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GETTING THE MOST FROM YOUR EDUCATION SAVINGS PLAN

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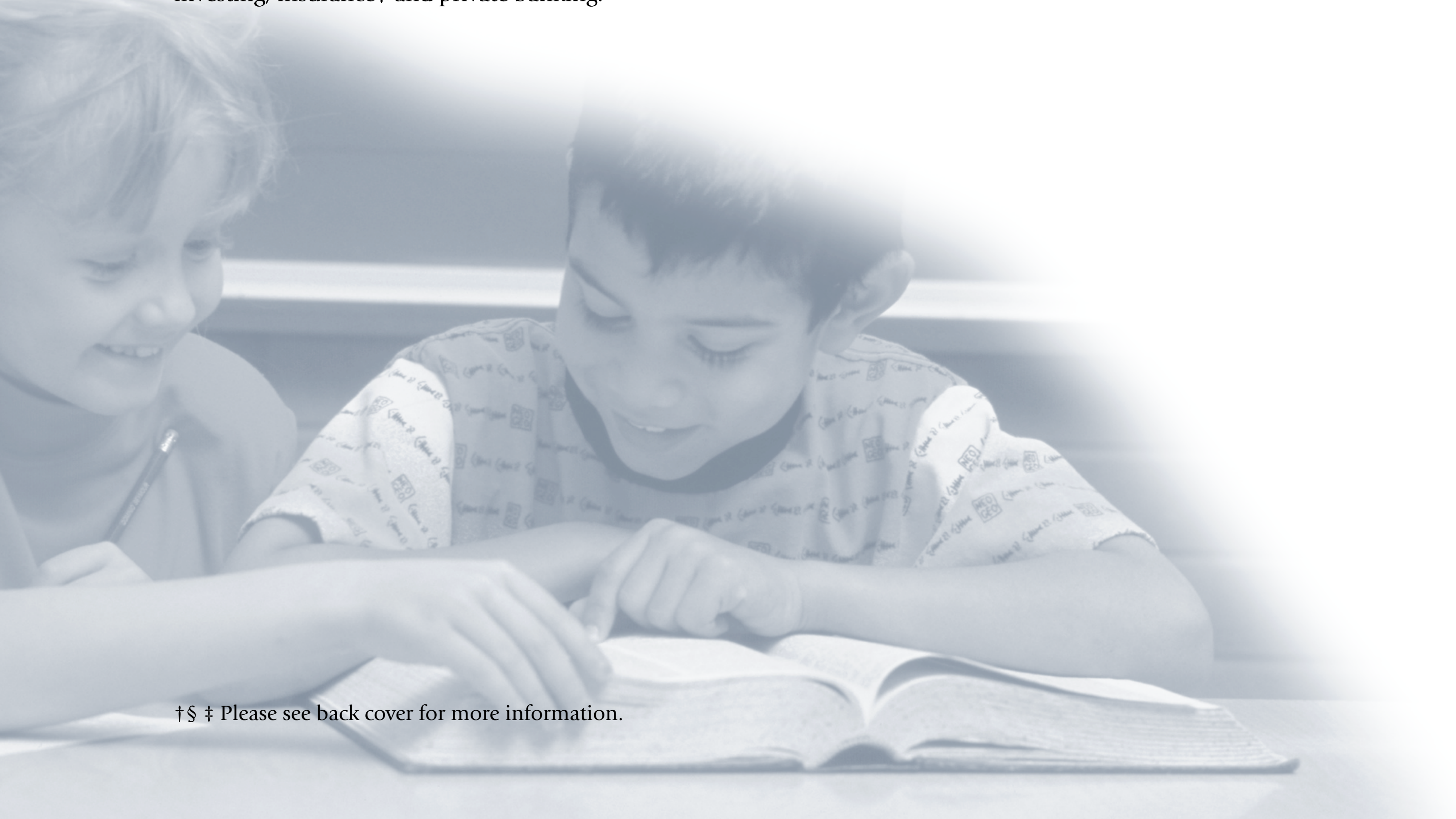

†§ ‡ Please see back cover for more information.

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INTRODUCTION

Should you open a Registered Education Savings Plan (RESP) to save for your child's post-secondary education?

Are there circumstances where an In-Trust account would be more beneficial?

These are the two most common questions that most parents and grandparents face when saving for a child's future education. The purpose of this publication is to assist you in answering these questions through an explanation of the advantages and disadvantages of RESPs and In-Trust accounts.

