ISAs versus pensions

ISAs now have more generous savings limits and pensions have become far more flexible. In an ideal world we'd maximise savings into both. But in the real world, where most of us can only save a limited amount of money each year, which should we invest in: ISAs, pensions or both?

The basics

ISAs and pensions are tax-efficient 'wrappers' – through which you can invest your money in stockmarket-based funds or cash savings. We've highlighted the key difference between each below.

How much can you save?

Pensions usually offer more generous limits than ISAs. But watch you don't exceed the 'lifetime allowance' as you could be hit with punitive additional taxes.

- **ISA**
  Everyone can now save up to £15,240 a year into an ISA. This can be saved in cash or shares. Savers are now free to switch between these assets as they wish.
- **Pension**
  Individuals can normally save up to £40,000 a year into a pension. However, those making the maximum contributions each year should note there is a lifetime allowance of £1m. This limit is the total value of the pension – so will include investment growth, plus any employer contributions. Those who have 'final salary' pensions should be very careful about making additional pension savings. Due to the way these valuable pension benefits are valued, some may risk breaching their annual allowance and/or lifetime allowance.

  If an individual is a member of a registered pension scheme during one or more of the previous tax years, they may be able to carry forward any unused allowances up to the previous three tax years. Allowing individuals to make contributions in excess of £40,000 without facing a tax charge. Those carrying forward any unused annual allowance must have sufficient relevant earnings in the tax year they are making the contribution in order to receive tax relief on them.

  For individuals accessing their pension benefits under the flexible rules, their annual allowance may have reduced from £40,000 to £10,000. Those subject to Money Purchase Annual Allowance cannot carry forward any unused allowances from previous years. For high earners, the £40,000 allowance reduces by £1 for every £2 of adjusted income they receive over £150,000 to a minimum of £10,000.

Which offers the biggest tax savings?

ISAs and pensions are taxed differently. As a basic rule of thumb pensions are more tax-efficient when you are building up a savings pot; ISAs are more tax-efficient when it comes to taking an income from these savings. But it isn't just income tax you have to consider:

- **ISA**
  There is no income tax to pay on cash ISAs – so interest on savings can roll-up tax free. If you are a higher-rate tax payer there is no further tax to pay on dividends within an ISA, while outside of an ISA you could be liable to additional tax on dividend income above the new £5,000 dividend allowance.

  Any income taken from an ISA is not subject to income tax; in fact you don't even have to declare this on a self-assessment tax form.

  In addition there is no capital gains tax to pay when you cash in an ISA, but they will form part of your estate for inheritance tax (IHT) purposes, so could potentially be taxed at 40% when you die – depending on the total value of your assets.

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ISAs versus pensions

- **Pension**
  The big advantage of pensions is they offer tax relief on contributions. This means that a £100 contribution into a pension scheme costs a basic-rate taxpayer just £80. This makes pensions particularly valuable for higher-rate taxpayers: the same £100 contribution effectively costs them just £60.

  But while you can take up to a quarter of your pension fund as a tax-free lump sum, the remaining income you take will be subject to income tax at your marginal rate. In reality many people are higher-rate taxpayers during their working lives, so get 40% tax relief on contributions, but become basic-rate taxpayers in retirement, making this a tax-efficient means of generating an income.

  Unspent pension funds aren't subject to IHT. If you die before 75 these can be passed on tax-free. After this age they are usually taxed at the recipient's marginal rate.

Which is most flexible?

ISAs definitely offer greater flexibility, as investors are free to access their money as and when they need it and can spend it how they like.

Pensions are far more flexible than they once were. However, the key constraint is savers can't access their money until they are 55. This will move in line with increases to the State Pension Age.

Previously there were limits on how much you could take out of a pension fund. New rules have swept these restrictions away: people will be free to spend their pension as they wish: they can keep it invested, buy an annuity, or spend the money.

Other considerations

- **Don't miss out on 'free' money**
  If your employer contributes to a company pension, make sure you contribute to this first. Many employers will match contributions up to a set limit, giving an instant boost to your pension.

  Missing out on these payments is akin to saying no to a pay rise.

- **Look under the bonnet**
  Think about how your pension or ISA is invested. Keeping too much of it in cash can restrict returns over the longer term. Stockmarket-linked investments are more likely to keep pace with inflation, but the value of your savings will fluctuate over the shorter term. Ultimately, the decision on how your money is invested will have more effect on your retirement savings, than whether it's in a pension or ISA.

- **Get the best of both worlds**
  Both pensions and ISAs offer valuable tax breaks so make the most of both. The flexibility of ISAs coupled with the generous tax relief on pensions.

  If you have no other savings ISAs are a great place to start, but look to build longer-term pension savings alongside this.

  Higher-rate taxpayers should maximise pension savings where possible to benefit from the higher tax relief.

REMEMBER: No one product offers a perfect solution. The key is to start saving, then to diversify – both in the type of savings you have (pensions and ISAs) and in the investments held within these products.

Important Information

This information is not investment advice or a recommendation for any particular product, service or course of action. Pension and retirement planning can be complex, so if you are unsure of the suitability of a pension investment, retirement service or any action you need to take, please speak to your financial adviser. The value of investments can go down as well as up and you may get back less than you invested. Eligibility to invest into a pension depends on personal circumstances and all tax rules may change. With pension products you will not be able to withdraw money until you reach age 55.

What to do if you need help?

This factsheet isn't intended to give you advice or to suggest you take a particular course of action. Retirement income is a complex issue, and if you would like to discuss your retirement options, please speak to your financial adviser.

Alternatively Pension Wise is a free and impartial government service that helps you understand your pension options and is available online, over the phone or face to face. Find out more at **pensionwise.gov.uk**.

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