Introduction

Individual savings accounts (ISAs) are now the first port of call for many investors seeking a tax-efficient way of holding fixed interest securities, equities, unit trusts, open-ended investment companies (OEICs) and bank deposits. ISAs have been in existence since April 1999, when they were launched to replace two other widely used savings vehicles, namely PEPs and TESSAs.

Personal equity plans (PEPs) were introduced by Nigel (now Lord) Lawson in his 1986 Budget. At the time, the aim was to 'broaden and deepen' share ownership by building on the successful privatisation programme. In the event, the first year that PEPs became available – 1987 – coincided with a serious stock market crash, which did nothing for the new plan's popularity.

By the following year, poor demand and administrative difficulties had driven some providers to stop offering PEPs: the Chancellor's brainchild looked set for failure. The government's response was to start a restructuring process for PEPs, which continued right up until the time PEPs were replaced for new investments by ISAs in April 1999. During its 21-year life, the PEP changed from being a vehicle primarily for direct investment in UK shares to a tax-efficient way of holding collective investments, such as OEICs. In April 2008, all PEPs became stocks and shares ISAs and the PEP legislation was repealed.

The tax exempt special savings account (TESSA) was the surprise element of John Major's one and only Budget in 1990. It was effectively a five-year tax-free savings plan linked to bank and building society deposits. The TESSA's success was such that ahead of the first accounts' five-year maturity date being reached in January 1996, the government became fearful of the accumulated savings that would be released to consumers. The then Chancellor responded with rules to allow the original capital in a TESSA to be reinvested in a new 'rollover' TESSA, sometimes called a TESSA II. No new contributions were permitted to the new plan.

TESSAs were also replaced by ISAs from April 1999. However, existing TESSAs were allowed to continue until the end of their five-year term and contributions could still be made to plans that had not received rollover monies. The last TESSAs matured in early April 2004.

The ISA is a more complex plan than its two predecessors, but it has nevertheless become a popular investment because of its tax benefits. Income and gains are broadly tax-free. However, despite much lobbying, the ability to reclaim the 10% tax credit on UK company dividends was withdrawn from 6 April 2004.

ISA investment components

ISAs have two distinct investment components:

- Cash.
- Stocks and shares.

Transfers from the cash component to the stocks and shares component (but not vice versa) became possible from 6 April 2008.

A third component, life assurance policies, was merged with the stocks and shares component from 6 April 2005. Only a handful of companies offered the insurance component and its disappearance was largely seen as a sensible piece of rationalisation.

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Cash component

The cash component's eligible investments include:

- A cash deposit or share account with a building society.
- A deposit account with any authorised bank, whether UK or European. In practice some banks have offered deposit accounts with 'interest' linked to stock market returns. These have primarily been aimed at larger sums derived from earlier TESSA reinvestments.
- Units in a money market fund or money market fund of funds that are authorised by the Financial Services Authority (FSA). Some 'cash' funds fail to qualify because they hold short-dated negotiable securities, and are therefore classified as securities funds.
- National Savings products excluding National Savings certificates and premium savings bonds that are specifically issued on terms that allow them to be held in the cash component.
- Certain life assurance policies and collective investment schemes which either:
  - ➢ Guarantee to return at least 95% of the original investment during the first five years of the investment, or
  - ➢ Have investments that significantly limit the risk to the investor's capital to a 5% loss or less at any time in that five-year period.
- Stakeholder cash deposits.

Stocks and shares component

The stocks and shares component's eligible investments include:

- Authorised securities or warrant funds in unit trusts and OEICs, but not money market and certain 'protected' funds. There are virtually no geographical restrictions on where the funds can invest.
- Investment trust shares listed on the London Stock Exchange.
- Shares in UK real estate investment trusts (REITs).
- Shares officially listed on any international stock exchange recognised by the Treasury. This does not include, for example, AIM listed shares, unquoted shares, warrants and futures and options.
- Shares originating from a save as you earn (SAYE) share option scheme, approved profit-sharing scheme or approved share incentive plan of the investor's employer. These can be transferred into an ISA within 90 days of receipt, free of capital gains tax (CGT) (see page 4, "Tax treatment"). There is no requirement to retain the shareholding after it has been transferred into an ISA.
- Most European government bonds and corporate bonds of listed companies, provided they do not mature within five years of the date of acquisition.
- Any EU-based collective fund (similar to OEICs) that satisfies the EU rules and the relevant ISA investment restrictions (eg no more than 50% in fixed interest securities which have less than five years to maturity when first purchased by the fund).
- Certain life assurance policies that do not guarantee a return of at least 95% of the amount invested during the first five years of the policy's life.
- Stakeholder medium-term products.

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- Cash, but only for future investment in any of the above.
- Any FSA authorised retail collective investment scheme, be it onshore or offshore, within or outside the EU fund rules. The only two provisos are that funds must not restrict access (thereby excluding limited redemption funds) and 'cash-like' funds may only be held in the cash component.