SAVING FOR YOUR CHILD'S EDUCATION

Registered Education Savings Plans (RESPs) and In-Trust accounts are widely considered to be the two most efficient ways to save for a child's post-secondary education. With the introduction of the Canada Education Savings Grant in the 1998 Federal Budget, it appears that the scales have tipped in favour of RESPs as the pre-eminent education savings option. Or has it? Deciding which savings option is right for you may not be as simple as it appears and can only be determined once you have considered the benefits and costs of both options.

WHAT IS AN RESP? HOW IS IT DIFFERENT FROM AN IN-TRUST ACCOUNT?

A Registered Education Savings Plan (RESP) is a tax-deferred savings vehicle designed to provide an effective means of accumulating savings for post-secondary education. The income earned within the RESP accumulates tax-free until withdrawn to fund education expenses. A subscriber contributes to the plan, and the beneficiary, who for a family RESP must be connected to the subscriber by blood relationship or adoption, receives the benefit of the plan. There are no relation limitations between subscribers and beneficiaries for RESPs set up as individual plans. However, RBC Dominion Securities Inc. and RBC Royal Bank only offer family RESPs and not individual RESPs. Typically, the subscriber is a parent or grandparent wishing to save for their child's or grandchild's post-secondary education.

Annual contributions are limited to $4,000 per beneficiary and total lifetime contributions cannot exceed $42,000 per beneficiary. The plan can be open for a maximum of 25 years, and contributions can only be made during the first 21 years of the plan. As well, for family RESPs, contributions can only be made for beneficiaries who have not attained the age of 21.

In addition to benefiting from tax-deferred growth, RESPs have the added feature that they can benefit from the Canada Education Savings Grant (CESG). This government grant supplements annual contributions by 20% of the first $2,000 (maximum of $400 per beneficiary) that the subscriber contributes annually for a beneficiary up to and including the year that the beneficiary turns age 17. Beneficiaries turning age 16 or 17 in a year have to meet special criteria before being eligible to receive the CESG. If the beneficiary decides to not pursue post-secondary education, the RESP must forfeit the accumulated CESG. The original RESP contributions are returned to the subscriber tax-free and, if certain criteria are met, the accumulated income within the RESP may be paid to the subscriber. This income will be taxed at the subscriber's marginal tax rate plus a 20% surtax and the government grant must be repaid in full. In Quebec, the additional 20% surtax is allocated between the federal and Quebec tax authorities. The taxation of this income can be reduced if the subscriber has available RSP contribution room (up to a $50,000 limit).

By contrast, In-Trust accounts are not registered accounts and therefore, do not benefit from tax-deferred savings. In addition, In-Trust accounts do not receive the Canada Education Savings Grant. In-Trust accounts facilitate income splitting between a parent/grandparent and a child/grandchild. Income splitting is the process of shifting income from a taxpayer in a high tax bracket to a taxpayer in a low tax bracket, thereby increasing the family's after-tax income.

There are three parties involved in an In-Trust account, the settlor, the beneficiary, and the trustee. The settlor is the individual who wishes to split their income and/or who wants to save for their child's benefit. The beneficiary receives the benefit of the settlor's gift and the trustee manages the assets.

The income earned from the account's assets is subject to the Income Attribution Rules under the Canadian Income Tax Act. Under the attribution rules, capital gains may be taxed in the hands of the minor child (the beneficiary), whereas interest and dividend income are taxed in the hands of the settlor. Hence, if the assets were invested in instruments generating capital gains, such as equities or equity mutual funds, then the gains could be taxed at the beneficiary's lower rate (assuming that the beneficiary has a lower marginal tax rate).

Figure 1 provides a summary of the key differences between RESPs and In-Trust accounts:

