CRA Slim Down Your Pension? How Retirees Can Use Their TFSA to Earn $13k per Year

Description

Many pensions are funded on a pre-tax basis. That means these pensions are subject to taxation, and after the CRA has had its fair share, you'll probably be left with a take-home amount that's a lot slimmer than you were initially expecting.

With bond yields as low as they are, there's never been a more frustrating time for retirees aiming to find the perfect balance between income and safety.

To make things even tougher, with life expectancies continually on the rise, today's retirees can expect to live for decades longer. That means retirees mustn't forget to consider growth when going on the hunt for high-income-paying securities, which typically don't offer much in the way of longer-term growth.

Unfortunately, unfavourable economic conditions won't grant you any mercy with the tax authorities when it comes to your pension.

What's one to do?

Look no further than your Tax-Free Savings Account (TFSA), a vehicle that can snowball your wealth and provide you with a viable source of income that, unlike your pension, is free from taxation.

With the right mix of investments in your TFSA, you can collect big dividends (or distributions) that won't be subject to tax unless you're one of the fortunate few who've broken the million-dollar TFSA limit – perhaps by going all-in on marijuana stocks back in their pre-legalization glory days?

If you're one of the many uninformed Canadians who have used their TFSA accounts as nothing more than a vehicle to hold cash (gotta love those "high interest" accounts!), you're now on alert. You're foregoing potentially hundreds, if not thousands, of dollars of tax-free monthly income.

Indeed, the opportunity costs of hoarding cash and letting it collect dust in a TFSA are unfathomably high. And if you're one of the many Canadians who have been regularly contributing to your TFSA, but haven't used the proceeds to invest in instruments other than bonds, GICs, annuities, cash, cash equivalents, or any other sort of low-return instrument vehicles in a rock-bottom interest-rate environment, you're not only surrendering your ability to compound your wealth, but you're also giving up one of your greatest legal tax advantages.

In essence, you're surrendering your ability to construct a second pension for which you're allowed to tell the CRA to take a hike.

HOT property

If you're a retiree who's been regularly contributing and investing in blended ETFs, you should have around $100,000 in your TFSA, enough to generate nearly $13,000 per year in tax-free income with securities like **American Hotel Income Properties** (TSX:HOT.UN) or AHIP for short, which now sports a massive 12.9% yield.

While, in theory, you could go all-in with the entirety of your TFSA in such a name and earn $13,000 a year in tax-free income, it's in your best interest to diversify your income stream across other instruments to average a yield of around 8% to be safe.

Although you'll only get $8,000 in annual tax-free income, you will drastically reduce the risks you'll bear and your long-term potential for distribution growth.

With that warning out of the way, AHIP can still help tilt your TFSA's yield to the higher end, depending on your personal tolerance for risk.

As you may have guessed, AHIP is in the business of investing in hotel properties, primarily in the U.S. market. While REITs are generally known as less correlated to the state of the broader economy, AHIP is more sensitive due that its peers to the cyclical nature of hotel properties.

Shares of AHIP have been under a considerable amount of pressure in recent years, hence the massive yield. Although the distribution may seem on unstable footing, I see the potential for income investors to lock-in the high yield alongside significant capital gains as the REIT gets operations back on the right track.

AHIP has made tremendous progress with its property improvement plan (PIP) renovations. Many projects came under budget, and as management moves its focus to higher-quality hotel properties (and away from economy hotels), I also see the potential for AFFOs to go on the uptrend gradually over time.

AHIP certainly isn't without its near-term risks, but the greatest danger is just holding cash in your TFSA.

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