ISA eligibility

To be eligible for an ISA, the investor must be:

- Aged 18 or over for the stocks and shares component. Since 6 April 2001, the minimum age for investors in the cash component has been 16.
- Resident and ordinarily resident in the UK for tax purposes or a Crown employee working overseas.
- Investing their own money. This can include gifted money, so a parent could write a cheque to open their child's ISA, provided the child was eligible.

ISAs cannot be arranged on a joint basis or be held by trustees. Once the investment has been made, the tax benefits of the ISA will continue, even if the investor becomes unable to make further subscriptions because they have become resident abroad.

ISA account structures

There is now only one type of ISA structure, but before 6 April 2008 there were two different types of ISA:

- The maxi-ISA, which had to offer a stocks and shares component, and could also offer the cash component. Investors could choose to invest in any one or both of the components offered.
- The mini-ISA, which consisted of a single investment component, ie cash or stocks and shares.

The removal of the distinction between mini-ISAs and maxi-ISAs from 6 April 2008 was welcomed by providers as a long overdue simplification.

The total annual subscription limits for 2009/10 are based on the component:

Date of birth	Date of investment	Cash component	Stocks and shares component
6 April 1960 or later	2009/10	£3,600	Remaining balance up to £7,200
5 April 1960 or earlier	Until 5 October 2009	£3,600	Remaining balance up to £7,200
	From 6 October 2009	£5,100	Remaining balance up to £10,200

Anyone who is 50 and over in 2009/10 has an increased subscription limit. The increase is, however, not effective until 6 October 2009, so if an individual had subscribed £3,600 in the first

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part of the tax year to a cash ISA, then they will be able to subscribe a further £6,600 after the 6 October. This could be up to £1,500 in the same cash ISA, or up to £6,600 in a stocks and shares ISA with either the same or another provider.

All of the subscription up to £7,200/£10,200 May be placed in the stocks and shares component if the cash component is not selected. The £10,200/£5,100 investment limits will apply to all eligible investors from 6 April 2010.

Tax treatment

- A review of ISAs was undertaken by the Treasury in 2006, following which the government said that ISAs will be 'a permanent part of the savings landscape'. This removed doubts about whether the existing tax regime for ISAs would end in April 2010.
  - For both investment components, there will be no personal CGT or income tax liability and thus nothing to report on the investor's annual tax return.
  - The CGT exemption is less valuable than it might seem – only an estimated 350,000 individuals and trusts were liable to CGT in 2008/09. The introduction of an 18% flat rate of CGT and the abolition of taper relief have reduced the value of the exemption and increased the number of CGT taxpayers.
  - There are no minimum holding periods to benefit from these tax advantages, which contrasts with the five-year term which applied to TESSAs.
- Until 5 April 2004, ISAs benefited from the 10% tax credit attaching to the dividends from UK shares, unit trusts or OEICs which were held in the stocks and shares component or as part of the underlying assets of the insurance component. Now only higher rate taxpayers benefit from receiving dividends via an ISA.
- For example, on a £7,200 investment invested in the UK stock market at the current average yield of about 4.8%, the income tax benefit for a higher rate taxpayer is around £86 a year, because the additional 22.5% tax on dividends is still avoided. The value of the benefit will increase for those who become 50% taxpayers in 2010/11 (the additional tax charge on dividends will be 32.5%).
- Fund charges were and are typically greater than the income tax savings, although for collective investments, such as OEICS and unit trusts, identical costs will usually be incurred outside the ISA wrapper.
- For fixed interest securities held in the stocks and shares component or underlying the insurance component, the 20% tax normally deducted from interest payments can be reclaimed by the ISA manager. There was no April 2004 cut-off. £80 net interest is therefore worth £100 within the ISA.
- Most income from REITs is received gross. The Finance Act 2008 extended the same gross treatment to property OEICs, but not property unit trusts. However, existing funds are structured as unit trusts, not OEICs, and suffer 20% tax on their income while paying dividends with a 10% non-reclaimable tax credit.
- On income tax grounds alone, this makes it more attractive to hold bonds and REITs than equities in the stocks and shares component.
- Any interest earned on cash held separately (not within funds) under the stocks and shares or insurance components is subject to a flat 20% charge within the ISA, irrespective of the investor's personal tax rate.

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- Only interest earned on cash in the cash component of an ISA is tax-free. Even then, if the cash in the ISA of a child aged under 18 originated from a parent, tax could be chargeable on the parent if the total ISA interest, together with any other income from that parent's gifts, exceeds £100 in a tax year.
- With the exception of shares originating from some company-wide employee schemes (see page 1, "ISA investment components"), shares cannot be transferred directly into an ISA.
- Some ISA managers offer a 'bed and ISA' option under which individual holdings may be sold and then repurchased within the ISA on preferential terms.
- This counts as a disposal for CGT purposes, but is not caught by the anti-avoidance legislation designed to counter 'bed and breakfasting' of securities.

