Pensions vs ISAs:
Which Should You Prioritise?

26th August 2025

One question we are frequently asked is "should I be paying into my pension or my ISA?" The answer tends to be the same... it depends!

This article aims to serve as a quick guide to what it depends on, without intending to be an exhaustive study of the differences between these two types of account.

Both pensions and ISAs are tax efficient vehicles that can be great places to invest over the longer term. Although they have many similarities, they also have important differences of which investors must be aware.

In short:

- Pensions give you tax benefits on the way in.
- Both give you tax benefits for the duration of investment.
- ISAs give you greater tax benefits on the way out.

Entire books have been written on pension and ISA legislation (which I have had the privilege to read, so you don't have to) and therefore it would be extremely ambitious to cover everything in this article. That said, I will do my best to cover what I believe to be the main points to consider when deciding whether to invest in a pension or an ISA. As always, it is essential to take advice which is specific to your circumstances and objectives, and note that the value of any investments held in these accounts will fluctuate in line with investment conditions.

Tax Relief

Personal contributions into UK pension schemes by UK resident taxpayers qualify for tax relief. What this means is that when you pay money into a pension using after tax income, you get back the tax that you would have already paid on that money. For basic rate tax payers, the tax relief will be automatically paid into your pension with any higher or additional rate tax relief claimed through a Self Assessment tax return.

For example, an £80 contribution will get uplifted to £100 inside your pension fund once basic rate tax relief is added. ISAs on the other hand have no such tax relief, so an £80 contribution stays as an £80 contribution. As part of your employment, your employer may also offer matched pension contributions, which again, means more money into your pension relative to an ISA.

Investment Growth

Generally speaking, pensions and ISAs are able to access the same investments as each other. Additionally, they both benefit from no tax on capital gains, dividends, and interest made on investments within the accounts. Outside of these tax wrappers, any investment gains made would be liable to Capital Gains Tax at the new rates of 18% or 24%. This is clearly a positive for both pensions and ISAs but does not put one in front of the other in this regard.

Withdrawals

When it comes to accessing your funds, ISAs offer access to the money at any time without penalty (with the exception of the Lifetime ISA) with no tax payable on withdrawal. On the other hand, only 25% of your pension savings (usually up to the lifetime limit of £268,275) can be taken tax free with the rest being liable to Income Tax at your marginal rate. It is worth noting that the taxable element of a pension fund can be offset against your tax-free Personal Allowance, currently £12,570, provided your other income is below this amount in the tax year.

Unlike ISAs, pensions are not accessible until you reach a certain age (the Normal Minimum Pension Age). That age is currently 55 but will soon be moving to 57 and likely 58 after that. This may initially appear like a clear win for ISAs; however, the access restrictions to pensions could perhaps force discipline in letting the investments grow for a longer period of time.

Contribution Limits

With both pensions and ISAs, there are restrictions to the amount of money you can pay in each year. For ISAs this amount is £20,000 in the current tax year. For pensions, it is the lower of £60,000 and your UK relevant earnings. If you have little to no earnings, you are still able to contribute £2,880 which is increased to £3,600 once tax relief has been applied. Any unused allowance from the previous three tax years can be carried forward and used in the current tax year (if earnings can support it). This is not possible for ISAs and therefore unused ISA allowance is lost.

Note also that for earners with adjusted income over £260,000 pa, the pension Annual Allowance is reduced by £1 for every £2 above this amount to a minimum of £10,000 (the Tapered Annual Allowance). To open and contribute to an investment ISA you must be over 18 and a UK resident, regardless of how much you earn. Junior ISAs are also available for UK residents under the age of 18.

When are ISAs better?

ISAs tend to be better for investors who are looking for flexibility and simplicity. Typically, when there is a chance that the money may be needed prior to reaching the Normal Minimum Pension Age, ISAs are preferred.

Additionally, once a flexible withdrawal is taken from a pension fund, you are then limited to the amount you can contribute to a pension in the future to £10,000 per annum; this is called the Money Purchase Annual Allowance (MPAA). This will limit scope to build up further retirement savings significantly. Therefore, an ISA may be a better option for saving for a large expenditure, such as a house, when you are still looking to invest for retirement after the purchase.

When are pensions better?

Primarily, pensions are best for investors who are looking to invest money to fund retirement. There is also the added bonus that you can reduce your immediate tax liability by way of tax relief. In effect, this means that you will have more money in your pension to grow tax-free for retirement.

Pensions are particularly effective for higher earners as they are able to claim additional tax relief on top of the basic rate that gets added to their plan. If an individual has earnings between £100,000 and £125,140, the effective rate of tax relief will be 60% on pension contributions as not only will they get 40% Income Tax relief, but they will also reinstate their tax-free Personal Allowance (which is lost as earnings go above £100,000).

Pensions also currently sit outside of your estate of Inheritance Tax and can be an efficient way to pass on wealth. This favourable tax treatment is due to be removed from 6th April 2027 as announced in the Autumn Budget 2024.

Conclusion

As mentioned at the start, a comprehensive review of pensions and ISAs is beyond the scope of this article. Pensions and ISAs have various other features that can be utilised to achieve your financial objectives and also important considerations before investing. For example: corporation tax relief for business owners; salary sacrifice to reduce National Insurance contributions; or Lifetime ISAs to purchase a first home.

To answer the original question of which one you should contribute to, it ultimately depends on your goals. If your goal is to save money for retirement and you do not need to access the money until then, or if you would like to save on tax in the short term, pensions will likely be best for you. However, if you are looking to invest some money but want to retain flexibility of when you can access it, an ISA may be a better option.

In practice, many investors benefit from using both pensions and ISAs to balance long-term retirement planning with short-term flexibility. As the correct financial decision will always depend on your individual circumstances and goals, taking financial advice helps to ensure that your strategy is suitable for you.

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August 2025

This article is not a recommendation to invest and should not be construed as advice. The value of an investment can go down as well as up, and you may get less back than you invested.

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