BLICK ROTHENBERG

Pension versus Individual Savings Account ("ISA")

When new pension rules were introduced in 2015, they did not change the fundamental tax treatment of pension payments, fund accrual or retirement benefits. However, the tax treatment of pension funds on death was much improved and new flexibility removed any concerns about access to those funds.

Pension funds no longer have to be substantially used to provide a lifetime income. Those over age 55 can draw on their "defined contribution" pension plans over a much shorter period or, indeed, as a single lump sum.

The benefit of "washing" funds through a pension plan is that, subject to certain limits, 100% of a pension contribution receives tax relief on the way in, but only 75% is taxed on the way out. If the pre-retirement tax rate, and so the tax relief, is higher than the post-retirement tax rate, the benefit of a pension contribution is further enhanced.

It is common to focus on a net contribution of £15,000 so as to compare a pension plan with an ISA (both subsequently providing tax free growth and £15,000 being just below the annual ISA limit). However, the principle holds good for any tax relievable pension contribution (up to £40,000 in a tax year with any unused annual allowance being carried forward for up to 3 years).

Example

A 45% tax payer makes a gross pension contribution of £27,272, but is a 40% tax payer post retirement.

With 45% tax relief, net cost is £15,000 (as it is with an ISA).

When drawn, £27,272 pension fund provides:

25% tax free	£6,818
75% (£20,454) taxed at 40%	£12,273
Net received	£19,091
Immediate gain	**£4,091**

The following table shows results for all variants on pre and post tax rates for a net cost of £15,000:

Tax rate in	Tax rate out	Pension return	ISA return	Immediate pension gain/(ISA gain)
45%	45%	£18,068	£15,000	£3,068
45%	40%	£19,091	£15,000	£4,091
45%	20%	£23,182	£15,000	£8,182
40%	45%	£16,563	£15,000	£1,563
40%	40%	£17,500	£15,000	£2,500
40%	20%	£21,250	£15,000	£6,250
20%	45%	£12,422	£15,000	(£2,578)
20%	40%	£13,125	£15,000	(£1,875)
20%	20%	£15,938	£15,000	£938

Someone being a basic rate tax payer while working and a higher rate tax payer when they are not may appear an odd notion. However, cashing in a pension fund of £55,000 or more will push some of the proceeds into the 40% tax bracket.

Pension funds cannot normally be accessed before age 55, so an ISA may be a better option for younger people who might need earlier access to their savings.

The Government has pre-empted individuals routinely diverting up to £40,000 of their annual salary via a pension plan, so as to reduce income tax by one quarter. Anyone accessing more than the 25% tax free element will be subsequently limited to paying a £10,000 annual pension contribution.

You will find more detail on the pension changes at:
www.blickrothenberg.com/Services/Financial-Planning

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