TFSA 101: How Retired Couples Can Maximize Tax-Free Income

Description

The Canadian government launched the Tax-Free Savings Account (TFSA) in 2009 with the intention of giving retirees and other citizens a new savings vehicle with which to generate income or build wealth while paying less tax.

TFSA benefits

Since inception, the maximum TFSA contribution room has grown to $69,500 per person. This means a couple can invest up to $139,000 in 2020 to generate a stream of tax-free earnings.

Interest, dividends, and capital gains created inside the TFSA remain beyond the reach of the CRA, which means income investors can pull the full value of dividends to complement pension payments.

Investors looking to save for their golden years can take advantage of the power of compounding to invest the distributions in new shares. When the price of a stock increases to your sell point, all the capital gains are yours to keep.

Retirees find the TFSA particularly helpful. Some people don't spend the full after-tax amounts they receive from company pension, CPP, OAS, and mandatory RRIF payments. The extra cash can go into the TFSA to serve as an investment fund for special projects.

When money is removed from the TFSA, it's not counted by the CRA toward income calculations used to determine OAS clawbacks.

TFSA Investments

GIC rates from the Canadian banks range from 1-2% right now. As a result, many people are turning to oversold dividend stocks to boost returns.

The volatility in the equity market in the past two months highlights the risk that comes with owning stocks, but there are companies that tend to hold their value well during difficult times. Others appear oversold right now and pay reliable dividends with attractive yields.

Let's take a look at two stocks that might be interesting picks today for a TFSA income fund.

Fortis

Fortis is a North American utility firm with more than $50 billion in assets. The company operates power generation, electric transmission, and natural gas distribution businesses in Canada, the United States, and the Caribbean.

Revenue primarily comes from regulated markets, meaning that cash flow is predictable and reliable. The business grows through acquisitions and development.

Fortis is currently working through a five-year investment program that will see it spend $18 billion on capital projects. The result should be a rise in cash flow to support average annual dividend increases of 6% through 2024.

The current yield is 3.5%. While this isn't overly high, the stock is holding up well in a volatile market and it is tough to find comparable quality on the dividend growth outlook.

Royal Bank of Canada

Royal Bank (TSX:RY)(NYSE:RY) is Canada's largest bank. It is also the most profitable.

Size matters in the current environment. Royal Bank has the capital to ride out the recession and could take advantage of its strong position to make strategic acquisition if the downturn extends into next year.

Royal Bank and its peers face some headwinds over the coming two or three quarters. This will show up in the earnings reports, and investors might not see the company maintain its recent trend of generating about $1 billion per month in profits. Nonetheless, Royal Bank has a balanced revenue stream and entered the crisis in strong shape.

While the dividend might not increase for the next 12 to 18 months, the distribution should be very safe. The stock is down to the point where most of the bad news appears to be priced in and investors can now pick up an attractive 5% yield.

The bottom line

Retirees can quite easily build a TFSA income portfolio composed of top dividend stocks that would yield an average of 5% right now, potentially providing a couple with a combined $6,950 in tax-free income per year.

If you are searching for top dividend stocks to get the TFSA income fund started, Fortis and Royal Bank deserve to be on your radar.

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aswalker