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The right way to withdraw RESP funds

By JOHN HEINZL

This move can save you tax and reduce RESP headaches

My daughter's Registered Education Savings Plan[1] has more funds than needed for her education. Do attribution rules apply to withdrawals beyond what is needed to fund education? Does the RESP need to be collapsed after finishing school or can the fund continue to grow tax free for many years until I withdraw the money? My daughter is 15 and I would like her to be able to use the excess funds to buy a home at some point after she finishes school.

Before we answer these questions, some quick background.

RESPs are a great way to save for your child's education. Not only does the money grow tax free, but the federal government kicks in the Canada Education Savings Grant[2] (CESG) worth up to $500 per beneficiary each year (slightly more for families with incomes below certain thresholds), to a lifetime CESG limit of $7,200. There's also the Canada Learning Bond[3] for low-income families, and grants from certain provinces. With tuition costs soaring, this free money comes in handy.

The downside of RESPs is that they're complicated – particularly when it comes to tapping into all the cash that's accumulated. There are myriad rules, and RESPs have invented a language all their own to explain the various types of withdrawals, including Educational Assistance Payments[4], Refund of Contributions[5] and Accumulated Income Payments[6].

If you have an RESP, I strongly recommend that you take some time to familiarize yourself with how these plans work. There's lots of information on the Internet. Another helpful resource is *The RESP Book: The Simple Guide to Registered Education Savings Plans for Canadians*[7], by Mike Holman.

I asked Mr. Holman to weigh in on the reader's question.

"The best time to take money out of an RESP is when the child is going to school," he told me. "Make sure you empty the account while the child is still a student."

You'll need to provide proof of enrolment to your financial institution, but if you withdraw more than your child needs for tuition, textbooks, housing and other expenses, there is no penalty, he said. The federal government's CanLearn.ca[8]website indicates that the financial institution "may ask for receipts for school purchases to prove the money is being spent on allowable educational expenses," but Mr. Holman said he's never heard of an institution asking for such receipts.

"It's not even practical anyway. If I want to give my son $400 per month for food, does he have to provide receipts for every pizza he orders? Of course not," he said.

"This person should take any extra money not needed for school and save it in a separate account, preferably a tax-free savings account – either the parent's or the student's – if they have the contribution room."

Understanding the various types of RESP withdrawals is important. An Educational Assistance Payment (EAP) is deemed to come from the government grants, interest, dividends and capital gains in the plan, but not from the original contributions. EAPs are taxable in the student's hands, but since most people attending school have low incomes – and are entitled to various tax credits –

there may be little or no tax to pay. For full-time students, there is a $5,000 limit on EAP withdrawals for the first 13 weeks of schooling, but no limits thereafter – as long as the student remains enrolled.

A Return of Contributions (ROC) is just that – a withdrawal of money originally put into the plan. These withdrawals are not taxable and there are no limits on the amount. When you make an RESP withdrawal, you designate what portion is an EAP and what portion is a ROC. For the EAP portion, the government uses a formula to determine how much consists of grants and how much is from the plan's earnings.

Mr. Holman says it's generally a good idea to make EAP withdrawals first (this is also the default for most financial institutions). That's because, if the child finishes school or drops out and there is still grant money and accumulated income in the plan, the grants will ultimately have to be repaid and the withdrawal of the remaining income – in the form of an Accumulated Income Payment (AIP) – will be taxable to the subscriber. What's more, there is an additional 20-per-cent penalty tax. You can defer the income tax – and avoid the penalty tax – by rolling up to $50,000 of the AIP into an RRSP if sufficient contribution room is available.

By depleting the RESP while the child is still in school, you'll avoid those headaches. You can even make an EAP withdrawal for up to six months after the child has stopped going to school, so there's no reason to leave money sitting in the plan, he said.

References

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