ISAs V Pensions

Time for the tides to turn?

New rules introduced in this year's Budget have driven a need to look at the pros and cons of using ISAs and Pensions in retirement planning.

Until the latest Budget, pensions were just ahead of ISAs in terms of tax advantages, but now the balance has shifted. ISAs received a boost thanks to a significant increase in the annual limit, while pensions saw tax relief eroded for higher earners.

Is there now a group of people for whom building retirement savings with ISAs makes more sense than using pensions?

Pensions and ISAs have elements in common. Both allow the gross roll-up of gains and are free from capital gains tax. Neither can reclaim the tax credit on dividends, but they can do so on interest payments. However, the similarities end there – payments into ISAs are made out of taxed income, while payments into pensions currently attract tax relief at an investor's marginal rate of 20 or 40 per cent. Income from ISA investments is tax free, whereas income from pensions - (whether or not you take the 25 per cent tax-free lump sum) - is subject to tax.

Until now, pensions were indisputably the most tax-efficient way to save for retirement. Pensions are the most effective way to save for a retirement income. In the majority of cases, investing in a pension also produces a more reliable source of retirement income than an ISA. ISAs are only really suitable for retirement savings for those who can tolerate fluctuating income and capital values.

The recent Budget brought in new rules for those earning more than £150,000. Tax relief on pensions will be gradually eroded until, at an income of £180,000 or more, investments into pensions will only attract tax relief at 20 per cent. This changes the relative merits of ISAs and pensions for some people.

For the majority of the population, nothing has changed and tax rates are as they were. But there is a minority who wil be paying 50 per cent tax on their income from April 2010 and may only be receiving 20 per cent tax relief.

Those who are basic-rate taxpayers - while working and in retirement - will still be better off using pensions and those who are higher-rate taxpayers while working and are either basic or higher-rate taxpayers in retirement, will also be better off using pensions.

Those earning between £100,000 and £115,000, using a pension actually makes more sense, following the Budget. Their personal allowance is wiped out at earnings of £115,000 or more. This means they effectively get 60 per cent tax relief on contributions for that £15,000. It is therefore important to know your grouping, those earning over £150,000, those between £100,000 and £150,000 and everyone else.

The two key groups that will be worse off using pensions are those paying 50 per cent tax or higher and those who are basic-rate taxpayers and become higher-rate taxpayers in retirement. If someone is being taxed at 40 per cent or even 50 per cent on their retirement income, or if someone starts off as a basic-rate taxpayer and ends up as a higher-rate taxpayer at retirement, there would be a disincentive to make additional contributions.

The critical thing is the amount of tax relief going in versus the amount of tax you pay on the income coming out. If people are receiving 40 per cent going in and are only subject to 20 per cent coming out, pensions look more efficient. If people are only getting 20 per cent going in and are subject to 40-50 per cent coming out, then the numbers start to break down. For such groups, ISA savings look more efficient. The new higher limit of £10,200 for the over-50s is a bonus (the new limit starts from October 2009), enabling a larger pot to build up. For this group, £10,200 is still a relatively small amount and it doesn't reduce taxable earnings. ISAs still come out of taxed income. This may push people towards other tax-efficient savings vehicles, such as VCTs (Venture Capital Trusts) or EISs (Enterprise Investment Schemes).

Investment limits remain one of the key advantages of using a pension. The government maintained pension contribution limits in this year's Budget at 100 per cent of earnings or £3,600, whichever is the higher, and capped at the annual allowance of £245,000 for 2009-10. Pensions are subject to lifetime limits, which is not the case for ISAs. If investors are particularly lucky with the growth of their investments, there is no risk of these being subject to onerous tax charges.Nor is the comparison between ISAs and pensions a purely mathematical one. The government has changed the rules around pensions frequently, while ISAs have been largely untouched.

Ultimately, it's got complicated. The maths still favours pensions over ISAs for retirement planning for the majority of clients. It may well be that for those higher earners for whom it is more efficient to save via an ISA, the ISA limits are still too low and they will use traditional pensions anyway. However, ISAs score highly on flexibility and can generate additional tax-free income in retirement. As such, they are likely to be an integral part of any long-term retirement plan.

Past performance is not a guide to future returns and the value of investments, and any income from them can go down as well as up. You may not get back as much as you put in. Please bear in mind that for funds that invest in overseas markets, changes in currency exchange rates may affect the value of your investment.

Levels and bases of, and reliefs from, taxation are subject to change