# HIGHER EDUCATION

My friend Aaron has a dilemma. Four bright kids with high ambitions. The oldest is in University and the other three are not far behind. "I keep telling them to set their sights lower", he laments, "but they just don't listen." I am not sure if he is joking.

Aaron is a successful dentist who values education. He's grateful to his parents for helping him through dental school and he wants to help his children with their education. He is, however, quite concerned about how school costs will affect his cash flow and lifestyle.

After the purchase of a house and a dental practice, your children's post – secondary education may be the largest expense that you encounter. According to a report by the Canadian Centre for Policy Alternatives1, the average cost of tuition at Canadian universities could reach over $7300 per year. Add in living expenses, food, transportation and spending money, and a four-year undergraduate degree can easily hit the $80,000+ mark.

Dentistry is another story entirely. As I recall, our tuition during dental school in the late 80s/early 90s was about $7000 per year. It seemed painful at the time. Today, the annual dental school tuition, once you factor in books, instruments and ancillary charges, hover around $42,000. Total cost of a four-year dental education (including living expenses) in Ontario – around $230,000.

This financial reality clearly calls for a long term plan. So to get you started, let's look at strategies to fund your children's education.

## Strategy #1 | Start an RESP

RESP's are the Backbone of Education Savings for most Canadians. The basics of a Registered Education Savings Plan are well known but there are numerous rules that regulate this government plan. See Figure 1 for a list of the more important points.

If you have not started an RESP for your children yet, now is the time. There are three main benefits for using the Registered Education Savings Plan to fund education:

Free money from the government. For every annual contribution, the government will give you a 20% grant (CESG). There is a maximum grant of $500 per year** for contributions of $2500 or higher. It is not every day that the government gives you money – so don't be shy and take advantage of it.

But what if you have an RESP but did not contribute for a number of years? Fortunately, the program does allow for carry-over of the grant, but only to a maximum of an extra $500 grant per year. Therefore, if you did not make a contribution last year, you can contribute $5000 and receive $1000 in CESG grant this year.

***Grants can exceed $500 per year depending on your family income. This illustration assumes that family income is over $87,907.*

Any RESP savings will grow tax-deferred until it is withdrawn by the student. Therefore, the funds will be able to grow and compound in a tax sheltered environment until it is required for school. The sooner you start an RESP, the greater the benefit of this tax sheltered growth. You can start an RESP account once you apply for and receive a Social Insurance Number for your child.

When the funds are withdrawn, it is taxed in the hands of your child. Since most students do not have any significant income, they will pay income tax at a much lower rate. Therefore, these tax deferred funds are converted to actual tax savings.

## Strategy #2 | A Lump Sum RESP Contribution

What if you passed on the annual 20% government grant in favour of a large lump sum contribution?

There is no restriction on how much you can contribute into an RESP per year, as long as you do not exceed the $50,000 life

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*FIGURE 1 – Important attributes of an RESP*

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|---|
| Contributions can be made to an RESP up to a lifetime maximum of $50,000 per child. |
| For every contribution made, the government will kick in a 20% grant, with a maximum grant of $500 per year/ per child. |
| RESP funds can be used towards qualified post-secondary education. |
| The contributions are not tax deductible, but the funds grow tax deferred until withdrawn by the student. |
| When RESP funds are taken out of the plan and used for education purposes, it is taxed in the hands of the student. |
| A self-directed RESP can be invested in a variety of different vehicles – including stocks, bonds, GICs, mutual funds, ETFs, etc. |
| A family RESP can be set up to save for more than one child. At time of withdrawal, the funds distributed to each child do not necessarily have to be equal. |
| If an RESP is not used for education purposes, there will be penalties and taxes upon withdrawal of the funds. In addition, any government grants will have to be returned. |
| For a complete list of RESP rules, visit http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/resp-reee/menu-eng.html |

time contribution limit. However, the CESG grant is only paid on the first $2500 contribution per year (maximum yearly grant is $500 for the first $2500 yearly contribution).

So why would you forego this gift from the government? In the right circumstances, you can come out ahead by contributing a lump sum to your child's RESP and giving it time to grow.

Let's look at a comparison between one lump sum contribution vs. 15 smaller contributions + the corresponding CESG grant:

- Suppose you have a $50,000 lump sum invested in a non-registered account. You pay annual taxes on the interest, dividends and capital gains at your high tax rate.
- You open an RESP account for your child – assume on his/her first birthday.
- Average annual rate of return on investments = 5%
- Your child starts university or college at age 18 (17 years after first contribution).

From Figure 2, the compounding effect of the larger sum outpaces yearly contributions over 17 years – even with the CESG grant included. The tipping point is approximately 4.5% annual rate of return. If you feel that you can achieve an average investment return of more than 4.5%, then the lump sum contribution will generate more savings by age 18. Keep in mind that investment returns are not guaranteed, so there is some risk that your lump sum will not grow as you anticipate.

## Strategy #3 | Optimizing your RESP using Asset Allocation

Unlike retirement savings, the time horizon for an RESP investment is likely only 18 years. Therefore, it is important to maximize growth through proper asset allocation.

