Lifetime ISA v pension v ISA

As from April 2017, a new variant of the ISA will become available to investors under the age of 40, namely the Lifetime ISA, or 'LISA'.

Investors' contributions will be limited to £4,000pa, but unlike standard ISAs, LISA investments will be topped-up by the Government with a 25% bonus on all contributions made before the age of 50, so that those making the full £4,000 contribution will receive a top-up of £1,000.

Sums invested can be drawn from the age of 60 to provide income or capital for retirement, or they can be drawn earlier to fund the purchase of a first-time home with a value up to £450,000. Withdrawals made in any other circumstances will forfeit the Government bonuses and growth on those bonuses and incur a 5% penalty.

Comparing LISAs with pensions, both offer tax-assisted investment growth, but where the pension provides tax relief on contributions at the investor's highest marginal rate, the 25% top-up on the LISA equates to only basic rate tax relief of 20%. The big unknown here is that the Government may well at some future date (possibly the March 2017 Budget?) reduce the rate of tax relief on pensions.

Another factor favouring pensions is that tax relief is immediate for basic rate taxpayers, whereas the LISA bonus is not paid until the end of the year in which each contribution is made. Also, pension funds can be drawn at age 55, whereas the LISA investor must wait until age 60.

A major plus point for LISAs is that withdrawals will be tax-free whereas, apart from the 25% which can be drawn as tax-free cash, pension fund withdrawals are subject to Income Tax at the tax-payer's highest marginal rate.

So, overall the LISA is likely to be a better proposition for the basic rate taxpayer; and it is markedly superior for anyone who might be a basic rate taxpayer when contributing a higher rate taxpayer when drawing benefits.

By contrast, pensions are more likely to appeal to people who can claim higher rate tax relief on contributions but expect to be basic rate taxpayers in retirement – subject again to any changes in the relief available on contributions.

Pensions also win if employers are contributing. LISAs cannot accept contributions from employers, but pension contributions can be paid by employers and have the advantage of being exempt from National Insurance contributions.

Some employees ask their employers to reduce their salary and pay an equivalent amount, plus the employer's saving in NI contributions, as pension contributions – an arrangement known as 'salary sacrifice'. This practice has become so popular (and therefore costly to the Government) that it may not be available for much longer.

The limiting factor with LISAs is the low contribution limit. This is consistent with the fact that the main beneficiaries will be basic rate taxpayers and new home owners, and suggests that this new product is aimed primarily at the younger generation, who might progressively be weaned off the assumption that pensions (which are expensive for the Government to subsidise) should be regarded as the automatic means of providing for retirement.

For higher rate taxpayers and more mature investors, standard ISAs (for which the contribution limit will rise to £20,000 in April 2017) will continue to be attractive, ideally as a complement to pensions. It will not be permitted to invest in both LISAs and standard ISAs.

Dividend changes for employees

With effect from 6 April 2016, the way in which share dividends are taxed has changed; and the change will affect shareholder directors who have benefited from drawing remuneration in the form of dividends rather than salary, and thereby avoided the impact of National Insurance contributions.

Of particular concern to HMRC have been the personal service companies which have been set up for computer consultants and other freelancers who would otherwise have either been self-employed or employed by the firms for which they work, and thereby subject in either case to NI contributions.

Before the changes, dividends carried a 10% tax credit, which was added to the amount of the dividend to produce a gross sum on which tax was then levied. So a £1,000 dividend would give rise to a taxable receipt of £1,111. Now, tax is levied simply on the amount of dividend received.

Under the new arrangements, the first £5,000 of dividends received in any tax year is excluded from tax (although included as income for the purposes of calculating liability to higher rate tax).

Dividends in excess of £5,000 p.a. are subject to tax at 7.5% in the hands of basic rate taxpayers; 32.5% in the hands of higher-rate taxpayers; and 38.1% in the hands of additional rate taxpayers. The tax rate applicable to trusts is also 38.1%, though the first £1,000 is taxed at basic rate. However, trusts do not have the benefit of the £5,000 'allowance'.

The net result is that it is clearly advantageous for a shareholder director to draw a dividend of up to £5,000 in lieu of salary, because this is subject neither to tax nor NI contributions. However, the possible savings on larger dividends are smaller.

Basic rate taxpayers and non-taxpayers do not gain any advantage from the £5,000 allowance and will be worse off if they receive dividends in excess of this amount, on account of the 7.5% tax charge.

If you would like to discuss any of these matters further please contact:

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