FIGURE 1

RESP	In-Trust account
Contributions belong to the subscriber of the plan (parent/grandparent)	Assets belong to the beneficiary of the account (child/grandchild)
RBC Dominion Securities Inc. and RBC Royal Bank offer only family RESPs	Only one beneficiary per In-Trust account
Eligible for the Canada Education Savings Grant (CESG)	Not eligible for government grant
Potential tax penalty if child does not pursue post-secondary education	No tax penalty if child does not pursue post-secondary education
Maximum annual contribution of $4,000 per beneficiary Maximum lifetime contribution of $42,000 per beneficiary Family RESPs are also limited in that contributions for a beneficiary can only be made prior to the beneficiary turning age 21	No contribution limits No age limits
Maximum plan contribution period = 21 years Maximum period plan can be open = 25 years	Maximum contribution period = no time limits Maximum period account can be open = no time limits
Investment income is tax deferred until withdrawals are made	Investment income is taxable on an annual basis as income is realized
No creditor protection	Potential creditor protection to the settlor
Income from RESP may be taxed in the hands of the beneficiary if the beneficiary pursues post-secondary education, otherwise the accumulated income is taxable in the subscriber's hands	Interest and dividend income may be taxed in the settlor's hands for a beneficiary under 18 years of age due to the attribution rules. Capital gains are potentially taxable in the beneficiary's hands

COMPARING AN RESP TO AN IN-TRUST ACCOUNT

The most important consideration in deciding whether to use an RESP or an In-Trust account is the likelihood that the beneficiary (child or grandchild) will pursue post-secondary education. While this consideration may seem obvious, it is a fundamental question that will drive your decision. The reason that RESPs and In-Trust accounts exhibit different saving capabilities is that they have different tax implications, and also RESPs can benefit from the Canada Education Savings Grant (CESG).

In developing a model to determine the appropriate circumstances for choosing an RESP or an In-Trust account, several assumptions were made. First, the subscriber of the RESP and the settlor (giftor) of the In-Trust account each contributed $2,000 annually to each plan. The $2,000 contribution to the RESP is assumed to receive the maximum CESG grant of $400. Thus, the RESP gains $2,400 in principal annually, whereas the In-Trust account's principal increases at a rate of $2,000 per year. The contributions were made for up to a maximum of 21 years, thereby limiting the principal of the account to $42,000, the maximum lifetime contribution for a RESP. For a family RESP, this assumes that the contributions start shortly after the beneficiary is born in order to remain eligible to make contributions for 21 years. The maximum CESG is $7,200, which is in addition to the $42,000.

Second, it was assumed that all growth was earned in the form of capital gains, so that there would be no income attribution issues to consider with the In-Trust account. The growth was tax-deferred in the RESP because of its registered nature, whereas tax was payable by the beneficiary (child) in the In-Trust account on an annual basis (if annual income exceeded the child's basic personal exemption).

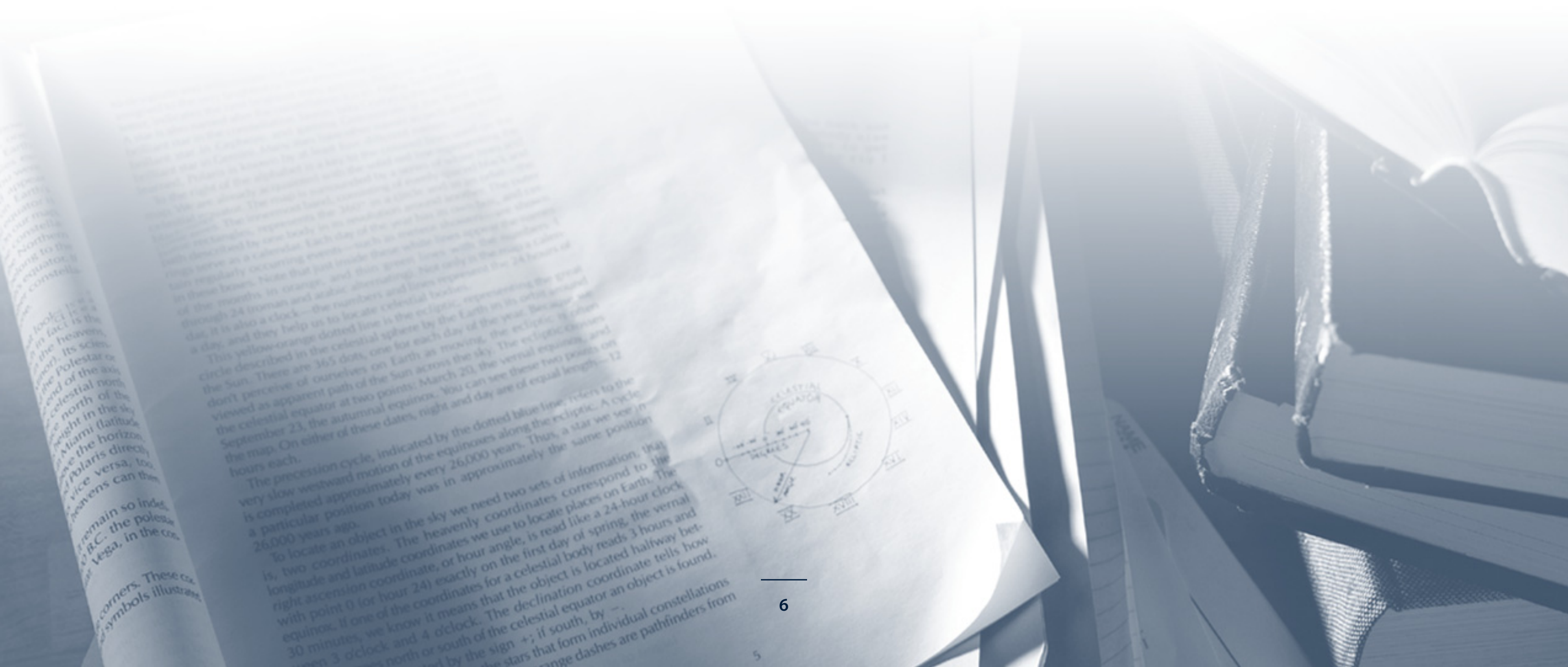
It was assumed that the accounts were open until the beneficiary reached the age of 22, an age when the beneficiary would have completed four years of post-secondary education. Under the circumstance that the child decided to pursue post-secondary education, $10,000 was withdrawn each year between the ages of 18 and 21, to pay for the cost of tuition, board and other expenses. As the cost of post-education rises annually, this withdrawal was indexed at 5% annually, meaning, for example, that the cost of education for a beneficiary who is five years old today would be significantly higher than the cost of education for an older beneficiary who is 15 years old today.

