CRA 101: How Retirees Can Use the TFSA to Generate Tax-Free Income and Avoid OAS Clawbacks

Description

The Canada Revenue Agency (CRA) implements a pension recovery tax on Old Age Security (OAS) payments when net world income tops a minimum threshold.

Seniors across the country say living costs are rising faster than the rate of inflation. Food prices and property taxes, for example, are common pain points. As a result, Canadian retirees are searching for ways to squeeze more income out of their savings.

CRA clawback

The CRA places a 15% OAS recovery tax on all income earned above a certain target. The number to watch in 2020 is $79,054.

While $79,000 is adequate for most people to live comfortably, it doesn't take long to hit that amount when all the taxable income streams are considered.

Retirees pay income tax on company pensions, CPP, OAS, and RRIF payments. Earnings from table investment accounts, part-time work, or income properties is also added to the net world income calculation. As a result, a retiree could quite easily hit the minimum threshold for the OAS clawback.

TFSA advantage

Generating income inside a Tax-Free Savings Account (TFSA) is one way retirees can boost income without putting OAS payments at risk or getting pushed into a higher tax bracket.

All interest, dividends, and capital gains earned inside the TFSA are beyond the reach of the CRA. When the gains are removed, the earnings are not counted toward the net world income calculation.

The TFSA contribution limit is as high as $69,500 in 2020. A retired couple would have up to $139,000 in contribution space to generate income.

Best stocks to buy

The 2020 market crash is providing investors with an opportunity to buy top-quality dividend stocks at attractive prices. That said, caution is warranted in such a volatile environment, so it makes sense to be conservative and search for businesses with recession-resistant revenue streams and strong track records of dividend growth.

Let's take a look at one top Canadian dividend stock that appears cheap right now and might be an interesting pick to start a diversified TFSA income fund.

Fortis

Fortis (TSX:FTS)(NYSE:FTS) owns more than $50 billion in utility assets in Canada, the United States, and the Caribbean. The portfolio includes power generation, electric transmission, and natural gas distribution businesses that operate in regulated sectors, which means revenue and cash flow should be predictable and reliable.

Fortis has more than $18 billion in capital programs underway. The company expects the investments to significantly increase the rate base in the next few years. As a result, Fortis is targeting average annual dividend growth of 6% through 2024.

Fortis raised the dividend in each of the past 46 years. The current payout provides a yield of 3.7%.

The current lockdown across Canada and throughout much of the United States means households are using more electricity and natural gas. Computers, appliances, lights, hot water tanks, and heating systems all need power.

The residential surge could offset the reduction by commercial or industrial operations. As such, Fortis could report solid results in the coming months.

The bottom line

Fortis is just one stock among a group of top Canadian companies that would be attractive for a balanced TFSA income portfolio. Getting an average yield of 5% is possible right now.

This would generate $3,475 in tax-free dividend income on a $69,500 TFSA fund that wouldn't put OAS payments at risk of a clawback.

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Date
2025/07/29
Date Created
2020/04/03
Author
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