Saving for retirement – Pensions and ISAs

Sooner or later we all have to think about how we'll manage financially when we retire. State handouts may not be enough to see you through retirement. So what else can you do to gain extra income?

Fairly small changes now can make a big difference to your future lifestyle. So with a bit of planning, you can do a lot to prepare for retirement. Here are some useful tips to help get you started.

Pensions

Most people will qualify for the basic State Pension and some for the additional State Pension (whether from SERPS – State Earnings-Related Pension Scheme, or from the State Second Pension), but what you get depends on your circumstances. You can also add to your retirement provision by putting money in a pension either through a company pension scheme or by starting your own personal pension.

A pension is a long-term investment. The money you pay in is invested and used to provide an income when you retire. Exactly how this is done depends on the type of pension you have. You can't touch the money until you are at least 50 (going up to 55 in April 2010) so it's your long-term prosperity you're saving for.

A major advantage of saving for retirement through a pension plan is the tax relief available on your contributions: each £100 investment you make into your pension will only cost £80 – the taxman pays the rest. In addition, if you pay tax at the higher rate you can claim the difference through your tax return. Even modest amounts saved now could make a big difference years later. You can get tax relief on contributions of up to 100% of your earnings (salary and other earned income) each year, provided you pay the contribution before you reach 75. But the amount you save each year towards a pension is subject to an 'annual allowance'. For the tax year 2009-10 the annual allowance is £245,000.

If you are a child under 18 or an adult without earnings you can still make pension contributions through a stakeholder pension and benefit from tax relief on the contributions you pay in. You can contribute up to £2,880 in any one tax year and the Government will top this up with another £720 of tax relief, providing total pension savings of £3,600 per year.

Your pension fund doesn't pay tax on any capital gains or investment income. Also, when your pension matures you can take up to 25% of it as a tax-free lump sum, provided your pension scheme rules allow it, you are under 75 and your total savings are within the 'lifetime allowance' for the year in which you take your benefit. For the tax year 2009-10 the lifetime allowance is £1.75 million. Lump sums or income drawn from savings above the lifetime allowance will be subject to tax charges.

Although you don't have to join a company pension scheme, it's usually a good idea to do so, because your employer may also pay into it and you often get other benefits. You may also be able to top up your employer's contributions up to the annual allowance and receive tax relief on your contributions. The Government is planning changes from 2012 that mean all employers will have to offer and pay into a pension in the future, through the Personal Account scheme.

There are lots of different long-term savings and investments you could use in addition to a pension to save for your retirement. However, it's worth noting that although you may be able to get your money sooner, you won't get the benefit of tax relief and you may also pay tax on the interest or other income you earn.

Individual Savings Accounts (ISAs)

ISAs can work well with pensions to build your retirement strategy. Although often overlooked, they are tax-efficient savings wrappers and can play a pivotal role in even the simplest of financial plans. Make use of the annual allowance on offer each year – all growth is exempt from Capital Gains Tax and any Income Tax payable has already been deducted. For the tax year 2009-2010 the annual ISA limit is £7,200. However, the annual ISA limit for those 50 or over by 5 April 2010 has recently increased to £10,200 of which a maximum of £5,100 can be held in a Cash ISA. All ISA investors will be able to take advantage of the new limits from 6 April 2010.

There are a number of circumstances in which you might consider using an ISA to build up an income in retirement. For example, if you will be liable to at least 20% tax on all your retirement income withdrawals, and you are a basic rate tax payer when paying into the pension. You might also choose an ISA for the ease of access to capital and flexibility of income.

If you can afford it, it's best to think of an ISA as an additional savings plan for retirement rather than a pension replacement. While an ISA does offer greater flexibility and control over capital, in many cases these freedoms will not be sufficient to offset the advantages of using a pension. The chief attraction of ISAs is that you can save in cash or shares, or both, and your savings are not hit by the taxman (although as in a pension the 10% tax credit already paid on dividends cannot be claimed back).

Access to cash is another ISA benefit as you are free to withdraw capital or income at will, tax free. But once you've invested your annual limit, you cannot pay more in, even if you have made a withdrawal. Also, bear in mind that access to capital can be a mixed blessing. If the intention is to save for retirement, then the fact that the investments can be cashed in easily is not necessarily a good thing — you can't live off your ISA investments in retirement if you cashed them in beforehand. In contrast, pension savings are subject to tight restrictions as to how they are paid out. The Government insists that money accumulated in a pension should be used primarily for the purpose of providing a retirement income.

Note that the tax treatment of pensions and ISAs depends on your individual circumstances and may be subject to change in the future.

At a glance

Most people get a state pension.

You can supplement this with a company or personal pension.

Tax relief is available on pension contributions up to an annual allowance.

ISAs offer a tax-efficient way of boosting your retirement income.

Our offerings

At The Share Centre we offer both a Stakeholder Pension in association with Legal & General and a Self-Invested Personal Pension (SIPP) in association with Sippdeal, along with Stocks & Share ISAs and a range of share accounts. We also offer a cost-effective dealing package suitable for investors who wish to make regular investments. And if you are a frequent trader consider our 'Trader' option which costs just £20.00 + VAT per quarter. It enables you to buy or sell shares up to the value of £25,000 for a flat dealing commission of £7.50. Deals over this size are charged at an additional £7.50 per £25,000 of value, or part thereof.

Financial planning needs to be tailored to your personal circumstances. Simple, effective budgeting and planning now, and marrying your incomings and outgoings with your future aspirations, will give you a better chance of reaping rewards in retirement. And don't forget, if you need some help deciding which investments are most likely to improve your chances of having the retirement lifestyle you dream of, our Advice team offers expert investment advice at no additional cost.