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Top 10 Education Savings Strategies

Invest Children's Own Money. If the Child Tax Benefit cheques and/or the Universal Child Care Benefit cheques are put in a separate bank account for the children, Revenue Canada then assumes that this money belongs to the children. Any investment income generated from this money will be taxed in the children's hands, and as long as they do not earn over $11,138, no tax will be payable.

The money can be used to buy term deposits, Canada Savings Bonds or mutual funds. Over the long term, a mutual fund that invests in the stock market has historically outperformed interest-bearing investments.

Once the children are earning their own income, you can give them an allowance to spend and get them to save and invest their income. The children should file tax returns even if they do not have any tax to pay so that they create RRSP room from their earned income.

Open RESP Accounts. You are allowed to contribute up to $50,000 per beneficiary to a RESP over their lifetime. The first $2,500 contribution per year is eligible for a Canadian Education Savings Grant of 20% to a maximum by age 18 of $7,200. If you have not received the CESG in the past, you can catch up on the missed grant by $500 per year (contributing an additional $2,500).

You do not get a tax deduction for the contribution, but the investment income grows tax deferred until withdrawn. When it is withdrawn, the grant and investment income is taxed in the hands of the children. The capital is returned without tax.

If you are going to accumulate savings, you may wish to put them into an RESP just to shelter the investment income from taxes. If one or all of your children do not attend post-secondary education, you may be able to change the beneficiary to another child or receive the money yourself. You would have to pay tax on the income (including a 20% penalty tax) unless you use the income to make an RRSP contribution.

Gift Money to Minor Children. If a parent or grandparent gives money to minor children, and the children invest the money, Revenue Canada will attribute the investment income back to the parent or grandparent. This attribution of income (interest and dividends) continues until the money is transferred back. There is no attribution of capital gains or second generation income (interest earned on interest).

You should contribute your money to a separate account in your spouse's name "in trust for your children." Once the money is in the account, your spouse can use it to invest on a monthly basis into mutual funds that invest in international equities. Over the long term, this will provide a good return while investing only small amounts monthly. If the investments earn capital gains, the gains are taxed in the hands of the children, not the parent.

You could use the money to invest in blue chip Canadian companies that have Dividend Reinvestment Plans. The dividends would be taxed in your hands at a lower rate and would be used to buy additional shares. The dividends from the new shares would be taxed in your children's hands. Also, any capital gains realized by the children on any of the shares will be taxed in their hands.

You could use the money to invest in assets that only produce capital gains such as gold or real estate. Any capital gain will be taxed in the children's hands. You should periodically "realize" the capital gain so that the children do not earn more that $11,138 ($22,276 of capital gains) in any given year.

Get Rid of Debt. By paying down your mortgage and other loans, you will free up some of your cash flow so that you could fund your children's education as they go. The benefit is that the after-tax return on the "investment" is equal to the interest rate on the loan. On a 4% mortgage, an individual in the highest tax bracket would have to earn 6.56% interest to beat paying down their mortgage.

Gift Money to Adult Children. Once your children reach age eighteen, you can gift money to them without the investment income having to be taxed in your hands. The income would be taxed in their hands at their potentially lower tax bracket.

To reduce your taxes now, and help fund your children's education, you could give your adult children some amount that they could invest. In doing so your children will pay the tax on the investment income rather than you. When your children are finished their education, they can give the money back to you and you can invest it for your retirement.

Gifting RRSP Contribution. If your children have income above $11,138, you may consider giving money to your children to contribute to their RRSP. This may reduce their taxable income to a point where their tuition fees and education credits would be transferable to you.

Buy Rental Property. If your children will be attending post secondary education away from home, you could buy a rental property and hire your children to manage it. They could rent the property out to other students to pay the mortgage and property taxes. You could pay them a management fee that can be used to pay their share of the rent and/or their living expenses.

Use Private Corporation to Fund Education. If you are the shareholder of your own company, you may be able to hire your children to work for you in your business. This would be a tax deduction to the company and an earned income to the children (creating RRSP contribution room). They can earn up to $11,138 without paying any tax. The payment must be reasonable for the work done.

If the children are not able to work for your business, the corporation could lend them money. If the money is not repaid before the end of the following corporate taxation year, the amount must be included in their income for the year. If this is less than $11,138, no tax will be paid. If the children repay the loan in a subsequent year, they will get a tax deduction for the amount of repayment.

Your corporation can pay tuition fees for you, your spouse or your children. This is a tax deduction for your corporation and a tax-free benefit to you if the corporation benefits from the education. If the corporation does not benefit from the education, the payment is a taxable benefit to the recipient.

If your children are shareholders of the corporation, they could receive dividends from the corporation. They could earn up to $33,000 of dividends and pay no tax. There may be significant taxes to pay if your children are under age 18 at the time of receipt.

Use Life Insurance. You can purchase life insurance to build up a tax-deferred capital balance that can be used to fund education. A portion of the premium goes to pay for life insurance (that you or your children may not need or want) and a portion goes into an accumulating fund. When it is time to pay for the education, you can borrow the cash surrender value or cancel the policy and receive the accumulation fund in cash.

There is no tax deduction for the insurance premiums and there is no tax on the growth of the accumulation fund until it is withdrawn. When you withdraw the funds or borrow the cash surrender value, the profit will be taxed. The accumulating fund can be invested in fixed income investments or in segregated funds (similar to mutual funds).

Borrow From RRSP. If you or your spouse are attending post secondary education, on a full time basis, you can borrow up to $10,000 per year ($20,000 cumulative over 4 years) interest free from your RRSP. Your spouse can also borrow up to $20,000 cumulatively from their RRSP. This money must be repaid over a ten-year period starting five years after your first withdrawal.

Changes to the income tax laws are continually being made. You should consult with your financial planner before you begin to implement any of the above strategies.