TECHTALK ANSWERS… ISA, LISA OR PENSION?

We compare the main features and benefits of ISAs, LISAs and pensions.

LUCINDA CHOW

Lucinda is a graduate trainee in the Financial Planning team, with a law degree from the University of Nottingham. She is currently working towards her CII Diploma in Insurance and seeks to simplify complex legislation and engage people on planning for the future.

When it comes to retirement savings, which route is best to take? On top of the traditional choice of a pension, your clients can also put their money into an Individual Savings Account (ISA), and since 6th April 2017, a Lifetime ISA (LISA). There has been a range of commentary on the advantages and disadvantages of each option, so we are here to bring it together and present you with a comprehensive view.

THE BASICS

THE ISA

What it offers: The ISA is an account to shelter savings and investments from tax; there is no capital gains tax and no UK tax on income within an ISA.

Eligibility: Anyone aged 18+, but 16+ for Cash ISAs.

Conditions: In the 2017/2018 and 2018/2019 tax years, the maximum amount clients can save into ISAs is £20,000. This includes contributions to cash ISAs, stocks and shares ISAs and innovative finance ISAs.

THE LISA

What it offers: The LISA offers a 25% tax-free Government bonus on savings up to £4,000 (maximum bonus of £1,000) per year.

Eligibility: Between the ages of 18 and 40.

Conditions: The bonus only applies up to age 50 (this means a maximum of £33,000 of bonuses). Savers can withdraw their own contributions for retirement purposes at age 60. The amount put into the LISA counts towards their £20,000 ISA limit. It is also designed to help savers buy their first home.

PENSION

What it offers: A tax-efficient long-term savings plan specifically for retirement.

Eligibility: No age restrictions, although tax relief on personal pension contributions are not available for those aged 75+.

Conditions: Most personal pensions are unable to be accessed before age 55 (57 from April 2028). There is an annual allowance of £40,000; however, you can carry forward unused allowances from the previous three years. There is also a lifetime allowance of £1,000,000 in 2017/18 (£1,030,000 in 2018/19). If the value of all a client's pension benefits exceeds this, any excess will result in a tax charge of 25% if it is withdrawn as an income (e.g. annuity or flexi-access drawdown) or 55% if taken as a cash lump sum.

TAX MATTERS

Below is a summary table outlining the tax positions of each option.

	ISA	LISA	PENSION
Funds In	No tax relief on contributions	25% Government bonus equates to 20% tax relief	Income tax relief on contributions at highest marginal rate(s)
Investment Returns	No tax paid on income and gains	No tax paid on income and gains	No tax paid on income and gains
Funds Out	Not subject to income tax or capital gains tax	Tax-free if used towards first home in the UK after at least 12 months; the house can be worth up to £450,000 Tax-free from age 60 or on diagnosis of terminal illness Can access earlier, but subject to 25% deduction	25% of fund paid as tax-free cash Remaining fund subject to income tax at highest marginal rate(s)
Workplace Arrangements	Employer cannot contribute	Employer cannot contribute	Employer can contribute Employer contributions exempt from employer NI, employee NI, and income tax Employer/employee NI savings possible via salary sacrifice
Death Benefits before age 75	Forms part of estate and subject to inheritance tax (IHT) if estate exceeds nil-rate band and not left to exempt beneficiary Spouse/civil partner can inherit additional ISA allowance based on value of deceased's ISA funds	Forms part of estate and subject to IHT if estate exceeds nil-rate band and not left to exempt beneficiary Spouse/civil partner can inherit additional LISA allowance. It will count towards the LISA payment limit but not the annual overall ISA allowance	Paid as a lump sum, annuity or drawdown to nominated beneficiary free of all tax. Lifetime allowance restrictions can apply Does not normally form part of member's IHT estate
Death Benefits age 75+	Forms part of estate and subject to IHT if estate exceeds nil-rate band and not left to exempt beneficiary Spouse/civil partner can inherit additional ISA allowance based on value of deceased's ISA funds	Forms part of estate and subject to IHT if estate exceeds nil-rate band and not left to exempt beneficiary Spouse/civil partner can inherit additional LISA allowance. It will count towards the LISA payment limit but not the annual overall ISA allowance	Paid as a lump sum, annuity, or drawdown to a nominated beneficiary and taxed at their marginal rates of income tax. Does not normally form part of member's estate

