EP.113 - RESP 101: What Every Empowered Parent Needs to Know

Lawrence: Welcome to The Empowered Investor. My name is Lawrence Greenberg, and I'm joined by my co-host, Jackson Matthews. Jackson. How are you?

Jackson: I'm good. Lawrence. You know, tax season just ended, so we finished high there and we're back to creating content, making podcasts, serving our clients as always, obviously. How about you?

Lawrence: Yeah, it's always a good time when tax season ends and we're into the summer now it's mid-May when we're recording. We're very excited for the summer season. A little bit of travel, some sun. It's all good things. All right, Jackson, so let's dive in. So, what is an RESP? So, the RESP is a registered account that allows people to save for their child's post-secondary education.

And it allows people to make contributions that are growing tax free, but that are not tax deductible. Any person can open the account. It's most often the parents, but it could be grandparents or other family members who want to help save money. For kids' educations, there is a total contribution limit for the lifetime of the account of $50,000 per beneficiary, but there's no annual limit, which is quite good.

So Jackson, why don't we jump in and go over some of the contribution rules for the RESP.

Jackson: Contributions to this account are not tax deductible like an RRSP, for example, but the growth and grants do grow tax sheltered until withdrawals happen, so contributions can be withdrawn tax free at any time.

I'll repeat that. The contributions can be withdrawn, tax free. But however, withdrawing early may require repayment of some grants. Ask your advisor for some details on that before you do so. So, you can contribute for up to 31 years after opening the RESP, but the plan must be closed after 35 years. I think it's worth noting that when you make contributions that earn grants, you can earn grants for a beneficiary up until the end of the calendar year in which they turn 17 years old.

So, for example, if my child turns 17 tomorrow, May 16th, $2,025, I can contribute to this account and earn grants up until the end of this year. However, starting January 1st, next year, they will not be able to earn any grants on any of the contributions made. So just to dive a bit deeper into the grants here, there's a couple kinds of grants that you can earn in this account.

There's the Canada Education Saving Grant, which is the federal grant, and then there's the Quebec Education Savings Incentive, which is the provincial grant. There is a third kind of grant here. It's called the Canada Learning Bond, and this one is income tested, so it's for lower income families to earn a bit of extra grants on any contributions made.

So just to dive deeper with these Canada and Quebec grants, the way it works is if you contribute $2,500 per year to this plan, the federal grant gives you 20% of the first $2,500 contribution. So that's $500 of grant. The Quebec grant gives you 10% of the $2,500 you contributed. So that would be $250 per year.

The maximum amount of federal grant you can earn over the lifetime of this plan per beneficiary is 7,200, and the maximum Quebec grant is 3,600. So, if you do the math and you make contributions every single year of $2,500, it would take you just over 14 years to earn all the grants. So, the 7,200 plus the 3,600 per beneficiary.

Lawrence: That's a lot of money that is available to people in Canada who want to save 7,200 for the federal and 3,600 for the provincial.

That's free money that if you don't use this account, you are leaving it on the table. And if you are able to do the $2,500 per beneficiary per year to maximize these grants, you will max out the contributions in approximately 14 and a half years.

Jackson: Exactly. So, the whole point of this account is to save for post-secondary education. Post-secondary education can be a bit vague, a bit ambiguous. Lawrence, what exactly can you use these funds for?

Lawrence: You can use it on the obvious ones like tuition and enrollment fees and textbooks and so on. But the umbrella is actually very wide on what you can use these funds in when the kids are actually enrolled in post-secondary education.

So you could really spend this money on anything. It could be for a computer or a car to get to school for rent if they want to live downtown or they're out of province, for example. And the truth of the matter is, you do not have to submit these receipts to any governing body. It's really that once these kids are in school and they're enrolled, and you've proven that to the institution, this money could go virtually anywhere.

Jackson: That's a good point. Lawrence, can you explain to me a little bit about the plan's flexibility?

Lawrence: Okay. Yeah. So, there's actually two types of RESP plans that you could open. There's a family plan and there's the individual plan. So, under an individual plan, if you have three children, there's one account per child versus a family plan where you have one account and you have all three beneficiaries in that account.

Which is generally preferred if you have multiple children, there's more flexibility. It's easier to track. For example, the most important thing is if one of the three kids do not go to post-secondary education, you could use the income and growth on the other children. However, you'd have to give back the grants and we'll explain that a bit later.

But generally speaking, this is our recommendation. So now let's go into a little bit about how money comes out of the RESP.

Jackson: Yeah, and this is a pretty important part, right? Because since it's a registered account, the accumulation phase is very important. There's tax deferral. However, the decumulation phase is just as important.

Lawrence: We've talked so far about putting money in the account, the money has to come out, right? So, you got a plan for that. So how the withdrawals work is that there's several buckets in the account that are kind of these sub-accounts. First off is the contribution that you made. So that $2,500 per year you used to maximize that is the PSE, the posts secondary education.

