

## CRUNCHING THE NUMBERS BY TALBOT STEVENS

# Why RESPs are at head of education financing class

*In almost every case, registered education savings plans are the best way to provide for post-secondary schooling*

**A**FTER SAVING FOR RETIREMENT, saving for an education is one of the most common financial goals. Crunching the numbers shows that, with the introduction of the Canada education savings grant in 1998, registered education savings plans are the best way to save for post-secondary education — if the beneficiary goes to school. If the child doesn't pursue post-secondary education, or perhaps drops out after a term or two, alternative strategies can be better.

RESPs were significantly enhanced by the CESG, which amounts to 20% of the first \$2,000 in yearly contributions, to a maximum of \$7,200 per beneficiary.

The obvious risk of RESPs is when the beneficiary skips post-secondary education. In this case, the CESG must be repaid. Further, up to \$50,000 of the RESP's growth can be transferred to an RRSP, if there is sufficient contribution room available. Otherwise, the growth is taxed as income and faces an additional

20% penalty tax. Contributions to an RESP are always withdrawn tax-free, because taxed dollars are invested. These options are still much better than before 1998, when all RESP growth was lost when the child didn't go on to school.

Here's a look at some other strategies:

■ **IN TRUST FOR ACCOUNTS:** Before 1998, "in trust for" accounts were a popular alternative and many advisors still believe they are better than RESPs. With this strategy, equity investors can take advantage of the fact that parents investing ITF a child results in the capital gains being taxable to the child and not attributed back to the parent. Interest and dividends earned by minors are taxable back to the source of the funds.

Although the ITF strategy doesn't offer the benefit or appeal of a 20% gift from the government, there are no restrictions on how the child uses the money. The funds can be used for any purpose, including school, starting a business or

buying a home. Because equity funds often have little or no interest or dividends to be taxed back in the parents' hands, the ITF approach can be almost as tax-efficient as RESPs.

With a basic tax exemption of about \$7,750, \$3,200 in education amount and, say, \$3,900 of annual tuition fees, a full-time student can earn about \$14,850 a year tax-free. Accounting for the fact that only 50% of the capital gain beyond the amount invested (the adjusted cost base) is taxable, a student with no income could withdraw more than \$30,000 of capital gains without paying any taxes.

This can even be improved by using an "optimized" ITF approach, in which the equities are sold and then repurchased to trigger tax-free capital gains because of the child's basic tax exemption. This increases the adjusted cost base, which reduces the amount taxable in the future.

■ **LEVERAGING:** This is another option for equity investors. In a 35% tax bracket, parents could invest \$2,000 a year after-tax to

rent about \$38,500 at 8% interest. Unlike RESPs, for which all the benefits go to the student, leverage benefits parents or grandparents with a modest tax deduction. As with either the regular or optimized ITF strategies, there are no negative consequences if the child does not pursue a higher education. In fact, because the investment will be in the parents' or grandparents' names, the funds don't even have to go to the child.

■ **CHILD TAX BENEFIT:** The child tax benefit, which has substantially increased since replacing the old baby bonus, technically is the child's money and thus can be invested in the child's name for any purpose, including an education. Although it is subject to a clawback, the CTB is received by most families and paid until children reach 14. In the child's name, the CTB can be invested in equities or conservative fixed-income investments and grow tax-free to be worth tens of thousands of dollars per child by age 18.

■ **WORK:** The education financing strategy that I think is best for

## Education investment strategies: How RESPs stand up to the alternatives

If child stays in school vs if child doesn't stay in school<sup>1</sup>

Child goes to school strategy	Four-year annual after-tax income		Note
	3% returns for 5 years	9% returns for 15 years	
RESP - \$2,000 student income	\$3,430	\$21,440	0.5%-14% more than with high student income
RESP - \$14,000 student income	\$3,410	\$18,790	Reference
Equities in trust for - \$14,000 student income	\$2,860	\$17,460	7%-17% less than RESPs
Optimized in trust for - \$14,000 student income	\$2,860	\$18,080	4%-17% less than RESPs
Interest, parent's name, 35% tax	\$2,730	\$13,240	20%-30% less than RESPs
Leveraged equities, 8% interest	\$1,300	\$24,510	62% less or 30% more than RESP
Child doesn't go to school strategy	After-tax cashout value, 5 years later <sup>2</sup>		Note
	3% returns for 5 years	9% returns for 15 years	
RESP - 35% tax, 20% penalty tax	\$11,450	\$66,980	Reference
Equities in trust for - \$14,000 student income	\$12,650	\$92,600	10%-38% more than RESPs
Optimized in trust for - \$14,000 student income	\$12,680	\$95,860	11%-43% more than RESPs
Interest, parent's name, 35% tax	\$11,670	\$64,730	2% more to 3% less than RESPs
Leveraged equities, 8% interest, 35% tax	\$5,700	\$119,950	50% less to 79% more than RESP

1. ASSUMES \$2,000/YEAR INVESTMENT AND TOTAL STUDENT BASIC TAX EXEMPTION OF \$14,850 (\$7,750 BASIC EXEMPTION, \$3,200 EDUCATION AMOUNT, \$3,900 TUITION) WITH INCOME TAXED AT 22.1%

2. CASH OUT FIVE YEARS AFTER FIVE- TO 15-YEAR INVESTMENT PERIOD

SOURCE: TALBOT STEVENS' ATI PROFESSIONAL SOFTWARE

INVESTMENT EXECUTIVE CHART

kids and parents is to pay children for legitimate work so they earn their own way through school.

