PENSIONS VS. ISA FOR RETIREMENT

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Which **tax wrapper** is the most suitable for your savings? With the difference in tax treatment of pensions and ISAs, and the introduction of the Lifetime ISA, it can be difficult to decide exactly where to put your money.

It is important to remember that the **fundamental investment choices** within the tax wrapper of an ISA or pension are exactly the same, it is just the **wrap-around tax treatment** that differs. Our note on Risk and Asset Allocation gives more details of how you should decide where to invest.

Here we compare the main features of pensions and ISAs, and look in detail at the pros and cons of each wrapper.

SUMMARY

When saving for **retirement**, a **pension is usually the first choice** to benefit from tax-relief to boost funds and help retirement goals be reached. However, **ISAs can also offer tax advantages** in addition to - or, for some - instead of, pensions.

Pensions may offer greater overall tax benefits than ISAs, especially for higher rate taxpayers, and now offer flexible access. However, pension access is restricted before age 55 (rising to age 57 from April 2028), and so **ISAs** remain the product of choice for savings where access may be needed before this point.

The **Lifetime ISA** introduces a cross between pensions and ISAs, and increases further the choice for lower/basic rate tax payers who may make smaller pension contributions. However, the LISA will only be suitable for certain individuals, with employer pension contributions (where available) more likely to offer better value.

A distinction should always be made between the choice of '**tax wrapper**' surrounding your funds (e.g. pension or ISA), and the **choice of assets** into which the funds are invested (e.g. cash, bonds, equities). The asset choice will be broadly the **same** regardless of the tax wrapper chosen, and is the **most important** determinant of the level of risk you take, and the eventual return you receive.

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INTRODUCTION

With pension legislation complex and seemingly ever-changing, and alternative simple tax-wrappers such as ISAs available, some may question if pensions remain the first choice for building assets for retirement.

Under current legislation most pensions can pay up to 25% of the fund at retirement as a tax-free cash lump sum. The maximum total tax free cash you receive from all your pensions is governed by the Lump Sum Allowance. For most people this means a maximum of £268,275, unless pension protections apply.

The balance of the fund must provide a taxable income, either via an annuity, flexi-access drawdown (no minimum or maximum income restrictions), or one-off withdrawal (Uncrystallised Funds Pension Lump Sum; for further details, see the relevant Research Notes).

Benefits can only be drawn from age 55 (rising to age 57 from April 2028), and an annuity, flexi-access drawdown, or UFPLS can be entered into at any time thereafter – although there is no compulsion to do this. However, in practice, most individuals will want to take advantage of the 25% tax free cash sum available before age 75 (as beneficiaries' withdrawals after death at this point would be subject to income tax), and so may therefore consider at least a drawdown pension by this point.

The major incentive for making pension contributions is the tax relief available on contributions into pensions, which is at the investor's highest marginal rate (i.e. 20%, 40% or 45%, or even higher if the income relieved is in an effective rate tax trap such as the band where the personal allowance or child benefit is also lost).

Any pension income is taxable to income tax at the usual rates.

Contributions to ISAs are made from taxed income, with no tax relief given. ISAs, however, can be encashed, wholly or partially, at any time, and free from further tax on income or capital receipts.

As detailed further in the table below, the Lifetime ISA is positioned in the middle ground between a pension and a traditional ISA - offering a bonus equivalent to basic rate tax relief on contributions up to £4,000 net per annum. However, in order to retain this bonus, access before age 60 is not allowed.

The treatment of ISA and pension funds whilst invested is broadly the same in tax terms, i.e. both grow free of capital gains and income tax.

The pension therefore follows the 'EET' model – contributions Exempt from tax, growth Exempt, and proceeds Taxed (although 25% can be taken tax free). The ISA follows the 'TEE' model – contributions have suffered Tax, growth Exempt, proceeds Exempt.

The Lifetime ISA potentially offers an 'EEE' model for basic rate taxpayers, and so will be of interest where benefits of a higher value elsewhere are not lost as a result (e.g. employer workplace pension contributions).

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PENSIONS VS. ISA VS. LISA

	Pension	ISA	Lifetime ISA
Initial Tax Relief	Basic rate tax relief for all up to £3,600 gross contribution. Contributions above this attract relief at the individual's highest marginal rate of income tax.	None	None, but bonus available (equivalent to basic rate tax relief) when ISA used for retirement funding or first time house purchase of under £450k.
Income Tax / CGT on funds	None	None	None
Tax on Exit	25% tax free cash available up to a maximum of the Lump Sum Allowance (£268,275 unless protection applies). Balance is subject to income tax when taken.	None	None, unless penalty applies as detailed below.
Inheritance Tax Position	Usually no IHT applying on death.	IHT applies on death (inter-spousal transfer available).	IHT applies on death (inter-spousal transfer available).

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PENSIONS VS. ISA VS. LISA

	Pension	ISA	Lifetime ISA
Age Restrictions for Contributing	None	Minimum age 18.	Age 18-39 to open. Age up to 50 to contribute.
Age Restrictions for Withdrawals	No access before age 55 (age 57 from April 2028).	None	Access allowed before age 60 but penalty applies (if not for first time house purchase).
Other Restrictions	None	None	Not eligible for workplace pension schemes, so will lose the benefit of employer pension contributions if used in preference to a pension. Funds withdrawn before age 60 (and not for a first time house purchase up to £450k after 12 months of opening LISA) suffer a steep penalty 25% of the amount withdrawn (equivalent to 6.25% on the funds+growth saved by the individual). Only one LISA can be paid into each year.
Funding Limits	Tax relief limited to level of earned income in the year, or the available annual allowance if less (£60,000 plus any available carry forward; reduced for some – broadly those with incomes over £260,000 or already taking pension income)	£20,000 per annum.	Maximum £4,000 per annum, which receives 25% bonus (equivalent to basic rate tax relief on pensions). This is part of the overall £20,000 ISA allowance, so reduces ISA savings capacity available in other ISAs.

