WOODRUFF
FINANCIAL PLANNING

What you need to know about...

Pensions v ISAs

Most people realise that pensions and ISAs are both tax-efficient wrappers into which you can save your money. However, there is often debate over which is the best vehicle for your savings. This leaflet examines some of the pros and cons of these wrappers and the benefits of using one versus another. The short answer is that the best place for your money depends on your own circumstances.

What do pensions and ISAs do?

Basically, they are both tax-efficient wrappers for your savings, but with very different rules. The main difference is that you pay into a pension from pre tax earnings, but get taxed on the income from the plan. With ISAs you contribute out of post tax earnings but do not pay tax on income.

What are ISAs?

ISAs allow you to invest up to £7,200 each tax year. The contract is a wrapper into which can be put shares or cash. The growth and income are largely free of income tax and capital gains tax.

Benefits of ISAs

The main benefit is tax-free growth and income (in the main). You can also get your money out whenever you want it.

Negatives of ISAs

The main downsides are that the savings will be paid from your post tax income anyway. This means that although any growth or income from your ISA is tax-free, you will have already paid tax on this money anyway!

What are pensions?

Pensions are long-term savings wrappers which grow mainly free of tax. The contracts allow a boost from tax relief on your contributions, but the money cannot be accessed until age 55, and then only 25% can be taken as a tax-free lump sum; the rest must be taken as an income.

Benefits of pensions

The fund will grow largely tax-free. Any contributions are paid from pre-tax income, which will save you on tax, and this is used to boost the plan as tax relief. Your employer can pay into the plan, and often this works well as a tax-efficient portion of your salary.

Negatives of pensions

The main downsides are the restrictions placed on access to the fund. You cannot take benefits until age 55, and then you are limited to taking up to 25% as tax-free cash; the rest buys an income. Any income will be taxable.

Some issues to consider

Here we give some thoughts on the differences between the contracts and give our verdict on which is best in each situation.

Access

If you need access to the fund then the ISA wins hands down. You can cash in your investment at any time. With a pension the earliest you can get your hands on the money is age 55.

Restrictions

There are no restrictions on what you do with ISA

Continued overleaf...

funds; with a pension you can take up to 25% as a tax-free lump sum, and the rest must go to buy an income.

Investment choice
With ISAs you are limited to cash and investment funds. With pensions you can choose from investment funds to more specialist investments such as commercial property.

Tax-free growth?
Both contracts allow your funds to grow largely tax-free.

Tax relief
With an ISA you get no tax relief. With a pension your personal contributions attract tax relief based on your income tax rate. If you are a basic rate tax payer your contributions will grow by 25%; if you are a higher rate tax payer your contributions will grow by 66%. There are not many investments which can boast this level of growth on day 1, and it is this area where the pension beats the ISA. Over time this can be a significant difference, especially if you are a higher rate tax payer now, but become a basic rate tax payer when you retire.

Payable from taxed earnings
Money going into an ISA comes from sources which have already paid tax. With a pension, the contributions go in before you pay tax, making it more efficient.

Employer contributions
Your employer can pay into a pension plan, but not an ISA. Often employers match employee contributions. If this is the case your £100 investment could be £225 into your pension with tax relief.

Company contributions into pensions are also an allowable expense against corporation tax. This means that pension contributions can be a tax-efficient form of wages for a company.

Income
Income from an ISA is tax-free. It is taxable from a pension. There are also complex rules surrounding pension income choices.

Investment limits
You are limited to £7,200 into an ISA each tax year. Pension contributions are up to 100% of your earned income to a maximum of £235,000.

Inheritance tax
If you die your ISA will be cashed in, and the proceeds could attract inheritance tax. With a pension, this is usually written into a trust and the proceeds can go to your family free of inheritance tax.

Other
Pensions are protected in bankruptcy; ISAs are not.

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