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No Strings Attached: How The Tax-Free Savings Account Can Help Lower-Income Canadians Get Ahead

By John Stapleton and Richard Shillington

- Lower-income Canadians are entangled in government programs with clawback provisions that discourage or effectively prohibit personal saving.
- The federal government's new Tax-Free Savings Accounts (TFSAs) can help correct the problem, provided that provinces and territories refrain from imposing new asset tests and clawbacks that undo savers' potential gains.
- Governments should also consider supplementing the savings of poor Canadians, whereby TFSA savings are matched by special funds from government.

For some time, government programs in Canada have not only discouraged personal saving by lower-income Canadians, they have often effectively prohibited it. Whether it be seniors who face clawbacks of their Guaranteed Income Supplement (GIS) benefits because of withdrawals from a registered saving plan (RRSP), or single parents facing clawbacks of welfare benefits for putting a little money aside, the rules can make saving pointless.[1] Welfare-based programs often place severe restrictions on the acquisition of assets and income by recipients. Having modest savings (as low as $560 in Ontario for a single welfare recipient) can make one ineligible for support programs, like social assistance, which include asset tests. And most provinces and territories have not made their regulations flexible enough to exempt modest savings, as they have for education and for persons with disabilities.[2]

The intent of these limitations is to restrict access to benefits to those with accepted needs, which is reasonable in theory – but when governments penalize beneficiaries for saving, by reducing program benefits, these programs become traps. One way out, however, might be found in the new federal Tax-Free Savings Accounts, provided that provinces refrain from imposing new asset tests and clawbacks that undo savers' potential gains.

The Extent of the Problem

About half of Canadians retire with no occupational pension plan and most will have only modest retirement savings. Pension coverage in Canada is declining. Coverage stands at about 40 percent of the paid labour force and 24 percent for those in the private sector. Most retirees without a pension are among the 1.5 million GIS recipients in Canada who comprise 36 percent of all seniors.[3]

1 See Shillington (2003).

2 Recent changes allow savings in Registered Education Savings Plans (RESPs) and Registered Disability Savings Plans (RDSPs) for those receiving social assistance.

3 HRSDC website: http://www.hrsdc.gc.ca/en/isp/statistics/rates/pdf/aprjun08.pdf.

An effective savings strategy for those without an occupational pension plan is important, especially for lower-income families, and many of them do accumulate some savings for retirement. Almost half of households with occupants aged 55-64 and incomes under $30,000 had retirement savings (in 1999, amounts in RRSPs averaged about $40,000). GIS recipients had retirement savings that averaged about $25,000 and totalled $37 billion.[4]

At retirement, Canadians with no workplace pension and modest or negligible savings rely on Old Age Security, the GIS, benefits from the Canada Pension Plan (CPP) and provincial tax credits and supplements. However, clawbacks and program traps at the federal and provincial levels make it difficult for them to improve their incomes. At the federal level, GIS benefits are generally reduced by 50 cents for every dollar of income from the CPP or from RRSP withdrawals, and income from those sources remains subject to income tax. At the provincial level, programs like social assistance (welfare), subsidized housing, child care, and nursing home subsidies are asset tested with stringent limits. Poorer Canadians receiving asset-tested benefits are not allowed to save without becoming ineligible for such programs. Therefore, depending on the provincial response, the new federal TFSAs could be a useful platform for helping low-income Canadians to save.

Solutions for Low-Income Retirees

The federal government (Budget 2008) proposed Tax-Free Savings Accounts to hold registered after-tax savings without incurring further income tax liability on earnings or withdrawals, and stipulated that withdrawals would not be subject to the GIS clawback. This should allow Canadians with low incomes at retirement to save in a more fruitful way.

Some commentators may criticize TFSAs on the basis that "low-income Canadians don't save." But that is not the case – they do save, just in small amounts.[5] One real advantage of TFSAs for individuals without an occupational pension is that they will have a mechanism to save effectively.[6] The question is: What sort of impact will provincial income support programs have on TFSA savings? Table 1 highlights some of the interactions between registered savings and needs-tested programs for the two largest provinces.

The savings issues facing low-income Canadians[7] have long been known, and particularly in the context of earlier discussions of TFSA-like Tax-Prepaid Savings Plans.[8]

> "Diverse provincial approaches offer the best way for Canadians to learn what works in this area. An essential feature of provincial programs, however, and one that a simple federal TPSP will effectively promote, is that they must protect the savings of lower-income Canadians from the means-tested benefits that can otherwise render saving pointless."[9]

Now that TFSAs are on the federal agenda, it is all the more urgent that the provinces and territories address the obstacles to savings posed by needs-tested programs.