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MANAGEMENT CHARGES

Pensions once had a reputation for high charges. However, under the stakeholder pension rules the annual management fee on new contracts is no more than 1.5% per annum for the first 10 years, dropping to 1% thereafter, with no initial bid/offer spread. Many pension products are available for lower fees even than this.

For ISA investments, the total annual management fees are usually between 0.5% and 1.5% per annum, depending upon the fund, investment route, and level of adviser service chosen. The initial costs of investment, assuming no adviser charge or platform charges, are usually nil to 0.5%.

The difference in charges between pensions and ISAs is less marked than has been the case in the past, and therefore should not significantly affect the decision.

MAXIMUM INVESTMENTS

For investors with sufficient earnings the pension investment limits are far higher than the limits for ISA contributions.

Annual ISA contributions are capped at £20,000 per individual, although there is no earnings requirement necessary in order to justify these contributions. The maximum annual investment into a Lifetime ISA is £4,000 net.

The pensions Annual Allowance is currently £60,000 gross. For those with lower earnings than this, allowable contributions are limited by earnings; for those with higher earnings, Annual Allowance carry forward may be available to increase the allowable contribution.

Additional restrictions may apply for very high earners, or where pension income has already been accessed. Please see the relevant Research Notes on Rules on Saving into Pensions, and ISAs, for further details.

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INVESTMENT OPTIONS

Historically the investment options within a pension were relatively limited, and the vast majority of older personal pensions were invested in the default Managed and With Profits funds.

Pension providers now give considerably more choice than they used to and it is normally possible to access a large range of funds.

For larger pension funds, a SIPP offers a similar extensive fund choice as for ISAs, at a relatively low cost.

TREATMENT ON DEATH

The **position on death for any pension sums remaining undrawn is currently very favourable**, providing good Inheritance Planning opportunities. For **death before age 75**, pension funds can pass to the beneficiaries **generally free of tax**, as a lump sum or income via drawdown or annuity purchase (NB for lump sum death benefits above the Lump Sum and Death Benefits Allowance, income tax at the beneficiaries' marginal rate applies). Care must therefore be taken to ensure that the beneficiary is not the estate, as then an Inheritance Tax charge may be due. Individuals should ensure that older plans are written into a suitable trust, or are moved to newer plans which offer the full range of flexibility on death, and that the nomination of beneficiaries on newer plans is kept up to date.

For **death after age 75**, beneficiaries can withdraw a lump sum or take drawdown/annuity income taxed at their **marginal rate of income tax**. Any remaining funds on the beneficiary's death can again be passed on in a similar way, with tax treatment depending on the beneficiary's age on death.

An **ISA, however, will form part of your estate for IHT purposes** (unless invested in assets conferring relief from IHT such as AIM listed shares), and may therefore be subject to IHT, which is currently levied at 40% on the value above the nil rate band. Although transfers between spouses are in any case free from IHT, the ISA wrapper itself can now also be passed on to a spouse/civil partner on death.

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RESTRICTIONS ON ACCESS TO FUNDS

ISAs are significantly more flexible than pensions in this respect, as income or capital can be drawn from an ISA at any time. However, the new Lifetime ISAs will levy a significant penalty on access before age 60 (or first time property purchase as below), of loss of bonus and growth thereon, together with a substantial penalty of 25% of the amount withdrawn (equivalent to 6.25% of the value of the amount invested by the individual).

A pension fund cannot usually be touched until age 55 (rising to age 57 from April 2028). After age 55, benefits in the form of an annuity, flexi-access drawdown, or UFPLS can be taken at any time, or the fund can be left to grow if not required. 25% of the fund can usually be taken as tax free cash at the point when benefits are drawn, subject to the overall lifetime maximum of the Lump Sum Allowance (£268,275 assuming protection does not apply).

SUMMARY

Ideally maximum use of both pension and ISA allowances will be made. However, many will not have the savings capacity to do this. If a choice needs to be made, then the investor must primarily consider the level of flexibility and access they require to their funds.

If the sole purpose of the investment is to provide for an income of some sort in retirement, and separate funds are available elsewhere for shorter term/ emergency purposes – and in addition the individual is comfortable with the restrictions surrounding pensions – then the pension will usually provide the most tax favoured vehicle. This is especially the case for those who are eligible for higher or additional rate tax relief on their contributions, and expect to be paying income tax at a lower rate in retirement. Also, for non or basic rate taxpayers, the availability of tax relief on pension contributions, even where the tax has not actually been suffered, makes pensions an unusually tax favoured investment.

Lifetime ISAs may also be of particular interest to those who are zero or basic rate taxpayers, and who already take full advantage of any employer workplace pension contributions, and who can be sure of not requiring access prior to age 60 or first-time house purchase. Please see the comparison table above for a summary.

The decision can be a complex one and should be talked through with your adviser in order to achieve the right balance between pensions and ISAs.

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FIND OUT MORE

If you have any questions about our investment methodology, or would like some financial planning or investment advice, the clarity team are here to help.

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