RRSP & RRIF's: The Power Of Sheltering

We often hear the argument that the benefit of an RRSP is an illusion, after all, you are going to be taxed when you take the money out. We also hear people say that the benefit comes from the fact that when you withdraw the money you should be in a lower tax bracket. We strongly disagree with both statements.

The first statement ignores the power of sheltering, which we will demonstrate below, and the second is at best naive. Let us deal with the second one first. Our response is to ask the question; When was the

last time that tax rates went down? The only likely argument is that it will go down because your income will go down, but people who invest significant amounts of money in RRSP's, usually see their income remain high at retirement.

This might lead you to believe the first statement, but that would be a mistake. The benefit of RRSP's comes from the power of sheltering, and the power of sheltering is far greater than most people think.

First, let us explain the effect of doubling periods. It is because of this effect that a 10 percent return is worth more than twice as much as a 5% return. The effect of doubling is that when $1 doubles in value it is worth $2; when it doubles a second time it is worth $4; the third is $8; the fourth is $16; the fifth is $32; the sixth is $64; the seventh is $128; the eighth is $256 and so on.

Now, let us compare two investments. We will assume that investment A, earns an annual return of 7.2% and investment B earns a return of 14.4%. As you can see, investment B's return is double that of investment A. The reason we chose these two rates is that an investment with a return of 7.2% will double in value every ten years, while an investment with a 14.4% return will double every 5 years. This seems simple enough, double the return means that your investment will double in value twice as often. But what does that mean?

What if you were to invest $1 in investment A for 20 years and another $1 in investment B for 20 years, what would they be worth? The fastest way to determine this is to look at the doubling periods. Investment A doubles in value every 10 years, so it will double 2 times. As you can see from above, after 2 times $1 is worth $4. Investment B doubles every 5 years, so it will double 4 times. As can be seen from the above, after doubling four times $1 is worth $16. So, after 20 years, investment B is actually worth 4 times as much as investment A, even though it only earned two times the return.

Even if investment A was with pretax dollars and investment B was subject to a 50% tax upon withdrawal, investment B is still worth more. This is why tax shelters like RRSP's are so powerful. The deduction at the front end is nice, but that is made up for by the tax on withdrawal. However, the fact that there is no tax on the income in the plan means that you have a higher effective return on the investment, which will make a significant difference on the amount of money you have later on.

The following table compares the value of $1,000 invested inside an RRSP verses outside. It assumes a 10% per year return, and a 50% tax rate. This means that outside the RRSP the effective return is only 5%. We also assumed that the RRSP was taxed at 50% on withdrawal, and that the investment outside was made with after tax dollars, so it was only $500 to start, but it is not taxed on withdrawal.

Shelter vs. Non-Sheltered Investment

No. of Years	Sheltered/RRSP	Non-Sheltered
10	$ 1,297	$ 814
20	$ 3,364	$ 1,326
30	$ 8,724	$ 2,161
40	$ 22,630	$ 3,520
50	$ 58,695	$ 5,734

If we do everything the same but apply a 25% tax rate the results are as follows.

Shelter vs. Non-Sheltered Investment

No. of Years	Sheltered/RRSP	Non-Sheltered
10	$ 1,945	$ 1,546
20	$ 5,046	$ 3,186
30	$ 13,087	$ 6,566
40	$ 33,593	$ 13,533
50	$ 88,043	$ 27,892

As you can see the tax sheltered investment significantly outperforms the non-sheltered investment. Actually, our calculations show that even if there was no tax deduction for the original contribution, and the sheltered investments were also taxed on withdrawal, as long as you held the shelter for fifteen years, you would be ahead.

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