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Considerations for Structuring an RDSP

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In my last article I mentioned that for many families the RDSP might not be as good an investment option with regards to the taxes owed on it and the reduced matching grants for families making over $74,357 (Statistics Canada 2006 census found 50% of the families in Canada made over $70,000 per year after taxes, thus many families with disabled children would get reduced grants.)

For families who would benefit from the unreduced grants or for those who choose to have a RDSP as part of their investment portfolio, parents should put some thought into how the RDSP account can be set up and which variation might meet their needs best.

When parents set up accounts like RRSP's and RESP's (RDSP's will join this line up soon), the assumption is that cash will only be needed after many years of investment. As an advisor I hope this to be true for the families I work with but the reality is that sometimes unexpected life events require the money to be withdrawn early. Considering the regulations around RDSP's and that unexpected life events do happen, current and future life events may negatively affect RDSP values due to market adjustments and early withdrawal penalties.

For example, say that a disabled child falls down the stairs and now cannot walk anymore. The family may need to upgrade their dwelling with ramps, elevators and a whole host of equipment to accommodate this child. If the family withdraws money from the RDSP to pay for this unexpected problem, they may be faced with a surprising series of market adjustments and/or early withdrawal penalties that can significantly reduce the value of the money they receive.

Early withdrawal penalties can become even more serious for a disabled person who is no longer disabled, (either due to medical treatment or due to death) because of the government grants. Government regulations requires such a person's RDSP to be shut down, thus potentially triggering market adjustments and/or early withdrawal penalties that are applied to the account value before taxation and grant repayment thus leaving some parents with significantly less money than they put into the RDSP originally.

To understand the concerns better, let's look at the investment options and the early withdrawal penalties without getting into too much technical detail.

Market Adjustments are a process of increasing or decreasing the value of your investment during an early withdrawal to reflect current market conditions or prime interest rates. Market adjustments are problematic for RDSP's not only because and unexpected withdrawal coinciding with poor investment market conditions or low interest rates can result in your child receiving less cash from the RDSP than expected.

This condition can be worse if an RDSP has to be shutdown because your child is "no longer disabled" and the government grants have to be paid back first even if your investment is less than what you started with because of market adjustments. For example for a family making less than $74,357 a year that has deposited $100 into the RDSP and received a matching grant of $350 for a total deposit of $450, if at the time of a forced shutdown of the investment was worth $375 due to market adjustments, then the government would be paid back $350 and the parents would have $25 remaining from the original $100 they deposited. While this is not a common situation, it is a distinct possibility especially in a challenging investment market like this year.

The next logical question is which investments have market adjustments due to early withdrawals. The following chart shows the characteristics of various types of investments generally available and whether or not there may be a market adjustment that could decrease the value of the RDSP account money.

	Investment risk	Amount of return	Market adjustments	Is Money Locked-in?
GIC's, term deposits	Low	Middle	Depends on contract	Depends on contract
Cash savings	Low	Low	No	No
Bonds	Low	Middle	Depends on contract	Depends on contract
Money market Mutual Funds	Low[1]	Low to middle	Yes[2]	Yes if there is a DSC[3]
Mutual Funds	Varies up to high[1]	Varies up to high	yes[2]	Yes if there is a DSC[3]
Stocks	Varies up to high[1]	Varies up to high	Yes[2]	No[4]

[1] market based investments like some mutual funds and stocks can produce losses
[2] current value of your investment is based on market value and not on prime interest rates
[3] DSC- refers to a "Deferred Sales Charge", an early withdrawal penalty, duration around 6 yrs
[4] may have high trading commission charges to convert the investment into cash.

For market based investments, accounts are locked in a different manner. Various news reports and investment articles talk about a bunch of sales charge options like front end loads, back end loads and no load. Some of these loads can lock or impair the performance of your RDSP account. To understand the effects of a "load", let's look at what a "load" is.

For market based investments from banks and private investment firm advisors, your advisor is paid an annual salary based on a percentage of your investment account. This **trailer fee** is part of the management expense ratio (the percentage of the total investment returns that are used to pay salaries, commissions and operating expenses for the investment company) and is typically invisible to the parents. Advisors can also make an additional commission if they put a "load" on your account. These loads come in the form of a front end load or a back end load.

A "**front end load**" is a percentage that is removed from your deposit as it is deposited to your investment account which is then used to pay the advisor a commission on top of the trailer fees. For example a 2% front end load on a $100 investment means that only $98 will be deposited into your investment account and $2 will go to paying a commission to the. Front end loads have the disadvantage that they will impair the performance of an investment account from the beginning because the parents must earn back the commission charge first before they begin to profit from investment returns.

The back end load also known as a **"deferred sales charge (DSC)"** on the other hand doesn't impair investment returns like a front end load but a DSC is an early withdrawal penalty and basically an account lock. Typical penalties of 6% are levied on your entire investment account value if you move the whole account to another investment company or withdraw everything in the first year. This penalty will decrease by 1% for each year that the fund is held with the investment company until year 7 when the withdrawal penalty reaches 0%. This early withdrawal penalty effectively locks the account for 6 years because the parents have to consider this penalty before making the decision to move the account or withdraw money.

A little known feature of a DSC account is that any future deposits into such an account creates a 6 year early withdrawal penalty cycle on the new money that was just deposited (including any government grant money deposited).

A DSC creates an additional commission paid on top of the trailer fees and is therefore often a popular option with advisors because it does not impair investment returns like front end loads, it pays more to the advisor and it is seemingly harmless to the parents (unless an early withdrawal occurs or the account is moved or closed).

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A DSC however, can be an unexpected blow to the account value if say a disabled child is no longer disabled and a DSC has been applied to the RDSP account that must be dissolved according to regulations. As mentioned earlier in this scenario a DSC account's early withdrawal penalty is based on all of the money deposited including the government grant money. So, while the government grant money may seem like free money, an RDSP that is closed down while the DSC withdrawal penalty is active requires that you pay the withdrawal penalty on the government grant money as well the money you deposited before paying the taxes and paying back the government grants.

For example a family making less than $74,357 a year, a deposit of $100 into an RDSP will generate a $350 matching grant for a total balance of $450. If the RDSP is shut down in the first year due to sudden life events, the DSC penalty would cause a loss of $27 to the account balance and a $350 repayment of the grant to the government. This represents a 27% loss of the original $100 invested by the family and 4.5 times greater early withdrawal penalty to the parents because of the deposit of government grant money into a DSC RDSP account!!!

Worse, imagine if this account also had a market adjustment (in a bad market year), a DSC early withdrawal penalty, grant repayment and taxes owed, this could further reduce the or even eliminate the money the parents get back.

I have witnessed how sudden life events can penalize DSC client accounts, and as a result I recommend a "no load" option. A no load account has no early withdrawal penalty and no impairment to investment returns. Considering the regulations surrounding the RDSP, I suggest setting up your RDSP with an advisor who is willing to do a no load account to avoid the extra early withdrawal problems associated with government grants and DSC's.

For more clarification on investments and loads, speak to your investment advisor about appropriate investments for you and how to set up a no load RDSP account.

Next time I will discuss income and withdrawal options.

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