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ISA or pension – which should I take first?

You may have heard that it's more tax efficient to draw money from ISAs before pensions in retirement, and that personal pensions are something taken at a specific retirement age, such as an employer's 'retirement date' or when the state pension kicks in.

While this strategy may work for some people, many of those retiring before the state pension age could

end up with a bigger tax bill by only withdrawing income from ISAs.

This can be beneficial as far as inheritance tax on early death, but they run the risk of not utilising multiple years of their tax-free personal allowance.

Our case study shows that someone ceasing work at age 60 could potentially save tens of thousands of pounds in tax by drawing some of their income from pensions as soon as they retire, but in a controlled way. Read on to find out why.



How ISAs and pensions are taxed

The reason why it's often considered better to deplete ISAs before pensions in retirement is due to the way they're taxed.

Although ISAs don't provide tax relief on contributions, withdrawals are completely tax free. Personal pension contributions benefit from income tax relief, but when you come to draw an income from the pension, usually only 25% can be taken tax free and the rest is taxed at your marginal rate of income tax.

Another key difference between ISAs and pensions is the way they're treated for inheritance tax (IHT) purposes. While your spouse or civil partner can inherit your ISA tax free, if you pass it on to anyone else it will form part of your estate and be liable for IHT. Pensions usually sit outside your estate, which means they can be passed on to any beneficiaries free of IHT.

The theory is that by drawing money from ISAs first, you'll benefit from more tax-efficient retirement income and pass on a bigger pot of money to your loved ones.

The role of the personal allowance

In reality, things are not quite so clear-cut. The approach that's right for you will depend on your individual circumstances and what you want to achieve with your money. For example, if your ISA is big enough to last throughout your retirement, it may well be better to deplete your ISA and leave your pension fund untouched for the next generation.

Drawing money from ISAs first could also make sense if you're already receiving your state pension. The state pension is currently £10,600 a year. This pretty much uses up the £12,570 tax-free personal allowance. If you made personal pension withdrawals on top of this, you could pay tax on the lion's share of your pension income. You may also wish to leave your pension untouched if you think you'll want to contribute to it again in the future. Once you start drawing taxable income from a defined contribution pension, the maximum amount you can contribute each year and still get tax relief falls to £10,000.

On the other hand, if you retire earlier than the state pension age, taking some pension income as soon as you retire could prove tax efficient. The £12,570 personal allowance can't be carried forward from one tax year to the next, so if you were to draw all your income from ISAs, your personal allowance would effectively be wasted. Over time, failing to utilise your personal allowance could result in a bigger-than-expected tax bill.

Let's imagine you cease work at age 60 and decide to draw all your income from ISAs until the state pension kicks in at age 67. You won't pay any income tax during those seven years because ISA withdrawals are tax free. However, depleting your ISAs means the proportion of tax-free income you can draw in later years could be considerably smaller than if you'd accessed your pension earlier. The case study below illustrates the potential tax savings that could be made by taking some pension income from age 60.

Case study

Please note that these calculations do not take into account investment growth, charges or inflation.

Andrea retires at age 60 with £245,000 in an ISA and £950,000 in a personal pension. Andrea wants to be able to spend £35,000 a year in retirement. She plans to make tax-free withdrawals from her ISA until it runs out at age 67, after which she will draw her state pension and start accessing her personal pension. Andrea won't pay any income tax in the first seven years of retirement, but between the ages of 67 and 74, she'll pay almost £27,000 in tax.

Following a recommendation by her financial adviser, Andrea instead draws £16,000 a year from her personal pension from age 60. Of this, £4,000 is pension tax-free cash and £12,000 falls within the personal allowance. The remaining £19,000 a year comes from tax-free ISA withdrawals. From age 67, Andrea draws her state pension, plus £16,000 a year from her ISA, and £9,420 a year from her personal pension. She pays no income tax in the first seven years of retirement, and between the ages of 67 and 74 her tax bill is just over £7,000. The table on the next page shows that by drawing some of her pension from age 60, she saves nearly £20,000 in tax.

Case study: ISAs vs pensions in retirement

	Original situation	Taking some pension from age 60
Age 60 to 67	<ul style="list-style-type: none"> • Draw £35,000 pa from ISA 	<ul style="list-style-type: none"> • Draw £16,000 pa from personal pension (£4,000 tax-free, £12,000 within personal allowance) • Draw £19,000 pa from ISA
Situation at age 67	<ul style="list-style-type: none"> • ISA value = £0 • Pension value = £950,000 • Tax paid = £0 	<ul style="list-style-type: none"> • ISA value = £112,000 • Pension value = £838,000 • Tax paid = £0
Age 67 to 74	<ul style="list-style-type: none"> • Receive £10,600 pa from state pension • Draw £28,242 pa from personal pension (25% tax free; £3,842 pa tax on income) 	<ul style="list-style-type: none"> • Receive £10,600 pa from state pension • Draw £16,000 pa from ISA • Draw £9,420 pa from personal pension (25% tax free; £1,019 pa tax on income)
Situation at age 74	<ul style="list-style-type: none"> • ISA = £0 • Pension value = £752,306 • Tax paid = £26,896 	<ul style="list-style-type: none"> • ISA = £0 • Pension = £772,060 • Tax paid = £7,133

Source: RBC Brewin Dolphin. Calculations do not take into account investment growth, charges or inflation.

Next steps

Deciding how to draw a tax-efficient and sustainable retirement income can be complicated, and that's where getting some smart advice comes in. At RBC Brewin Dolphin, we can build a plan that is tailored to your individual circumstances, and help you feel confident you're doing the right thing with your money.



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