As shown in the table above, the tax position of all three options is the same while funds are invested, as no tax has to be paid on the funds on any income or gains. The differentiating factor is that pensions receive income tax relief on the contributions, but then pay income tax when funds are taken out, whilst ISAs and LISAs are paid in using taxed income yet receive tax-free withdrawals (note restrictions for withdrawals in LISAs). It could be argued that from a pure tax point of view, LISAs offer the best of both, with the Government bonus added to the savings and no tax to pay on withdrawals.

HOW DO THE NUMBERS COMPARE?

EXAMPLE 1

Tommas is 36, self-employed and earns £34,000 per annum and expects to be a basic-rate (20%) taxpayer in retirement. He aims to retire at age 66. He pays in £2,500 gross, and his fund grows 3% net every year.

	ISA	LISA (one-off contribution)	PENSION (basic-rate)
Investment (+relief/bonus)	£2,000	£2,500	£2,500
Fund value after 30 years	£4,854.52	£6,068.16	£6,068.16
Value on withdrawal	£4,854.52	£6,068.16	£5,157.93

We can see here that a LISA produces the higher value on withdrawal.

However, it is common that the tax relief gained from pension contributions will be greater than the tax paid on withdrawal, as many pay a lower rate of income tax when they come to take their pensions out (e.g. from higher-rate to basic-rate). At least some of the pension income withdrawn is also likely to fall within the tax-free personal allowance (£11,500 for 2017/2018, £11,850 for 2018/2019). This, combined with the 25% tax-free cash available from a pension, means that a pension can often produce a better outcome.

EXAMPLE 2

Christine is 32, self-employed and earns £55,000 per annum and expects to be a basic-rate (20%) taxpayer in retirement. She aims to retire at age 63. She pays in £4,000 gross, and her fund grows 4% net every year.

	ISA	LISA (one-off contribution)	PENSION (higher-rate to basic-rate)
Investment (+relief/bonus)	£4,000	£5,000	£6,667*
Fund value after 31 years	£13,492.53	£16,865.67	£22,488.68
Value on withdrawal	£13,492.53	£16,865.67	£19,115.38

*The contribution is higher because it anticipates higher-rate relief which is received through self-assessment tax returns.

Here, a pension brings the highest returns. If Christine were to be employed by a company, then the pension figure would be significantly higher, as she would be in a workplace pension within which her employer has to contribute at least 3% by 2019 under auto-enrolment rules.

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DEATH BENEFITS

Pensions have advantages in relation to death benefits. The benefits from a pension are normally outside of the member's IHT estate whereas with an ISA/LISA they will form part of the estate. It is also possible to pass pension funds down through the generations outside of anyone's estate, while keeping the funds invested in tax efficient beneficiary's drawdown. With an LISA/ISA, on death the allowance can pass to a spouse but it doesn't offer the wider IHT planning options and advantages of a pension.

SO, WHICH SHOULD CLIENTS CHOOSE?

The answer largely depends on the client's situation e.g. age, employment status, access requirements and the amount of funds available.

When it comes to age limitations, the LISA is by far the most restricted in every aspect. Contribution limits are also much lower than an ISA (£20,000) and a pension (£40,000 with the flexibility of carry forward).

The advantage of the ISA is the ability to withdraw funds at any time. LISAs can also be accessed, although this comes at a significant cost of the 25% penalty. However, it does provide greater flexibility than a pension.

Where a LISA may be more suitable for saving for retirement is for basic-rate tax paying self-employed clients who won't benefit from an employer contribution. The introduction of auto-enrolment in the workplace obliges employers to make contributions into a pension. This gives pensions an upper hand for those who are enrolled into a workplace pension.

Overall, it appears that a pension remains the best vehicle for many clients saving for retirement, especially if they also want to leave some of the money to their children. Nonetheless, there is certainly no harm in attaining the flexibility of the ISA/LISA and the tax benefits of a pension by ultimately funding both.

Note: Scottish resident taxpayers will have their own income tax rates and bands from 2018/2019 which may affect the tax outcomes in our examples.