To ensure that all comparisons were made in today's dollars, our comparisons are made in present value dollars, using a discount rate of 5%. The rate of return on both the RESP and the In-Trust account was assumed to be 8% per year. Finally, it was assumed that the RESP's subscriber and the In-Trust account's settlor shared the same marginal tax rate of 50%, and the beneficiary of each plan has a marginal tax rate of 25%. Note that although no province in Canada has a top marginal tax rate of 50%, we will use 50% in our comparisons for simplicity. The results of this comparison are illustrated on page 7.

WHEN IS AN RESP BETTER THAN AN IN-TRUST ACCOUNT?

While at first it might seem as though an RESP would always be the right choice because of the additional Canada Education Savings Grant, there are potential tax consequences for the subscriber of the RESP if the beneficiary does not pursue post-secondary education. If the child does not attend a post-secondary institution, the RESP must forfeit the accumulated CESG and the subscriber must pay a 20% Federal tax penalty in addition to his or her own marginal tax rate on the plan's accumulated income. For instance, if the child decided to not pursue higher education and the parent's (subscriber's) marginal tax rate was 50%, then the growth would be taxed at 70% (20% + 50%). This tax penalty is partially offset by the subscriber's ability to contribute up to $50,000 of the plan's accumulated income to their RSP, assuming the parent has sufficient RSP room available. **Figure 2** titled *"Child Does Not Pursue Post-Secondary Education"* illustrates this analysis. If the child does not attend a post-secondary institution, then an equivalent In-Trust account will have more after-tax growth than an RESP (based on the assumptions denoted on pages 4 and 5). As you will note, this general result is consistent for opening accounts for both short periods of time (when the child is older) and longer periods of time (when the child is younger). If the accounts were open for 21 years and the child does not pursue post-secondary education, the In-Trust account grew by approximately $8,000 more in today's dollars or 24.9% more than the RESP ($22,300 in 2023 dollars). In this situation, an In-Trust account acts as "insurance" because the annual savings are not explicitly intended for education and thus can be used by the child for any purpose.

On the other hand, if the beneficiary decides to attend a post-secondary institution, then an RESP may be a better choice than an In-Trust account. The reason for this result is that the accumulated CESG in the RESP is retained and it generates additional compounded growth. **Figure 3** titled *"Child Pursues Post-Secondary Education"* reveals the education saving advantage of an RESP. Under the same assumptions as the previous "no-school" comparison, an RESP will grow more quickly than an In-Trust account. If the accounts were open for 21 years, the RESP will earn nearly $12,000 more in today's dollars or 42.5% more than the In-Trust account ($33,400 in 2023 dollars).