Although this strategy is not available to all parents, business owners can pay children tax-deductible wages that will be mostly or totally tax-free in the student's hands. Note that this option is available to most financial advisors, who could probably benefit from a part-time assistant in administration, marketing, technology or systems development. In addition, students will be more committed and successful if they work for and pay for most of their education themselves.

Business owners have another option not available to the general public. They can set up an employee scholarship plan. As long as the offer is the same for all employees, which is easy for a small, family-owned business, the business can pay a tax-deductible scholarship directly to employees' children. Because it's not paid to employees, it is not a taxable benefit to the employee. This also takes advantage of up to \$3,000 of scholarship income that can be earned by the student tax-free, independent of other income from working or RESPs. Typically, the scholarship would be contingent on maintaining marks, say 70%, giving the student incentive and reward to stay focused.

**N**ote that financing an education, like retirement, is not about maximizing a before-tax lump sum. The goal is to choose the strategy that produces the most after-tax income in the student's hands over, say, a four-year period.

Realizing that we must evaluate four-year after-tax income values leads to a tougher analysis challenge. If the student earns \$5,000 a year and RESP withdrawals are \$20,000, what is the tax rate? Assuming no tax on withdrawals is another simplistic assumption that can lead to the wrong conclusions.

To analyse accurately investment strategies for after-tax income goals such as retirement or an education, we must calculate actual tax rates for contributions and withdrawals based on income that crosses tax brackets, similar to a T1 tax return. Unfortunately, because of the complexity, most financial software programs do not yet do this.

As student income is a factor in the analysis, I've analysed RESPs for "low" student income of \$2,000 a year and "high" student income of \$14,000, which uses up almost all of the \$14,850 that the student can earn tax-free. Income from \$14,850 to \$32,200 is taxed at 22.1%, and 28% after that.

The amount of funds withdrawn is also a factor. If the investment growth is small enough, either because of a short investment period or lower returns, it is more likely that the savings will be withdrawn tax-free. In these cases, RESPs always net the most student income, because of the 20% grants.

It is when there's a lot of investment growth that must be withdrawn on top of high student income that non-RESP strategies have the best chance against RESPs.

The table above summarizes the analysis of the education financing strategies that are available to all investors. The top section of the table compares the results of the hoped-for case in which the child pursues post-secondary education. The bottom half of the table compares the after-tax cash-out value five years after the modelled five- or 15-year savings period ends. This delayed valuation reflects the reality that children who don't go immediately to school may change their minds, and beneficiaries must be 21 to collapse an RESP anyway. The cash-out of RESPs assumes that there is no RRSP room to transfer the growth, allowing after-tax cash-out values to be compared.

The first column of numbers examines the case in which there is modest investment growth, which results in little or no tax on withdrawals, even if the student has a high income. In this situation, RESPs are always the best strategy if the child goes to school, and aren't too far behind if he or she doesn't.

It is only situations in which a lot of investment growth is withdrawn on top of high student income that alternative strategies come close to producing the same income in the student's hands as RESPs.

If \$2,000 a year is invested for 15 years averaging 9% returns, equities "in trust for" net about 7% less than RESPs with a student income of \$14,000. An optimized ITF nets about 4% less than RESPs. For high-income students, the ability for ITF accounts to net almost the same income benefits as RESPs — while producing a 43% higher cash-out value if the child doesn't go to school — means the ITF strategy can still offer clients a better combination of upside and downside.

In this case, filing tax returns and triggering capital gains when they can be taken tax-free to optimize the ITF is worth the trouble and increases after-tax income by \$620 a year for four years (\$18,080 vs \$17,460).

The only approach that has the potential to net more than RESPs is to be successful at the more aggressive strategy of leveraging. Of course, leveraging equities to average 1% higher returns than the assumed 8% cost of borrowing is not guaranteed and should not be a replacement for RESPs. For more confident investors, leverage should only be considered as a complement to other strategies, despite the potential improvement for 30% more student income and 79% higher cash-out values.

A separate analysis comparing RESPs with investing the CTB in the child's name found that the

CTB produces 6% to 17% less student income than RESPs, but almost a 90% higher cash-out value if the child doesn't go to school.

In designing the most effective plan to meet a client's education goals, the key factors an advisor must consider are the client's confidence that the child will attend school, the amount of investment growth that can be produced based on the time horizon and expected returns, and the student's income.

Also be aware of some of the risks of RESPs. If the child doesn't go to school, there are bigger risks with pooled plans than self-directed plans, and family plans compared with individual plans.

RESPs must be terminated after 25 years. If a family plan was started when the first child was born and the difference in sibling ages is great enough, it is possible that the plan will have to be terminated before the youngest beneficiary has completed school. Additionally, to transfer growth to an RRSP in the event the funds aren't used for school, all beneficiaries must be age 21 or older.

With even moderate age differences, this may not be possible before the 26th year for family plans, thus eliminating the possibility of avoiding paying taxes and a 20% penalty.

Regardless of the situation, diversifying by strategy using RESPs in conjunction with one or more other strategies is probably best. Unless there is little confidence that the child will attend school, the first \$2,000 a year should go into RESPs. Then CTB funds should be invested in the child's name. Equity investors with additional funds can use ITF accounts or leverage if there is a sufficient time horizon. **IE**

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