



## Boost your child's RESP How leverage can help you increase your savings

Times, well, they have changed from when you were young. Nowhere is that more apparent than the competitive environment in which children are growing up today. And once they get out into the workforce, they'll need a post-secondary education just to get into the running.

As a parent you realize that a good education is crucial to helping your children succeed.

But the skyrocketing cost of post-secondary education is another arena in which drastic change is apparent. Since tuition fees are dramatically increasing and the workforce requires a post-secondary education, saving for education is a challenge that requires smart financial strategies.

One of the most common ways to save for your children's education is by investing in Registered Education Savings Plans (RESPs).

But in today's reality of rising education costs and inflation, even maximizing contributions to your child's RESP may not yield enough to cover their post-secondary education.

So how can you possibly keep up with the rising costs and inflation? Leveraged investing can help.

As a supplement to your child's RESP, leveraged investing can help you save additional money and give you a tax break in the process.

### **WHAT ARE RESPS?**

Approved by the Government of Canada, an RESP is a savings plan registered with the Canada Revenue Agency.



While contributions to RESPs are not tax deductible like those to RRSPs, they do offer some tax benefits.

Income earned on RESP savings accumulates on a tax-deferred basis. When your children, the beneficiaries, start withdrawing payments for school, these payments are taxed in their hands as they are withdrawn, often resulting in little or no tax payable.

A plan can be opened for one person or a family plan can be set up for several children. And anyone can contribute to an RESP, not just the parents of a beneficiary.

### RESP CONTRIBUTIONS

The maximum amount that can be contributed for any beneficiary is \$4,000 per year, up to a lifetime limit of \$42,000 per beneficiary.

This maximum applies to each beneficiary and not to each subscriber who contributes to the plan. So, for example, if a parent and a grandparent (subscriber) each wanted to set up an RESP for their child/grandchild, the combined contribution of both subscribers, in any given year, cannot exceed \$4,000 and the lifetime limit cannot exceed \$42,000.<sup>1</sup>

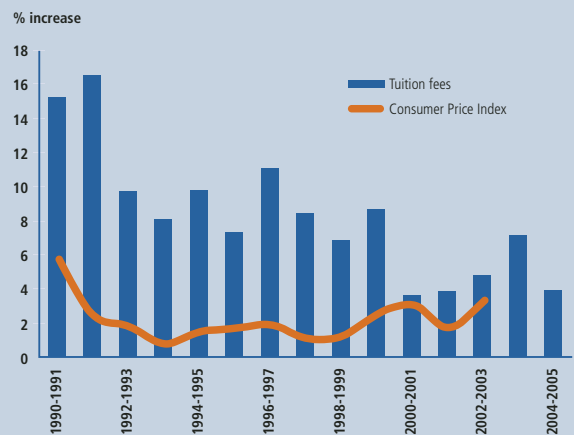
### TRENDS IN TUITION FEES

The costs of receiving a post-secondary education in Canada have increased substantially over the past decade. For example, between 1990-1991 and 2004-2005, average undergraduate tuition fees more than doubled, rising from \$1,464 to \$4,172.

From 1990-1991 to 1999-2000, undergraduate tuition fees rose by an average of 9.6% per year.

Since 2000, the rate of increase has slowed to an annual average of 5.3%. Nevertheless, average tuition fees continue to rise faster than inflation.

**Figure 1. Rates of increase in undergraduate tuition fees versus inflation**



Note: Consumer Price Index annualized by taking averages from September of year X-1 to August of Year X.

Source: University tuition fees. Statistics Canada, *The Daily*, Thursday, September 2, 2004.





## BENEFITS OF AN RESP

### CESG

A great incentive to starting an RESP is the Canada Education Savings Grant (CESG) – a grant from the Government of Canada paid directly into a beneficiary's RESP.

The CESG adds 20% to the first \$2,000 in contributions you make into an RESP on behalf of the beneficiary to a maximum of \$400 per year. Note that starting in 2005, the CESG is slightly enhanced for low and middle-income families.<sup>2</sup>

The CESG is available each year until the year the beneficiary turns 18 to a maximum amount of \$7,200.<sup>3</sup> Any unused CESG room can be carried forward to future years so that if a contribution is not made one year, the grant could be as much as \$800 (\$4,000 x 20%) in a future year.

This bonus will earn income right along with your contributions as your child grows.