ISA charges

There is a wide variety of charging structures for ISAs.

At the outset of ISAs, the Treasury introduced a voluntary maximum charging regime (see page 6, "Stakeholder standards"), but take-up was much lower than the government had hoped, as most fund managers believed the level of fees to be too low for anything other than an index tracking fund.

From April 2005, the CAT (charges, access, terms) standard was replaced by stakeholder standards. Like CAT standards, these are voluntary and, like CAT standards, they have had little success in the marketplace.

- For unit trusts and OEICs held in the stocks and shares component, initial charges range from 0% to as much as 6%, while annual management charges typically vary between 0.5% and 1.75%. Other charges, such as custody fees, are usually levied in addition.
- Investment through internet-based fund supermarkets or discount investment brokers can usually significantly reduce or even eliminate initial charges.
- Rebates on the annual management charge are much rarer and usually worth no more than about 0.25% a year.
- Bond funds and index tracker funds tend to have lower charges than actively managed equity funds.
- Unit trust and OEIC providers normally make no additional charges for the ISA 'wrapper' and, in some instances, charge less than they would for direct investment.
- While investment trust annual management charges are generally lower than their unit trust/OEIC counterparts, most investment trusts charge an additional fee for investment through an ISA. Typical charges are £30 + VAT a year (ie £34.50 currently) or 0.5% (+ VAT) of account value. Initial charges for investment trust ISAs vary between 0% and 4%.
- Self-select ISAs, under which investors can select their own securities, may have no annual charge, a value-based fee of around 0.5% (+ VAT) subject to an upper cash limit or a flat annual fee, eg £20 a year. All charging structures apply before stockbroking commissions. Some stockbrokers charge a dividend collection fee as an alternative.
- Charges on cash ISAs are not explicitly stated, but are in effect the margin that the provider can earn on the investor's money. As happened with TESSAs, some deposit takers pitch their ISA variable interest rates at unsustainably high levels to attract new funds and subsequently lower them to market levels or worse once they have raised sufficient

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funds. A similar trick is to offer eye-catching rates contingent upon taking up another less attractive product, eg a low-interest current account.

- The few ISA insurance policies, most of which are with profit, have a charging structure similar to unit trust/OEIC accounts.

Stakeholder standards

The Treasury has issued regulations setting benchmarks for the cash deposits and medium-term products that qualify as ISA investments, as detailed below:

	Stocks and shares component	**Cash component**
Charges	Maximum total charge 1.5% pa of net asset value for the first ten years and 1% pa thereafter. No initial charge.	No initial or annual charges. Charges for replacements (eg statements) allowed.
Minimum investment	Minimum investment of not more than £20.	Minimum transaction of not more than £10. Withdrawals within seven working days or less.
Investment terms	OEIC, authorised unit trust or life assurance investment fund with not more than 60% invested in listed shares and land/property. Investments must be diversified and selected and managed to achieve a balance between growth and risk.	Interest rate is no lower than 1% below Bank of England base rate. Upward changes within one calendar month. No other conditions, eg on frequency of withdrawals.

Stakeholder standards are not a government guarantee of quality or performance, and have been criticised as potentially misleading for inexperienced investors.

Transfers

An investor can transfer between ISAs, which now includes a transfer from a former PEP to an ISA:

- Partial or full transfers are allowed from an ISA to which no contributions have been made in the current tax year.
- Only the full value of the current year's ISA contributions can be transferred: partial transfers are not allowed in this instance.
- Transfers from the cash component to the stocks and shares component became possible from 6 April 2008.

ISAs in practice

For the potential investor, there is a range of factors to consider when choosing an ISA:

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Charges

The issue of charges is significant, because the tax breaks are limited for most investors and because, in a low inflation environment, overall returns are likely to be lower.

- The abolition of the dividend tax credit payment in April 2004 meant that for basic rate taxpayers with unused annual CGT exemptions, holding shares or equity-based collective investments in an ISA has become at best only marginally advantageous.
- Even for higher rate taxpayers, an ISA's charges may extinguish income tax savings.
- For example, the current dividend yield on the UK stock market is about 4.8%, which for a higher rate taxpayer leads to an additional total tax charge of 1.08% a year.
- Therefore, if the additional annual charge (including VAT) within an ISA is more than 1.08%, the ISA is less income tax-efficient than direct investment.

Capital gains tax

HMRC statistics suggest that the ISA's freedom from CGT is a tax break few investors need. The annual exemption (£10,100 in 2009/10) means that only a limited number of individual investors pay the tax. For those that do, the ISA investment ceilings are too low to make much difference in the short term.

