ISAGuide 2009/10

This is our guide to Individual Savings Accounts and how to make the most of the your annual tax year allowance. If you would like to discuss any of the information provided in more detail, please contact us.

What is an ISA?

ISA stands for Individual Savings Account, a tax-efficient wrapper offered under Government legislation as a way of encouraging you to save. An ISA sits over your choice of a number of different investments to shelter them from further tax on any income or gains earned.

There are just two types of ISA - the Cash ISA and the Stocks and Shares ISA. The standard allowance for both in 2009/10 is £7,200 or, if you are over 50, higher, at £10,200.

Within this, the limit for Cash ISAs - or for the cash element within a Stocks and Shares ISA - is £3,600 (or £5,100 if you are over 50). However, there is flexibility over how these limits can be used - you can, for example, put the maximum £3,600 (£5,100) in a cash account and £3,600 (£5,100) in a stocks and shares account. Alternatively, though, if you place just £2,000 in cash, you can use the entire remaining balance – £5,200 (or £8,200) in this case - to invest in stocks and shares. If you don't need cash at all, you can put the full £7,200 (£10,200) into stocks and shares.

In addition, you can transfer existing Cash ISA holdings to a Stocks and Shares ISA without impacting on your current tax year allowance. So, if you have £10,000 already sitting in existing cash ISA plans then this amount can be moved to a Stocks and Shares ISA, yet leave your entire current allowance still available for new investment.

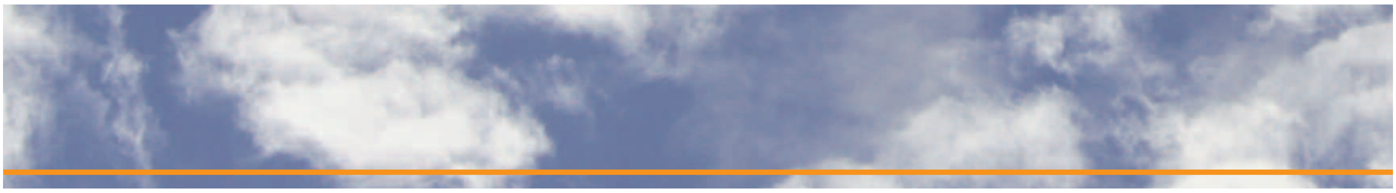
What makes a good cash ISA?

Cash ISAs are simply cash accounts which sit within the tax benefits of the ISA wrapper and are therefore amongst the most straightforward products in the financial market. The capital in a deposit account will not grow, but the value will not go down and will earn interest for the entire time it is invested. Therefore, in order to find the best one, you would generally just need to look for the highest interest rate.

However, there are some differences to be aware of. Some providers will hike their rates up for a short period to win your money but then cut them once you are invested. You should therefore consider their reputation for rate levels in the past and also read the small print to check for any rate guarantees

or caveats. Some providers might tie your money up for a period of time. These accounts pay higher rates because the provider can plan their own investments better – but you may have to wait up to 90 days if you make a withdrawal.

In essence, even the seemingly simplest of products needs some research. Make sure you make the right choice before you get tied in.



Stocks and Shares

Of your £7,200 2009/10 allowance (£10,200 if you are over 50), you can choose to invest up to £3,600 (£5,100) in cash and the rest of the balance in stocks and shares. Alternatively, however, if you don't need the cash ISA, or you believe your tax benefits are better used elsewhere, you can abandon the cash ISA completely and invest the full amount just into stocks and shares.

At the top end of the stocks and shares ISA market, there are Self-select ISAs. These allow you to choose your own investments, including the individual shares of any company listed on a recognised stock exchange. However, whilst the allowance is a significant amount of money for many people, in share dealing terms it is not very much – and if it is all invested in just one or two companies, the risk of losing out can be very high. Consequently – and particularly if your ISA investment is a significant proportion of your overall savings – it may be better to consider collective investment schemes.

Collective investments

By investing in a collective investment, you are accessing not just one or two but many different companies or holdings. Known as diversification, this approach means that should one company lose money, there are lots of others to help compensate for the loss.

Collective investments offer access to a whole range of different options. Some cover many asset classes under the one roof – equities, property and bonds for example. Others concentrate their efforts in just one – which could be anything from UK blue chip equities right through to Japanese bonds. To make the choice easier for you, most unit trust and OEIC funds are sorted into sectors by the Investment Management Association (the IMA) so that, at least loosely, you can identify which are trying to achieve what.