### FASTER GROWTH

Through tax-sheltered growth, the total value contributed to an RESP can grow more quickly. Once the plan matures, you receive the principal back tax-free since you contributed in after-tax dollars.

### MOTIVATION

An RESP also serves as an effective motivator for a child to continue learning.

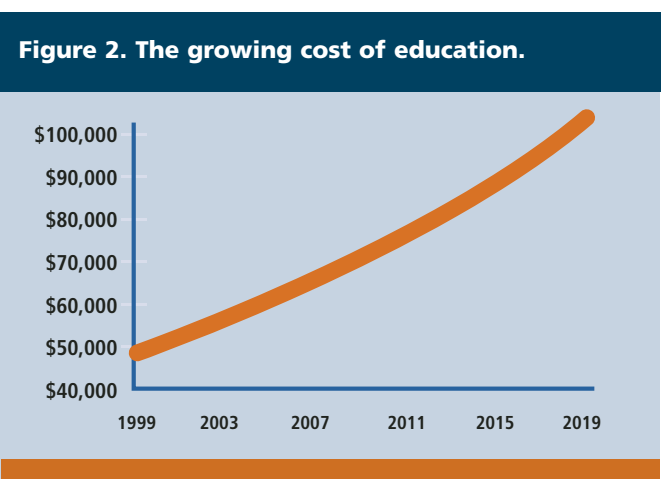
### TRANSFERABLE

If a child decides not to pursue post-secondary education, there are options:

- The RESP can be transferred to another child who is planning to attend;<sup>4</sup> or
- Parents can transfer the RESP income into their own RRSP tax-free provided they have sufficient room available up to a maximum of \$50,000.<sup>5</sup>

## THE GROWING COST OF EDUCATION

The costs of going to college or university, including tuition, books, school supplies, and living and accommodation expenses, have been rising faster than the rate of inflation. These costs leave many students in debt upon graduation as they must borrow to finance their education.



Source: Association of Universities and Colleges of Canada, 1998.  
Assumptions: A four-year university education now costs approximately \$48,000, and it is estimated that the cost will surpass \$100,000 by the year 2020.

## **ADD A LEVERAGED INVESTING STRATEGY TO RESPS**

As mentioned earlier, with the staggering increases in educational costs, even regular contributions to an RESP may not be enough to cover the expenses of post-secondary education. Today, many parents need to think of ways to supplement their child's RESP savings. That's where leveraged investing can help.<sup>6</sup>

Leveraged investing means borrowing money to invest with the expectation that your investment returns will be greater than the cost of borrowing. Simply put, you would borrow money, invest it, and use the proceeds to supplement your child's RESP.

## **BENEFITS OF LEVERAGED INVESTING**

There are three primary benefits to using leveraged investing to supplement your child's RESP savings:

### **SAVE MORE**

The strategy behind leveraged investing is that you make a lump-sum contribution at the start of your investment period. This allows the entire investment to benefit from the power of compounding for the full investment period, providing you with more savings in the end.

At the end of the investment period, after interest, taxes, and loan repayment, you keep any remaining investment gains. When you borrow to invest, the expectation is that your investment will grow over time and be worth more when you are ready to sell it.

Leveraging has the potential to produce more wealth than would be possible without a loan, allowing you to substantially increase the value of your investment portfolio over time.

Combining the growth from your leveraged investment with the contributions you've made to an RESP will leave you in a better financial position to cover post-secondary costs when it comes time for your child to attend school.

### **TAX-EFFICIENT**

The interest paid on leveraged loans for investment purposes is generally tax-deductible.<sup>7</sup> This effectively reduces the cost of borrowing and reduces the "break-even" return that you must achieve to make leverage investing worthwhile.

In many cases the "break-even point" – the rate of return at which you're better off borrowing than simply investing the money you would have paid in interest and taxes on annual investment income – is actually lower than the interest rate you're paying on the loan.





As an example, let's look at Liz and Mike. They each want to add to their child's RESP savings, and each has selected a different investment strategy to ensure they have sufficient funds for their child's post-secondary education, 10 years from now.

Liz's approach involves diligently making lump sum deposits into an investment at the end of each year, whereas, Mike chooses to borrow \$30,000 to invest immediately.

Mike's cost of borrowing is 7.0% annually, and that expense is 100% deductible.

At the end of each year, Liz makes contributions that are equivalent to Mike's net cost of borrowing. For both of them, the annual taxable portion of fund

return is 33%, the tax rate on income allocations from funds is 35%, and the marginal tax rate is 40%.