Income tax

- The income tax savings are more significant if fixed interest securities, REITs or bond funds are held in the stocks and shares component.
- 20% income tax is payable into the ISA.
- The higher rate taxpayer, who now saves about £70 a year by investing £7,200 in a UK tracker fund yielding 4.3% (after charges) through an ISA, would save £202 – nearly three times as much – by choosing a bond fund yielding 7% as their ISA investment. For a basic rate taxpayer, the corresponding figures are nil and £101.
- The same mathematical principles that apply to bonds also apply to the cash component, with short-term cash ISA interest rates currently similar to bond fund yields.
- The tax savings on an insurance policy will depend on the investments underlying the policy.

Uses of ISAs

Although the tax benefits of ISAs will be small for most investors, they should not be ignored. The choice will often be between investing through an ISA with a small tax saving or investing directly with no tax saving. ISAs have a range of applications:

Retirement planning

While pension contributions receive full tax relief and ISAs do not, the opposite applies when benefits are taken: pensions are fully taxable but ISA proceeds are tax-free. This simple picture is distorted by the fact that all pension plans now incorporate a 25% of fund tax-free cash element, giving the best of both worlds to investors.

At a time when long-term interest rates are at historically low levels, ISAs have the added appeal that they do not compel investors to buy an annuity in retirement.

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Portfolio planning

ISAs can be integrated into an investment portfolio to improve overall tax efficiency. For example, it may make sense for a higher rate taxpayer to hold as much as possible of the fixed interest element of their portfolio through an ISA to minimise income tax liabilities and/or increase net income.

Alternatively, for an investor seeking capital growth, the actively managed part of a portfolio could be held through an ISA free of CGT while core holdings held directly receive the benefit of the CGT annual exemption.

School and university fees planning

ISAs are natural vehicles for school and university fees planning. For the long term, holdings in equity-based ISAs could be used to maximise returns. For shorter terms, fixed interest holdings or zero coupon preference shares of the more conservatively structured investment trusts could be used together with the cash and with profit insurance components.

Mortgage repayment

Endowments have fallen out of favour as a means of mortgage funding. While ISAs are more tax-efficient than endowments as a mortgage repayment vehicle, they are just as reliant on investment returns to achieve the necessary funds at mortgage redemption. For those prepared to accept this investment risk, ISAs are worth considering, but many borrowers would prefer the certainty of a simple repayment mortgage.

Tax-efficient deposits

For investors who do not wish to invest in the stocks and shares component, the cash component makes a sensible alternative to traditional savings accounts. The interest earned will be tax-free and is usually higher than could be earned elsewhere on similar sums. The investor in a cash ISA now has the option to transfer into a stocks and shares ISA at any time.

PEPs

PEPs were subject to three major sets of changes in the nine years before they were amalgamated with stocks and shares ISAs from 6 April 2008.

Since 6 April 1999:

No new contributions have been possible into either general or single company PEPs.

In line with ISAs, the tax credit paid in respect of UK dividends was reduced to 10% and ended after 5 April 2004. Bond interest and reinvested cash interest are completely tax-free.

Since 6 April 2001:

The investment rules for PEPs (both general and single company) have been brought into line with those of the stocks and shares component of an ISA.

This has given PEPs a much wider potential for investment.

As earlier generations of rules restricted investment largely to UK and then EU securities, many PEP investors have had insufficient international exposure in their portfolios.

Partial switches between existing PEPs have been allowed.

Previously, only full plan switches had been permitted, which created complications when investors had accumulated substantial sums within a single plan.

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Since 6 April 2004:

The ability to reclaim the 10% tax credit on UK dividends has been abolished.

Although the legislation for PEPs has now been repealed and all PEPs have become stocks and shares ISAs, there is no requirement on providers to merge the two different types of plan, although this is an option.

Conclusion

ISAs offer a range of tax advantages, particularly for higher rate taxpayers. ISAs can be a more suitable vehicle than pensions for retirement provision in some circumstances. As a general rule, investors should seek professional advice when selecting an ISA. At the same time as choosing an ISA, it makes sense to review existing PEP investments. A fund chosen perhaps 15 or more years ago for a PEP might no longer be appropriate for the investor or performing adequately. Ideally the aim should be to integrate ISAs and ex-PEP ISAs into the overall investment portfolio rather than regard them as separate, stand-alone investments.

The major benefit of ISA investment builds up over time. For example, someone who had made the maximum PEP and ISA contributions since PEPs first became available in 1987 would by July 2009 have invested £168,600 and, if it had been placed in the UK stock market, could now be the proud owner of a tax-free portfolio worth around £450,000, based on a typical UK equity portfolio. Some shrewd investors have accumulated over £1m.

This guide is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking action on the basis of the contents of this publication. The guide represents our understanding of the law and HM Revenue & Customs practice as at September 2009, which are subject to change.

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