Those could be taken out at any time tax free. So, the money you put in could come out tax free. Secondly are the education assistant payments the EAP, which is a combination of the growth in income and the grants from the government. So those are the two buckets. And the EAP is taxable, but it's not necessarily in the way you think.

What's interesting is that the EAP is taxable in the kid's name. That's really important because if you do the proper planning, you're being taxed very favorably, maybe even not at all. So, Jackson, why don't we go into that a little bit.

Jackson: Obviously, this decumulation phase is very important. You want to have some sort of planning element towards this. For example, when your kids are either in CGEP or in their first year of university, they might have a summer job. They might be earning $5,000 per year. And this $5,000, they're not getting taxed on it because the first $15,000 or so dollars are non-taxed. So, you have a bit of room here to boost their EAP withdrawal since it is taxed in the beneficiary's hands.

If you compare that to, let's say they're in fourth year university and they're working a co-op as part of their program, they might earn $20,000 during their eight-month co-op or however long it may be. So, if they're earning $20,000 that year, but then you also take out $15,000 of EAP, all of a sudden, they have $35,000 of taxable income.

What you want to do is you want to front load the EAP withdrawals so that they are getting the EAP taxed in their hands when they're making a lower income. And I'll repeat it. The EAP consists of the income that is earned, the growth of the plan, plus the grants.

Lawrence: You actually choose where you're taking this money from. You have to work with someone who understands these things. And when you're pulling money out, you're taking from the, from the appropriate bucket. And that's a really important point. And there's often a lot of misuse or errors that are made when we talk about these types of things here.

Jackson: Absolutely. I did just mention front loading the income and grant withdrawals, but it's also worth noting that there is a rule within the first 13 weeks of post-secondary enrollment.

You can only withdraw $8,000 of the EAP. So, the income and the grants after that, after the first 13 weeks, then you can withdraw more, and you can start decumulating that from the plan. So obviously we're talking about the importance of planning this withdrawal. Can you talk to me about a couple common RESP mistakes that people can typically avoid if they plan for it, and we see plenty.

Lawrence: There's a bunch of, I'd say, pitfalls with the RESP. The first off is not contributing enough to get the full grants. Not everyone could save $2,500 per year. Every single year you can catch up, but you could only catch up one year at a time. So if you find yourself behind, you could do $5,000 per year, so $2,500 times two to catch up each year and get the full thousand dollars of grants, so, so two times the $500 per year of CESG.

Jackson: And that would also come with the two times $2500 for the Quebec grant, correct?

Lawrence: Exactly. Perfect. Yeah. So, another pitfall would be not taking out the EAP as efficiently as you can. So, the EAP as a reminder, I know there's a lot of terminology is the income growth and government grants. So, the taxable components, you must take that out proactively once the kids are enrolled.

So you want to be very careful and start de pleading, especially if the kid's income is low or you'll get hit with a tax bill later or even be penalized. And I'll go as far as to say, I've worked with plenty of people who use the RSP the way it should be for tuition and books and so on. However, for example, if the kid goes to school here in Quebec and you live in Montreal and they go to Concordia or McGill, and the tuition's quite low and you've saved a good amount of money.

Our recommendation is to pull money out of the RESP when it makes sense, and maybe even you could top up the kids' investment accounts. You could open up an FHSA or even A-T-F-S-A and put the money there, and if you need it for education later, great for A-T-F-S-A for an FHSA. You could help them save for a home, which is also great.

This is a very important question we get a lot is one of my children does not pursue a post-secondary degree.

Jackson: It's hard to know when you have a one-year-old kid if they're going to be pursuing a master's degree, but it's best to plan for that potential. There are some options if they don't go to post-secondary education of what to do with contributions, investment income grants.

So let's start with the contributions. This is what you've contributed to the account. Your after-tax dollars so they can come out tax free to the subscriber. It's usually the parent, but it might be the grandparent. This money can be withdrawn, tax free. Next up the grants. Unfortunately, if your child does not go to post-secondary education, you lose out on the grants, which means that you have to return them to the government, so you lose the federal grant and you lose the provincial grant.

The third bucket would be the investment growth, the accumulated income from the returns of the portfolio. You have a couple of options here. The first option would be you can roll it over to an RRSP, the parent's RRSP. They must have room to be able to do this option, and if they do, you can roll over up to $50,000 into the RRSP.

For this option, the RESP has to have been open for at least 10 years, and the beneficiary must be over 21 years and did not pursue post-secondary education. So, if these all align with your reality, then you'd be able to transfer up to $50,000 to your RSP. And like I said, you have to have contribution room available.

Lawrence: There are options if the kid does not go to post-secondary education. And I will add post-secondary is anything after high school, so it could be. A trade school. It could be CGEP, it could be university, an undergrad or a masters. It's actually quite broad in what does apply.

Jackson: Yeah. Just to close out that point there, if you don't have the option of rolling it over to an RSP, you might ask what happens to the income?

