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€? QUESTION OF MONEY

I'm 49, single and a good saver. I've €40,000 on deposit, which would see me right for six months-plus if I were to lose my job. I also save into a pension but a friend suggested I stop saving into my deposit account altogether and just save into my pension. I have €150,000 in my pension already so I'm reluctant; what are your thoughts?

Anonymous

I'm going to make a few assumptions: that you earn little or nothing on your deposit account; that you earn an average of 5 per cent after charges on your pension fund; that you pay tax at 40 per cent; that your total pension savings won't exceed Revenue limits; and that the tax rules surrounding pensions won't change in the near future.

When you save into a deposit account, you do so using "after tax" income, on which you have paid income tax, the universal social charge (USC) and pay-related social insurance (PRSI). Hence the funds are only about half what they were as gross income. The money you save into a pension fund, however, effectively comes out of your "before tax" income, subject to certain limits.

Your money on deposit is not likely to grow as it's probably not attracting any interest, although it is safe and readily accessible. The money in a pension fund is usually invested in a mix of shares, bonds and cash, and past experience indicates it should grow at a reasonable rate. This is not guaranteed; it could fail to grow, or even reduce in value, and you cannot access it in the same way that you can with your deposit account.

Take a simple example. You decide to save €100 out of your gross income. If you put it into a pension fund and it grows at 5 per cent a year for 18 years until you are 67, it should be worth about €240. If you put it into your deposit account, you first have to pay tax, PRSI and USC, leaving you with €48. If you get no interest, it will still be worth €48 in 18 years' time, and inflation may also have reduced its real value.

After 18 years you're free to spend the €48 on deposit as you wish, whereas drawing down the €240 in your pension fund is more complex. One quarter of it (€60) can be withdrawn tax-free and the balance either left to support an income (subject to income tax) or fully withdrawn, subject to 20 per cent tax and some limits. So you end up with €60 plus (€180 less 20 per cent tax = €144), giving you €204 — far better than €48. The amount of tax you pay will depend on your circumstances and the value of your pension fund when you retire.

So, which should you go for? The answer is both. Most advisers suggest you retain a rainy-day fund of about six months' net income in a deposit account and put the rest into a pension. As you already have that, you should probably save everything else into a pension fund. We advise you to talk through your options with a financial broker before you make any decision.

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Send your personal finance or consumer-related questions to money@sunday-times.ie