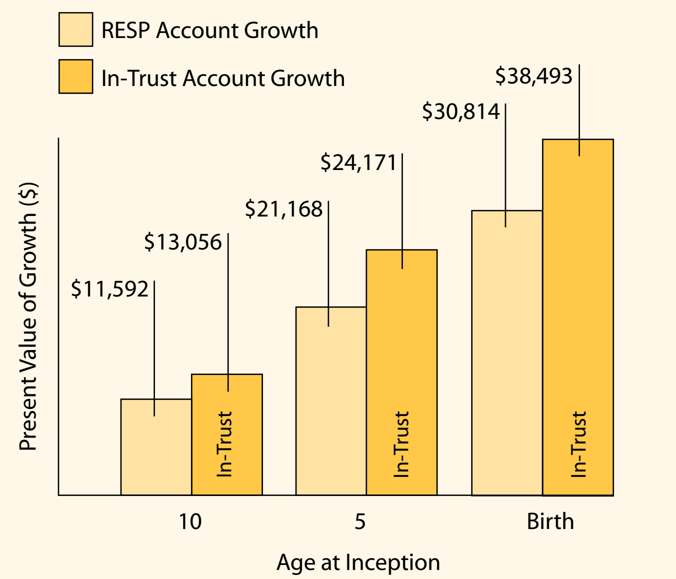


For a child who is age 10 at the time of becoming a beneficiary of an RESP, **Figure 2** (Child Does Not Pursue Post-Secondary Education) indicates that the present value, after taxes, of the growth in the plan in 12 years will be larger when funds are invested in an In-Trust account compared with investing within an RESP.

Similarly, the chart also shows that an In-Trust account provides an advantage over an RESP when the plan is open over a longer number of years.

FIGURE 2

Child Does Not Pursue Post-Secondary Education



For a child who is age 10 at the time of becoming a beneficiary of an RESP, **Figure 3** (Child Pursues Post-Secondary Education) indicates that the present value, after taxes, of the growth in the plan in 12 years will be larger when funds are invested in an RESP compared with investing within an In-Trust account.

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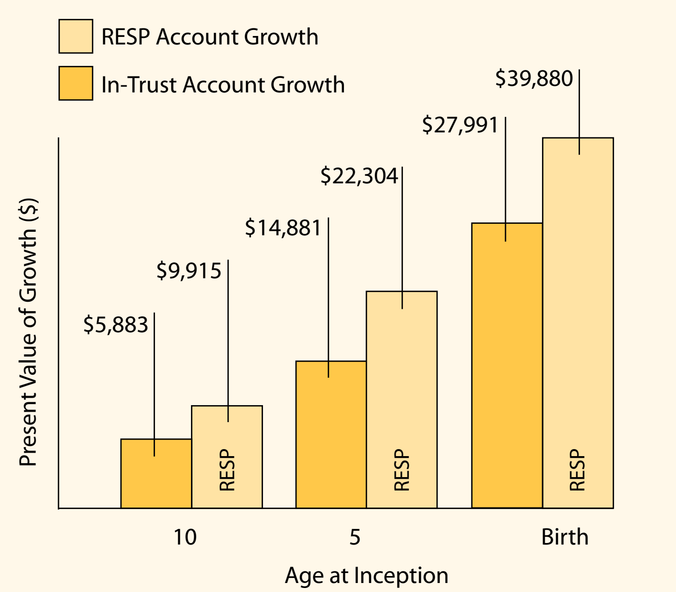
FIGURE 3

Child Pursues Post-Secondary Education



TRANSFERRING IN-TRUST ACCOUNT ASSETS TO AN RESP

Before the 1998 Federal Budget and the introduction of the CESG, many individuals compared RESPs and In-Trust accounts and determined that In-Trust accounts better met their desire to save for their children's future needs. Many individuals are now looking at the possibility of taking the money currently in these In-Trust accounts and contributing these funds to an RESP in order to obtain the CESG.

Unfortunately, there are several taxation and legal issues that are raised by the idea of transferring these funds from one vehicle to the other and it is recommended that parents and grandparents do not transfer amounts from an In-Trust account to an RESP.

