When it makes sense to maximize RESPs over RRSPs

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Jamie Golombek
Managing Director, Tax and Estate Planning, CIBC Private Wealth

I received a call from a friend who had set aside about $25,000 to make his annual RRSP contribution. Although he has established an RESP to save for his five young children's future post-secondary education, he has come nowhere near maximizing the annual contributions necessary to obtain all the Canada Education Savings Grants (CESGs) available to them.

His idea was to make an RRSP contribution of $25,000 and use the resulting tax refund of about $12,500 (assuming a marginal tax rate of 50%) to contribute to an RESP and collect some of the CESGs based on this contribution.

CESGs, provided by the Canadian government and Employment and Social Development Canada, are generally paid at a rate of 20% of RESP contributions, with an annual maximum of $500 per child unless you have unused grant room from prior years.

To maximize the total CESGs you can collect, you would need to contribute at least $2,500 annually for about 14.5 years to obtain the full $7,200 of CESGs available per child (i.e., 14.4 times $2,500 times 20%).

If you don't contribute each year, however, you can collect prior years' CESGs up to a maximum of $1,000, which can be paid in any one calendar year, per beneficiary. To do this, you would have to contribute $5,000 per child, at the 20% CESG matching rate.

In my friend's case, he would be able to collect 20% of his $12,500 RESP contribution, or $2,500, which could then be invested within the RESP and grow tax-deferred. But could he have done better?

I suggested he could potentially come out ahead if he were to bypass his RRSP contribution for the time being in favour of maximizing contributions to his RESP to start catching up on missed CESGs. If he were to contribute the full $25,000 to an RESP, the government would pay $5,000 in CESGs into his account (20% times $5,000 times 5 kids). He can always make those RRSP contributions later, once he has caught up on all the retroactive CESGs.

But what about the loss of the tax-deferred accumulation in the RRSP? Often, you can get the same result with the tax-deferred growth in the RESP. In fact, in many cases the RESP provides effectively tax-free accumulation since withdrawals of Educational Assistance Payments, which consist of the accumulated income, growth and CESGs, are taxable to the student, who likely won't end up paying any tax on EAPs withdrawn owing to various personal tax credits, such as the basic personal amount which is generally over $13,000 and the tuition tax credit.

Thus, the true benefit of going 100% on RESP contributions is to maximize the free government money while he can and save the RRSP contribution room for a later date.

Jamie Golombek, CPA, CA, CFP, CLU, TEP is the Managing Director, Tax & Estate Planning with CIBC Private Wealth in Toronto.

jamie.golombek@cibc.com