When RESPs are a good idea, and when they're not

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Question: I have a family RESP for my daughters to which I contribute enough to generate the maximum Canada Education Savings Grant. I also contribute to a non-registered account as a rainy day fund for their future (ie. wedding, car etc.). I was looking to move the money from a savings account to a mutual fund, for a better return, and the bank recommended contributing the money to the RESP rather than a non-registered mutual fund with the idea being the tax would be deferred. On the surface it appears like sound advice if my daughters attend a post secondary institution. But what if they do not? What are the tax implications and is it a wise investment strategy? My daughters are 4 and 2.

Answer: Contributing enough to your daughters' Registered Educational Savings Plan (RESP) to get the full Canada Education Savings Grant (CESG) each year is a great idea. The RESP is not, however, the right place to save money that you are intending to give to your children for purposes other than post-secondary education such as a wedding or a car. Here's why:

If you withdraw money from your RESP for purposes other than paying for educational expenses, the following will happen. First, the original money that you put into the RESP is given back to you tax-free - no great favour as it was already after-tax money when you put it in. However, the investment income that was earned on the money you put into the RESP is treated as taxable income, plus there is a 20% penalty. If you are in the top marginal tax-bracket this will result in you paying tax on this investment income at a rate of almost 66% (using Ontario's top 2004 tax rate of 46%).

A better solution for additional savings, after putting enough into the RESP to get the full CESG, is to open up non-registered investment accounts held "in trust" for each of your daughters. If the money invested in these accounts earns interest or dividends, this income will have to be reported on your tax-return each year. However, if the money grows by capital gains, this income is not reported by the parent but by the child. Given that only 50% of capital gains are taxable, and that the first approximately $9,000 of income of every Canadian is completely tax-free, your daughters may end up paying no tax on this investment income.

Typically, a mutual fund that invests in stocks will grow through capital gains. Equity funds are often used for "in trust" accounts because this type of income is taxed in the hands of the child. Keep in mind that a mutual fund that invests in stocks is typically more risky than investments that generate interest or dividend income.

Here's a technique you can use to gradually lower the risk of an equity-based "in trust" account while keeping the tax-bill down for the parents. Open the account in trust for the young child using an equity-based mutual fund. Set up the account so any annual distributions are reinvested not back into the equity fund but rather into a money market or bond fund. Over time, the portion of money in the lower risk money market or bond fund will grow through these distributions. These lower risk investments generate interest, but this income is not taxable in the parents' hands due to a fine point in the rules that says "income on income" is not attributable to the parent. If started at a young age, by the time the child reaches 18 and may want the money, they will have a large portion of the account in the lower risk investment, and still have no investment income taxable in the hands of the parents.

Keep in mind that if you invest money "in trust" for your children it is their money from that point forward. Unlike RESP contributions that can be taken back if needed by the parent, money held in trust must be used for the child and is legally theirs when they turn 18.

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