TAX CONSIDERATIONS OF THE TRANSFER

When the In-Trust account was set up, one of the primary purposes may have been to split or shift income into the hands of a child in a low tax bracket. This was achieved by investing the gifted capital so as to generate capital gains that are taxable in the child's hands. In order for this strategy to work, it must be clear that ownership of these assets in an In-Trust account passed to the trustee for the benefit of the child. The individual named on the account that is not the settlor acts as trustee of this informal trust and is responsible for the management of these assets but does not have any beneficial interest in the asset. Basically, the trustee is holding the asset for the beneficiary to ensure that the wishes of the settlor are adhered to. In contrast, the funds contributed to an RESP are the property of the parent and thus the capital can be withdrawn by the parent at any time with no tax implications, although CESG received may have to be repaid.

If the parent took assets out of the In-Trust account and put these assets into the RESP, then the basic assumption of the trustee owning the asset for the benefit of the child and the parent having no right to these assets looks like a fabrication.

By making the transfer, a parent is suggesting that the In-Trust account was not a trust at all and that ownership of the assets had never passed to the trustee for the benefit of the beneficiary. If the Canada Customs and Revenue Agency was to review this transaction, it is possible that it would disallow past income splitting into the child's hands. This means that all of the capital gains previously taxed in the child's hands must be instead taxed in the parent's hands. This change would require the parent to pay additional taxes, interest on those amounts and possibly penalties to the CCRA.

Further complicating the story is that there would be a disposition at Fair Market Value (FMV) of any assets transferred from a settlor's account to an RESP because there would be a change of ownership of those assets. This disposition at FMV would trigger capital gains or even capital losses to the settlor.

POTENTIAL LEGAL ISSUES WITH THE TRANSFER

A final consideration is that legally the assets in the In-Trust account belong to the trustee for the benefit of the child. The last thing that any parent wants is for the In-Trust beneficiary, the child, to come back years later and cause legal problems for the parent because assets that were rightfully the trustee's, however for the benefit of the child, were removed from the In-Trust account and put into an account (RESP) that was owned by the parent. This may be more of a concern if the child does not pursue post-secondary education and the amounts in the RESP were taken into the income of the parent.

MAKING YOUR EDUCATION FUNDING DECISION

In making an education funding decision, the subscriber/settlor (parent/grandparent) should assess whether or not the child will pursue post-secondary education. If it seems fairly certain that the child will pursue higher education, then the parents should consider opening an RESP. Likewise, if a parent has more than one child, opening an RESP may be the right choice because a family RESP will permit multiple beneficiaries. In this case, if one child decides to not pursue higher education but another child does, then the benefit of the RESP savings could be used by the child who chooses to pursue post-secondary education (although some or all of the CESG may have to be repaid). In this way, a multiple beneficiary RESP acts as a form of insurance, since the risk is spread across more than one beneficiary.

If an RESP has been established and it begins to appear that no beneficiary will pursue post-secondary education, the contributor can always consider suspending further RSP contributions so that the contribution room can be used to accommodate the transfer of the earnings from the RESP plan. This way the harsh tax consequences associated with having the RESP earnings taxed in the subscriber's hands in the case where no beneficiary of an RESP pursues post-secondary education can be mitigated or avoided.

If, on the other hand, the child does not express interest in post-secondary education or if the parents/grandparents would like the money to be available to the child for other purposes, then selecting an In-Trust account may be a good way to "hedge your bet." Even though the In-Trust account will be worth less than an RESP, if the child does pursue higher education, the accumulated savings within the In-Trust account may still provide sufficient income to fund the child's education.

The possibility of establishing both an RESP and an In-Trust account can also be considered for example, where the total amount of contributions by a parent and/or grandparent exceeds $2,000 per year for a child/grandchild age 17 or under in the calendar year. In this case the first $2,000 can be contributed to an RESP to take advantage of the $400 Canada Education Savings Grant. The excess can be contributed to an In-Trust account where it can be used for education or other purposes.

HELPING YOU MAKE THE RIGHT CHOICE

No matter which option you choose, your advisor can provide you with a unique solution. Family RESPs offer significant flexibility including the ability to name one or multiple beneficiaries. In-Trust accounts allow you to clearly identify the various parties involved (ie. trustee, beneficiary and trust property) to ensure compliance with Canada Customs and Revenue Agency requirements as well as assist in protecting you from any legal or estate concerns.

Since your specific saving needs and tax concerns are unique, you should consult your advisor to further explore the right options for you.

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