Therefore, if you want a lower risk fund which offers just a small exposure to equities, you may look at the 'Cautious Managed sector'. If you are looking to maximise long term growth, and are prepared for a 100% exposure to equities, the UK All Companies sector is a good place to start – but if you want to be more adventurous, there are equity fund sectors for every country in the world. Finally, if you are after an income, the bond sectors may be more appropriate, or perhaps a sector which offers a mix of these and equities.

The IMA Sectors

UK funds	Overseas equity
UK All Companies	Global Growth
UK Income	Europe inc UK
UK Equity & Bond Income	North American
UK Corporate Bond	European Smaller Companies
UK Gilt	North American Smaller Companies
UK Other Bond	Global Emerging Markets
UK Smaller Companies	Japan
UK Index Linked Gilts	Europe ex UK
UK Zeros	Asia Pacific ex Japan
	Asia Pacific inc Japan
Managed funds	**Other**
Cautious Managed	Global Bond
Balanced Managed	Money Market
Active Managed	Protected/guaranteed
	Specialist
	Technology & Telecommunications

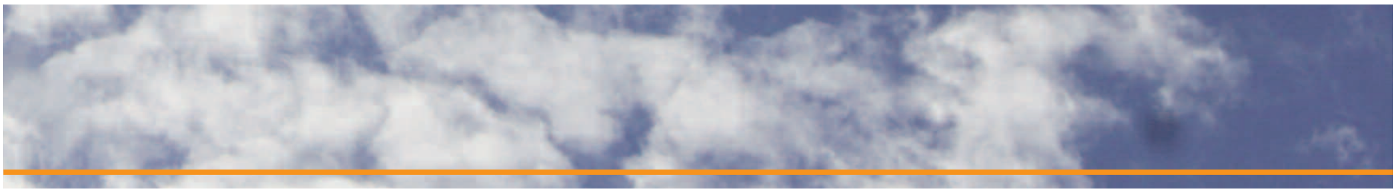
When making your choice, you should also be aware of the charges. A collective investment includes all the necessary research, share dealing and paperwork required to ensure you are up to date and getting the most from your investment. In return, you will pay an upfront and ongoing fee, the level of which will vary to reflect the complexity of the investment product. Therefore, a straightforward index tracker fund which mirrors a stock market's movements will be cheaper than a Taiwanese Smaller Companies fund which requires active management, in-depth research and a team of investment professionals to support it, although even the latter will rarely cost more than 2% a year.

Finally, your tax position could affect your investment choice – but that's a different matter entirely, which would need a guide of its own. If you are interested in discussing your tax position further please contact us at your earliest convenience.

Not all tax benefits are equal...

While ISAs are well known for being 'tax-efficient', your choice of investments can make a big difference on how beneficial they are for you. Whilst all the income and growth you receive from your ISA is tax free in your hand, how each asset class is treated whilst it remains invested is different – and this can be confusing.

Cash ISAs for instance, are entirely free of income tax. Therefore, if you earn £1 in interest, you receive the whole lot.



On a normal bank account, basic rate taxpayers currently pay tax of 20p on that £1 and higher rate taxpayers would be liable for another 20p. Therefore you receive more income from this account than you would do outside an ISA. However, cash ISAs make no capital gain and therefore if you are making profits on investments across your portfolio, a Cash ISA will be of no help in reducing the Capital Gains Tax burden on that aspect.

Similarly to cash, the interest on corporate bonds is also tax free. The tax which is paid by companies distributing interest to bond holders is reclaimed on your behalf by your ISA provider and invested into your corporate bond fund to increase the number of units or shares you hold. Unlike cash ISAs, the capital value can fluctuate, and there is therefore the possibility of a tax free capital gain as well as tax free income. Of course, on the flip side, that also means there is the chance of a capital loss if markets move against the investment – and also a risk to your income if a company defaults. As a result, corporate bonds generally pay a higher income than deposits as a way of compensating investors for taking on this additional risk.

The tax benefits on stocks and shares, however, are a little different. Under normal circumstances, basic rate taxpayers currently pay 10% tax on dividend income (which is taken from any dividend in the form of ACT – advanced corporation tax). This 10% tax payment is not refundable within an ISA, regardless of the tax position of the investor. You could argue, therefore, that a stocks and shares ISA offers little benefit to a normal basic rate taxpayer.

However, based on the historical performance, equities have offered greater long term growth potential than any other asset class. With the exception of a few higher dividend paying companies, much of the benefit of investing in shares comes from capital growth, therefore the fact that no Capital Gains Tax is payable is of benefit. In addition, for higher rate taxpayers, the benefit of not paying additional income tax on dividends cannot be understated.