Provinces and Territories Should Exempt TFSAs from Needs-Tested Programs

Three sets of decisions should be made by provinces and territories to accommodate TFSAs. They should:

1. Set an upper limit or ceiling on the amount of TFSA savings they will exempt for asset-tested programs – a starting point would be $5,000 to $25,000 in contributions as these are amounts already exempted under certain circumstances.
2. Decide to whom the ceiling will apply (applicants and recipients or current recipients only). They could start with recipients of these programs if there are concerns about caseload growth on social assistance programs.
3. Decide the circumstances under which they will allow withdrawals from TFSAs without affecting eligibility for needs-tested programs – they should start with withdrawals that will support self-reliance (e.g., for training).

4 Tabulations using Statistics Canada's Survey of Financial Security. (1999).

5 This can be inferred based on dividend income: Canada Revenue Agency web-site; http://www.cra-arc.gc.ca/agency/stats/interim-e.html.

6 They will need advice, though, on whether to save in an RRSP or a TFSA; advice that financial institutions in Canada should be preparing now.

7 Low-income status is usually defined by the Low Income Measure, low-income cutoffs or the Market Basket Measure. Each regards individual poverty as being in the $13,000-to-$18,000 range depending on community size.

8 See Poschmann and Kesselman (2001). The TFSA is effectively an example of their proposed Tax-Prepaid Savings Plan.

9 Poschmann and Robson (2004).

Table 1: Current Restrictions on Savings for Seniors and the Potential of TFSAs

Jurisdiction	Program	Rules Restricting Savings under Registered Instruments	How TFSAs will help
Canada	GIS RRSP	RRSP income reduces GIS by 50% per dollar of income. 100% of RRSP balance is taxable.	TFSA income does not reduce GIS eligibility. TFSAs are not taxable.
Ontario	Needs-Tested Programs (See Appendix 1)	RRSPs are counted 100% as income and assets. RESPs are not counted as income and assets.	**How TFSAs could help** TFSAs could be allowed to accumulate with: – Increased assets limits; – An approved plan leading to greater self-reliance; – A matching payment to encourage savings.
Quebec	Needs-Tested Programs (See Appendix 1)	RRSPs and RESPs may be accumulated up to a total of $60,000.	

Governments should Build on the TFSA Platform

Governments should consider supplementing the savings of poor Canadians, whereby TFSA savings are matched by special funds from government. The model for doing so is found in the partly matched Registered Education Savings Plan (RESP) and the new Registered Disability Savings Plan (RDSP).[10] Similarly, in the US, Individual Development Accounts savings are routinely matched.[11] With the federal platform in place, provinces and territories should decide the circumstances under which they may choose to augment or match the savings of program recipients – a good start would be a 1:1 match.

Canadians may wish to ensure that funds placed in a TFSA are spent wisely. Under current law, recipients of needs-tested benefits remain eligible for programs when they spend savings or windfalls on items or services that relate to their health or welfare, broadly interpreted. Provinces could design savings top-ups that meshed with their other social assistance programs, and they could make the exemption from provincial income and asset tests conditional on certain uses of the money, such as for education.

One of the goals of social assistance programs in Canada is to put in place measures to break the cycle of receipt of welfare benefits. Yet currently, a minor windfall, instead of being a happy event, may harm recipients, as it may result in sudden disentitlement from monetary benefits as well as prescription drug and dental benefits. The TFSA would allow beneficiaries to manage windfalls in a way that avoided the spending spree induced by the sudden and catastrophic loss of a variety of benefits. In this way, the TFSA is an instrument that has the potential to provide low-income Canadians with real choices in planning for their future. [12]

Governments have a duty to help those on social assistance improve their standard of living. Encouraging asset accumulation, even if in small amounts, is crucial in helping to lift people out of poverty. Provincial and territorial governments need to act swiftly. They should meet together soon to seize the opportunity provided by the TFSA to ensure that those on income supports across Canada are no longer actively discouraged from saving.

10 Provincial and territorial ministries and departments have agreed to ignore RESPs for determining eligibility for benefits, and many are considering exempting RDSPs.

11 Michael Sherraden in "Building Assets to Fight Poverty," http://www.nhi.org/online/issues/110/sherraden.html, 2000, notes the success of the IDA approach in encouraging low-income Americans to save.

12 At the opposite end of the income scale, for those concerned that TFSAs are overly generous to the wealthy, there could be a life-time contribution limit.

Appendix 1: Asset and Income Testing in Support Programs for Seniors in Ontario and Quebec.

	Program	Restrictions
Ontario	Guaranteed Annual Income System.	No benefit if income and OAS/GIS above minimum guaranteed level.
	Ontario Drug Benefit Program. Property Tax Relief for Low-income Seniors and Low-Income Persons with Disabilities.	Income test for deductible and for variable payment. Income test for clawback.
Quebec	Financial Assistance Program for Domestic Help Services. Shelter Allowance Program.	Variable assistance above basic amount is subject to income test. Subject to income limits. Couple's financial assets should be below $50,000.
	Tax Credit Respecting Home-Support Services for Seniors.	Credit subject to reduction for family incomes above $50,000.

Source: www.canadabenefits.gc.ca

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