So basically it gets withdrawn from the account and there's a penalty to pay on the accumulated income. What that penalty is, it becomes taxable in your hand, the subscriber, and it's subject to an additional 20% penalty tax on top of your marginal tax rate. It's 12% in Quebec and 8% in federal. So, you add those together, you get a 20% penalty.

If you are in a high tax bracket, you will end up paying very high taxes on this income that you do not use for post-secondary education. So that makes the RSP rollover super attractive. You don't want to get hit with that penalty. While we're talking about the decumulation, let's just take a step back.

Go back to the accumulation phase, Lawrence. What would be a good strategy to, if you have the extra capital to front load the account and take advantage of time and compounding.

Lawrence: That's a really important one. So, the plain manila plan here is when the kids are born, or as early as you could do to open the account and do $2,500 per year per child.

However, that only gets you up to $36,000 of total contributions. Now there's $14,000 left on the table. The best way to optimize this account, of course, if you have extra capital, is to do $14,000 in year one plus the $2,500 for that year where you basically max out the grants. When the kids are 14 to 15 plus, you have that $14,000 working for you in a tax preferred manner for those 14 years.

You're not topping it up at the end. You're topping up at the beginning and you're benefiting from compounding from tax deferred growth. From what we've seen, the best way to optimize this account, obviously not everyone could do so, but if you can, it's an excellent way to shelter some money and to maximize the benefits of this type of account.

Jackson: That's a hundred percent true, and that's because the maximum contribution room is $50,000. Right? And after 14 and a half years of maxing the $2,500 you get only to $36,000. Like Lawrence said, you have that $14,000 gap at the end, which you could take advantage of right at the beginning.

Lawrence: So, we didn't touch on one important concept here is how do you invest in an RESP?

We want to make sure we talk about a little bit of asset allocations. An RESP is like any other registered account. It is a bucket that you could open to invest in any type of investment. So, you could hold cash in it. GICs stocks and bonds, ETFs, mutual funds, all that. Generally speaking, with an RESP, it's somewhat unique that you know the time horizon.

For this type of account, you open it up in the first couple years of life, or if you're really on it, it's year one. When the kid's born, you know that when they are in their late teens, most likely you'll be needing some of this capital. So, you have an 18-year runway where funds start coming out. But if you have three kids and they're staggered a couple years apart, you may have a 10-year period of withdrawing from the time the first kid starts taking their tuition out versus the last child.

So there's actually a fair amount of time that these funds are being invested. So generally speaking, the first phase where you're nowhere close to the withdrawals, you'll want to likely hold a riskier portfolio. Now this is risk tolerance dependent and based on your goals and your comfort levels, but you want to make sure you have enough growth in there.

Whatever that means is somewhat personal, but you want to take a little bit more risk. And generally speaking, as you approach the years where the money will start coming out, you start tapering down the risk and having a more of a balanced account to prepare for the cash coming out. You don't want to take too much risk and have too much volatility and bumps in the road if you'll be needing a fair amount of capital every year for tuition.

Jackson: That's a great point, Lawrence. So just to ask a question here, would that mean if year one you start investing, would you be, like you said, personally dependent on everyone's risk tolerance, but you might invest in, let's say an 80/20 portfolio. Sure. And then two years away from the first withdrawal, you might invest in a 60/40 or a 50/50, but that's the concept, right?

Lawrence: Yeah, exactly. You want to take more risk earlier on when you have more horizon and then taper down that risk to a more balanced portfolio. Like Jackson said, there's no perfect formula here, but we want to make sure we touch on certain ways to think about this account because it is somewhat unique.

So let's wrap up. It's important to talk about some kind of tips and tricks. In order to maximize the RESP. So, Jackson, why don't you go first?

Jackson: My takeaways are pretty simple. Start early because when you have your first child, that's when you could open the account. And if they're going to do a post-secondary education, that might be in 17 or 18 years.

So you got 17 or 18 years of compounding on your side. That's my first takeaway. My second takeaway is why not invest in this account? It's free money from the government and it's a guaranteed 20% return from the federal grant and a guaranteed 10% return on the Quebec grant. We can't guarantee that in the investment market

How about you, Lawrence?

Lawrence: I'd say for me, my biggest tip would be to be proactive with your withdrawals when the kids are enrolled. Take out potentially more than you need, maybe open up A-T-F-S-A in the kid's name or yours if you have room. And it gives you a little more flexibility. You don't want to find yourself in a position where you have a lot of income and grants left and that door closes and the children are no longer eligible and they're not enrolled anymore, and you're stuck with a large amount of grants and income.

So you want to be proactive and plan when this account is in that zone.

Jackson: That's a good point as well. And I think I have one more thing to say about this account and it's, it's not a simple account. There are a lot of complexities to this account, and we know that we manage them. So, if you're found with questions and you don't necessarily know what you're doing within the RESP, reach out to your advisor because it's definitely worth planning for.

It is your kids' education savings.

Lawrence: So that would be my last point. All right. Thanks Jackson. This is a great episode. I think people could really benefit from this information. Thanks for listening. Yep. Till next time,