CHAPTER 44

TAX EFFICIENT INVESTMENTS

44.1 Introduction

In this chapter we shall take a look at the more common types of tax efficient investments available to investors in the UK. In particular, we will be concentrating on one specific form of investment. These are Individual Savings Accounts or, as they are more commonly called, "ISAs".

44.2 National Savings products

National Savings products, such as National Savings Certificates and Premium Bonds, are a very popular form of investment.

Income from **National Savings Certificates** and **Premium Bond winnings,** are **exempt** from tax. National Savings Certificates are particularly popular because they guarantee a rate of return over their five year life.

Premium Bonds do not guarantee a rate of return because when you buy a Premium Bond, you are effectively buying a ticket in a raffle. There is a draw every month, and only if your numbers are drawn do you win a prize. Premium Bonds are attractive because there is a possibility – however remote – that an investor could win a £1 million prize at any time. This prize would be completely free of tax. Premium Bonds can be cashed in at any time and the money returned.

National Savings Income Bonds also guarantee a fixed rate of return although interest earned on National Savings Income Bonds is taxable interest income. The interest is paid gross.

National Savings accounts are run by "National Savings & Investments" (NS&I) who offer an investment account and an Easy Access Savings Account (EASA) which has replaced the ordinary account. The interest on both accounts is paid gross and is taxable.

44.3 Individual savings accounts ("ISAs").

ISAs are "individual savings accounts". These are effectively tax-favoured funds in which a taxpayer can hold a range of different investments.

The main benefits of ISAs are:

- No tax on income (eg interest, dividends etc) from an ISA; &
- No tax on capital gains arising on the encashment of an ISA;
- No minimum "lock in" period and withdrawals can be made at any time

Taxpayers can invest **up to £10,200 in 2010/11.** From 6 April 2011, the ISA limits will be increased each year in line with the Retail Prices Index. The annual ISA allowance is not transferable and cannot be rolled forward into the next tax year if it hasn't been used. A husband and wife have one ISA allowance each.

There are two types of ISA:

1) A "**Stocks & Shares" ISA** in which an individual can invest up to **£10,200** (to be increased to £10,200) per tax year; &
2) A "**Cash" ISA** in which an individual can invest up to **£5,100** per tax year.

Cash ISAs hold cash only (no other investment is allowed). The Cash ISA is therefore effectively a tax-free savings account.

Stocks & Shares ISAs can hold a variety of investments such as shares, securities, unit trusts, bonds and investment trusts.

An individual is allowed to pay into both a Stocks & Shares ISA and a Cash ISA during the same tax year, **provided the total investment does not exceed the £10,200 limit** on the accounts combined and **does not exceed the £5,100 limit on cash deposits**.

For a Cash ISA, an individual can only invest with one provider per tax year (although they can change to different providers in different tax years).

The position is the same for a Stocks & Shares ISA. The Cash ISA and Stocks & Shares ISAs can themselves be with different providers in the same year.

Illustration 1

Stacey aged 29, opened a Cash ISA with Z-Bank on 1 May 2010 with £2,200 in cash. At this point she has £8,000 of her ISA allowance remaining for 2010/11.

She could then;

1) invest up to another £2,900 in cash with Z-Bank before 5 April 2010; and/or

2) open a Stocks & Shares ISA up to her remaining allowance with any ISA provider (not just Z-Bank).

In 2011/12 she could open another Cash ISA (maximum £5,100 deposit) with any provider and/or invest up to £10,200 in a Stocks & Shares ISA (again with any provider).

Investors can transfer ISA balances from one provider to another without affecting the annual investment limit. However, Cash ISA balances can only be transferred to other Cash ISAs (and likewise with Stocks & Shares ISAs). If the balance on a cash ISA is transferred to a Stocks & Shares ISA, it will use up part of the current year's annual investment limit.

To open an ISA, an **individual must be aged 18 or over** (16 or over for a Cash ISA). Individuals cannot hold an ISA jointly with, or on behalf of, anyone else.

The individual investor **must be resident in the UK**. If an individual moves abroad and becomes non-UK resident, he/she may keep the ISA (and retain the tax benefits) but no contributions can be made to the ISA in the non-resident period. Crown employees or members of the Armed Forces etc working abroad can continue to pay into ISAs while non resident.

Example 1

Which of the following sources of income are exempt from tax?

a) Premium Bond winnings

b) Interest on National Savings Certificates

c) Dividend from an ISA

d) Dividend from a VCT

e) Dividend on EIS shares

Answer 1

		Exempt	Taxable
a)	Premium Bond winnings	✓	
b)	National Savings Certificates	✓	
c)	Dividend from ISA	✓	
d)	VCT dividend	✓ *	
e)	EIS dividend		✓

* Only dividends from the first £200,000 invested in shares in a VCT in a tax year are exempt.