Retirees: How to Turn a $63,500 TFSA Into a Tax-Free Mini Pension

Description

Are you a retiree or retirement saver looking for a great way to supplement your retirement income? A Tax-Free Savings Account (TFSA) is a great option for doing so.

Although TFSAs have less contribution room than RRSPs, they're great to use for "extra" tax savings after you've filled up your RRSP. Additionally, TFSAs have one tax benefit that RRSPs don't offer: tax-free withdrawal. Whereas RRSP withdrawals are taxed at your marginal rate, TFSA withdrawals are taxed at $0. This is a great benefit for retirement savers who want to maximize their tax-free income as much as possible.

Right now, it's possible to deposit up to $63,500 into a TFSA — that is, this year's $6,000 contribution plus $57,500 from previous years. It's not exactly a tonne of money. However, you can add to it every single year. Additionally, by buying dividend stocks with strong dividend-growth prospects, you can gradually build cash holdings without needing to bring in money from outside the account. Here's how it works.

Buy high-yield dividend stocks with strong dividend-growth prospects

If you're a reasonably experienced investor, you're probably aware that there are some stocks out there with extremely high dividend yields. Preferred share yields in particular can get unbelievably high, as can the yields on certain REIT units.

However, I'd argue that you shouldn't reach for the absolute highest yield you can find. There are two reasons for this.

First, ultra-high yields often indicate a stock that's been beaten down — perhaps justifiably.

Second, extremely high yields can raise questions about high payout ratios, which in turn raise questions about dividends being cut in the future. What's the point of buying a 5% yield stock if the payout is just going to get cut next quarter?

So, what you want to do instead is buy stocks with *moderately* high yields and high dividend growth. Many stocks increase their payouts over time. Over a number of decades, a real dividend grower can see its income rise 1,000% or more. If you want to build income in your TFSA, it's these stocks — not the ultra-high yielders — that you want to buy.

A great stock for this strategy is **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD).

TD Bank is Canada's fastest-growing bank, with an ultra-successful U.S. retail business that's growing by leaps and bounds. The U.S. is a much larger banking market than Canada, which gives TD way more room to grow there. Additionally, the bank is ranked ninth among U.S. retail banks, which is high enough to give it brand recognition yet small enough for it to continue growing.

In recent quarters, TD Bank has been growing at 5-10% year over year. That's enough for the bank to keep up its dividend increases, which have also averaged about 10% a year. So, while TD's present yield of 3.94% isn't the highest you'll find, it's likely to increase over time.

Reinvest your dividends

Once you've found a quality dividend-growth stock to invest in, your next step is to reinvest your dividends. Dividend reinvestment gradually increases your position by passively buying up more shares. Not only are the new shares acquired automatically, but they are purchased without any commissions, saving you money.

Over enough years, dividend reinvestment can amplify your returns considerably.

Once you're ready to retire, you can consider stopping your dividend-reinvestment program and letting your dividends flow out to provide a source of income. This is a good idea, since income becomes a much higher investing priority the closer you get to retirement age.

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