After 10 years, their cost of investing has been the same, but Mike ends up with almost 40% more money than Liz. Even though both investors realized an 8% annual return, Mike's strategy put him in a better position to harness that growth by utilizing the tax deductibility and compounding power of his investment loan.

So when it comes to bumping up his child's RESP savings, Mike adds significantly to the overall amount he contributed to the registered plan by taking advantage of the tax savings on his leveraged investment.

	Liz: Annual Investment Contribution	Mike: \$30,000 Investment Loan
Initial Contribution	Nothing	\$30,000
Annual Return	8.0%	8.0%
Total Amount Contributed after 10 Years	\$16,616	\$0
Net Cost of Borrowing after 10 Years*	\$0	\$16,616
Portfolio Value after 10 Years	\$22,804	\$64,768
Less Loan Repayment	\$0	(\$30,000)
Less Capital Gain Tax on sale of Investment	(\$938)	(\$4,659)
Net Equity after 10 Years	<b>\$21,866</b>	<b>\$30,109</b>
Internal after-tax rate of return	6.2%	13.0%

\* Net cost of borrowing includes the after-tax investment cost plus annual taxes paid on the taxable portion of investment income. The example above is for illustration purposes only and assumes an investment in segregated funds with a constant rate of return over the 10 year period. Results will vary depending on actual performance. Investment returns of segregated funds will fluctuate and are not guaranteed.



## A DISCIPLINED APPROACH TO SAVING

When you leverage to invest, you have to make a monthly loan payment. In essence, you have created a forced savings plan.

Making monthly payments on a loan provides structure and discipline to your savings plan. For many, it's easy to say that you'll put away a certain number of dollars every month. But it's even easier to stray from your savings plan – after all, expenses can get in the way. But by making monthly payments on a leverage loan, you will have to allocate funds for it just like any other bill that needs to be paid every month. Investors who have found it challenging to save in the past may find this helps them to be more disciplined.

## THE EQUATION FOR AFFORDABLE EDUCATION

Saving for your child's education is a challenge for which you can use all the help you can get. RESPs provide many benefits that make them an effective vehicle for education savings. Add to that the additional savings and tax relief from leveraged investing, and you may find that the sum of both of those investments help you stay ahead of rising costs and inflation. With your child's education on the line, can they afford for you not to utilize all the help you can get?

## REFERENCES

- 1 Government of Canada, [http://www.sdc.gc.ca/en/hip/lld/cesg/promotersection/module\\_2/RESP\\_Contribution\\_Limits\\_and\\_Overcontribution.shtml](http://www.sdc.gc.ca/en/hip/lld/cesg/promotersection/module_2/RESP_Contribution_Limits_and_Overcontribution.shtml)
- 2 For families with income below the first federal tax bracket (\$35,000 in 2004), the CESG matching rate will increase to 40% on the first \$500 contributed to an RESP for the year. For families with income between the first and second federal tax bracket (\$35,000 and \$70,000 in 2004), the CESG matching rate will increase to 30% on the first \$500 contributed to an RESP for the year. All other contributions eligible for the CESG will continue to qualify for the 20% matching rate.
- 3 Government of Canada, [http://www.hrsdc.gc.ca/en/gateways/nav/top\\_nav/program/cesg.shtml](http://www.hrsdc.gc.ca/en/gateways/nav/top_nav/program/cesg.shtml)
- 4 RESPs can be transferred to another beneficiary, even if an individual plan and not a family plan, provided certain conditions are met. Please ensure all conditions are reviewed prior to taking any action.
- 5 Government of Canada, [http://www.cra-arc.gc.ca/E/pub/tg/rc4092/rc4092-e.html#P131\\_10446](http://www.cra-arc.gc.ca/E/pub/tg/rc4092/rc4092-e.html#P131_10446)
- 6 Borrowing to invest is suitable only for investors with a higher risk tolerance. You should be fully aware of the risks and benefits associated with investment loans since losses as well as gains may be magnified. You must meet your loan and income tax obligations and repay your loan in full.
- 7 Tax deductibility of loan interest depends upon a number of factors with the Income Tax Act providing the framework for determining deductibility. It is always best to consult a professional advisor for any tax or legal advice.

Commissions, trailing commissions, management fees and expenses all may be associated with segregated fund investments. Please read the information folder before investing.

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