Having said this, it is worth noting that whilst equities have provided greater long term growth in the past, this is not guaranteed for the future. If you are investing in equities, always consider them as a long term investment and that you may not get back what you originally invested, particularly in the first few years. Before making any investment decision you should weigh up the tax advantages against the potential risks and likely returns of your ISA.

Use it or lose it

One thing is not up for debate: you only get one allowance every tax year. You cannot carry your allowance over to next year and therefore, if you do not do something about it, you will lose it.

Your annual allowance can be used at any time during the tax year. The deadline of April 5th helps to concentrate the mind and we generally witness an increase in ISA investments at this time of year. However, you do not have to wait. You can use your allowance at any time – and many would suggest that the earlier the better, particularly with cash ISAs where the earlier you get in the more interest you make.

For stocks and shares ISAs, there is an argument for trying to 'time' your investment so you buy in when the assets are cheap (in order to make more when they recover later). However, if anyone had really uncovered the truth about how to time the market, we would all be millionaires by now. For the sake of a few pounds, if you are that concerned about investing in shares, perhaps you should reconsider whether the risk is appropriate for you. Alternatively, try drip feeding your allowance in on a monthly basis instead so that you can take both the rough and the smooth as markets fluctuate.

Regardless of how or where you decide to invest your money, you must get in before April 5th. At the end of the tax year, your allowance is gone. Make your decision, have your conversations, do your research, but start it now and make sure you don't lose out.

YOUR QUESTIONS ANSWERED

When were ISAs introduced

ISAs were introduced by the Labour Government in 1999. Around 17 million adults* (almost one in three of the adult population) now hold an ISA.

How long will they be here?

The Chancellor has now stated that ISAs will be available indefinitely.

Who can open an ISA?

You must be UK resident for tax purposes and over the age of 16 to open a cash ISA or over 18 to open a stocks and shares ISA.

If you open an ISA and then move abroad, you cannot add any new money to that ISA. However, you are able to keep the existing investment open and continue to earn the tax benefits on that.

What happens if I open two ISA accounts in the same tax year, by mistake?

If this happens, the second ISA will become fully taxable. You are not able to nominate the second ISA as the preferred account for this tax year – so make sure you are happy with the provider you have chosen before you make your move.

Note: If you pay into an ISA via regular savings, the first payment on or after 6th April automatically opens an account for the new tax year. If you wish to stop payments into an existing account and move to a new one, make sure you provide instructions to the provider and your bank, well in advance, or you will be stuck with it for another year regardless.

How do ISAs differ from PEPs

PEPs or Personal Equity Plans were the predecessors to ISAs and were withdrawn to new money when ISAs were introduced. They no longer exist having been brought in line with ISAs and fully absorbed by them in April 2008.

* Source: www.hm-treasury.gov.uk, as at April 2008

Can I change my mind if my investment provider under-performs

Yes, you can transfer your ISA proceeds to a different manager at any time. However, you should always bear in mind, particularly with bonds property or equity investments, that this is a long term decision and that short term fluctuations in markets mean the value of your investment can go down as well as up.

There are normally some charges involved in a transfer so these should always be weighed up against the potential gains.

How would I transfer an ISA to another provider?

In order to transfer the money and retain the tax benefits, you must complete a 'Transfer request' with your chosen new provider. They will then contact the existing provider on your behalf and arrange to take charge of the proceeds for you.

You cannot close one ISA and then reinvest the proceeds in another as this is deemed to be a withdrawal. Once you withdraw, you lose all tax benefits on the money and cannot reinvest, except where the amount falls below your current tax year's unused allowance.

How do I monitor performance?

Your ISA provider will normally send you statements every 6 months to let you know how much your investment is worth and you can therefore compare this to previous statements to see how your investment is progressing.

In between times, if you are invested in a collective investment or direct shares, the prices of these are readily available on the internet or in certain newspapers. If you are invested in a cash deposit account, make sure you monitor mail from the bank telling you of changes to interest rates – and compare this with tables in Sunday newspapers and on internet finance sites to make sure you are getting the best deal.

When can I withdraw my money?

Some accounts may have notice periods but you can give instructions to withdraw at any time. The provider will then divest your money and return the proceeds to you.

You do not need to withdraw all of your money at the same time. You can take just a proportion of your investment and leave the rest invested – although do note, some providers also have minimum investment levels which your remaining investment value will have to meet.

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