave post-secondary education (or they never attend), then special onerous rules apply to withdrawals. Therefore you should generally use up all the funds while your kids are still in school.

The priority should be first to use up all “grant” and “income” money accumulated to that point, since those withdrawals are treated more harshly if left until after your kids’ schooling is finished. There is also the possibility of transferring RESP money to a sibling or other close relative.

Here’s how the withdrawal rules work if your kid is not in post-secondary education (although there is a six-month grace period after the end of schooling). Under these rules, “grants” are taken back by the government. “Contribution” money can still be withdrawn without paying tax (but contribution withdrawals generally trigger a proportionate clawback in grant money).

There are two main options for taking out “income” (now termed “accumulated income payments” or AIPs): if you as contributor withdraw the funds, then the AIP withdrawal is taxed in your hands at your tax rates plus an additional 20% penalty; alternatively, you can roll up to $50,000 in AIP money over into an RRSP if you have unused RRSP contribution room. Note that other complicated rules apply to AIP withdrawals including that the RESP must be completely collapsed within a short period.