Over the long term, stocks have historically outperformed bonds, but with multiple peaks and valleys. Therefore, a good way to invest your child's RESP savings is to hold a greater percentage in equities at the beginning, while there is adequate time to overcome short term volatility. Then, five years before university or college, look for a good time to sell equities at a high point and adjust your assets to hold a larger proportion of fixed income. Speak with your investment advisor about constructing a suitable asset mix and setting a strict time frame to move to less volatile investments.

In terms of equity investments, holdings in well capitalized, liquid companies with a history of positive earnings, steady earnings growth and good cash flow are ideal for this type of portfolio. Stable and conservative growth should be your mantra when investing inside an RESP.

*FIGURE 2*

| LUMP SUM CONTRIBUTION SCENARIO | ANNUAL CONTRIBUTION PLUS YEARLY GRANT SCENARIO |
|---|---|
| • $50,000 + $500 grant = $50,500<br>• 17 years of growth at 5% return = $65,247<br>• Total RESP at age 18 = **$115,747** | • $15,000 + $500 grant in year 1 = $15,500<br>• Subsequent $2500 contribution + $500 grant per year for the next 13 years.<br>• One more contribution of $2500 + $200 grant in year 15. This maximizes life time contribution to $50,000 and maximizes the CESG grant to $7200.<br>• 17 years of growth at 5% return<br>• Total RESP at age 18 = **$103,590** |

*REFERENCES*

1. MacDonald D, Shaker E: Eduflation and the High Cost of Learning, Canadian Centre for Policy Alternatives, September 2012.

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## Strategy #4 | Smart Withdrawal

There are two separate baskets of funds inside an RESP, and you can dictate which basket to withdraw from. Your lifetime contributions are called PSEs (post-secondary education payments) and can be withdrawn tax free. Any grant or growth of the portfolio is called an EAP and is taxed in the student's hands on withdrawal.

The general rule is to try and draw out the EAP first - when your child is less likely to have significant income. Also, if your child decides not to continue their schooling mid-way through their degree, any grants must be returned and any growth is heavily penalized. By withdrawing and using the EAP first, you minimize the chance that these funds can be clawed back.

## Strategy #5 | Investing the Universal Child Care Benefit

Under the Universal Child Care Benefit program, the federal government provides a monthly benefit for families with children under 18. As of July 2015, the amounts are as follows:

Children under 6 years old
$160 per month/per child.
Children 6 to 17 years old
$60 per month/per child.

A good strategy is to use this monthly benefit to invest for your children's education since tax attribution rules do not apply. In other words, once an investment account is set up in your child's name, earnings (interest, dividends, capital gains) derived from the UCCB are taxed in the hands of the child, not the parents. Since most children under age 18 have little income, they will end up paying little or no taxes on the investment earnings. Investing a small monthly amount may not seem significant but it can add up quickly.

Similarly, any income that your child earns through part-time or summer jobs can also be invested in their account. Investment earnings from this source of income is taxed in your child's hands as well.

## Strategy #6 | Paying dividends to your child from a professional corporation

Once your children turn 18, you can pay them dividends from your Dentistry Professional Corporation and they will pay income tax at their own graduated tax rate. The good news is that if they have no other income, you can pay each child over $40,000 in dividends per year and they will pay no tax. PC dividends can help fund your children's education in a tax effective manner.

To illustrate this, let's look at Bobby and Billy Adams:

Bobby and Billy are identical twins who just turned 18 and will be attending university in the fall. Since they do everything together, both have set their sights on Columbia University in New York. Cost of tuition and living expenses – about $60,000 per child, per year. Luckily, their mom has taken several steps to plan for their post secondary education. Firstly, she has named both Bobby and Billy as dividend-only (non equity) shareholders in her corporation – Barb Adams Dentistry Professional Corp. Secondly, Barb has been planning for this cash outlay for the last five years. She has retained extra earnings inside her PC over this time and will pay dividends to the boys to cover school expenses of $60,000 per year/per child. By splitting income through dividend payments to Bobby and Billy, she will realize significant tax savings compared to funding their education with her after-tax dollars. Figure 3 shows a comparison:

Be sure to consult an experienced dental lawyer to set up your corporate structure. Ideally, the structure should allow you to pay PC dividends to any shareholders independently and on a discretionary basis. This way, you can tailor your dividends to minimize taxes for your own unique situation.

Without a doubt, post-secondary education can stretch a family's finances. But with a little planning and some focused discipline, you can help your children reach their educational potential. Who knows, as a thank you, they may even treat you to lunch ….. on their meal plan.

*FIGURE 3*

| | Barb uses her after tax income to fund children's education | Dividends paid to Bobby and Billy directly to fund their education |
|---|---|---|
| Corporate Earnings Before Tax | $215,400 | $156,200 |
| Corporate Taxes | ($33,400) | ($24,200) |
| Dividend Payout | $182,000 | $132,000 |
| Personal Income Tax | ($62,000) assume 34% dividend tax rate after c orporation receives refund | ($12,000) approximately $6000 income tax for each child |
| **Net Income** | **$120,000** | **$120,000** |
| Savings Over One Year | | $59,200 |
| Savings Over Four Years | | $236,800 |