

The Big Book of ISA

Facts, Figures and Planning

September 2023

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A brief history of (ISA) time

The Individual Savings Account or ISA for short was introduced to us on 6 April 1999. This replaced PEPs (Personal Equity Plans) or TESSAs (Tax-Exempt Special Savings Accounts).

In a nutshell they're very tax-efficient wrappers to invest in, they're not subject to income tax or capital gains on any investment returns, nor are they subject to tax when the investor withdraws any money from them.

When launched there were some choices as to where subscribers invested within the initial annual allowable amount of £7,000. Subscribers either used a mini or maxi ISA to invest in either stocks and shares, cash, or life insurance.

In 2005 the life insurance ISA component was removed. However, within a Stocks and Shares ISA you can still invest in a life insurance contract.

In 2008 the concept of Mini and Maxi ISAs was abolished too. So, you simply had a Cash ISA or Stocks and Shares ISA.

Junior ISAs were introduced for children that did not have child trust funds in 2011. You can't have a Junior ISA as well as a Child Trust Fund. If you want to open a Junior ISA but have a child trust fund, from April 2015 you ask the provider to transfer the trust fund into a Junior ISA.

In 2014 the concept of the new ISA (NISA) came into being. This meant that the whole ISA allowance could be placed into cash – for the first time, you could always invest the whole allowance into stocks and shares. Or you could combine cash and stocks and shares investing in any proportion you wanted.

The Help to Buy ISA in 2015 commenced to help with saving for a first house purchase.

The Lifetime ISA was introduced in 2017 and was the first ISA that had an eye on retirement (with the other eye aimed at purchasing a first house). At the same time the Innovative Finance ISA was introduced too.

Finally, 2019 saw the end of subscribing to help to buy ISAs.

And that, as it said at the start, is a brief history of the ISA.

The statistics (without the lies and damned lies)

Back in 1999 there were around nine million subscribers, evenly split between cash and stocks and shares. This number rose, peaking at around 15 million a decade ago before falling again and in 2021/22 there were around 11.8 million ISA subscriptions.

In 2021/22 £66.9 billion was placed into ISAs (a decrease of £5.3bn from 2020/21) with around £40.8 billion being cash ISA subscription. Since 1999 the average ISA subscription has never been over £6,500.

The ISA is in its 24th year but the latest value we have on adult ISA holdings is for 2021/22 at £741.6 billion. The majority of subscriptions have been to cash ISAs, but the majority of the holdings are in stocks and shares (62%).

The ISA statistics also tell us the income, age, and gender make-up of the ISA holders too. And it's all very intuitive:

- around 33% of the entire UK population have an ISA
- the higher the income bracket the higher the average holding. Average values "jump" at £50,000+
- 15% of subscribers use their full allowance. The higher the income the more likely it is, but around 10% of all the lower income bracket subscribers (£0 – £50,000) pay in the full amount.

- Gender balance is pretty much equal.
- The proportion of active savers falls as age increases. The under 25s are 78% active with ISA savings. The ages go up in 10-year tranches until you get to over 65 where the active savers are only 31%.
- The higher the age of an active contributor the higher the average ISA value is. The over 65 average is around £58,700.

So, there's lots of people actively saving and lots of money held within the ISA wrapper right across the age and income spectrum.

It's a nice tax efficient (mostly) place to be but that doesn't mean it's not a place where no further planning is required. Planning is about delivering outcomes for clients, and can better outcomes be achieved? Looking at the statistics, the answer maybe yes. We just need to ask ourselves a few questions.

Adult ISA Subscription Limits		
Tax year starting 6th April	Overall Subscription limit	Cash ISA Limit
1999/00	£7,000	£3,000
2000/01	£7,000	£3,000
2001/02	£7,000	£3,000
2002/03	£7,000	£3,000
2003/04	£7,000	£3,000
2004/05	£7,000	£3,000
2005/06	£7,000	£3,000
2006/07	£7,000	£3,000
2007/08	£7,000	£3,000
2008/09	£7,200	£3,600
2009/10	£7,200 ^(a) / £10,200 ^(b)	£3,600 ^(a) / £5,100 ^(b)
2010/11	£10,200	£5,100
2011/12	£10,680	£5,340
2012/13	£11,280	£5,640
2013/14	£11,520	£5,760
2014/15	£11,880 ^(c) / £15,000 ^(d)	£5,940 ^(c) / £15,000 ^(d)
2015/16	£15,240	£15,240
2016/17	£15,240	£15,240
2017/18	£20,000	£20,000
2018/19	£20,000	£20,000
2019/20	£20,000	£20,000
2020/21	£20,000	£20,000
2021/22	£20,000	£20,000
2022/23	£20,000	£20,000
2023/24	£20,000	£20,000

Junior ISA Subscription Limits		
Tax year starting 6th April	Overall Subscription limit	Cash Junior ISA Limit
2011/12 ^(e)	£3,600	£3,600
2012/13	£3,600	£3,600
2013/14	£3,720	£3,720
2014/15	£3,840 ^(f) / £4,000 ^(g)	£3,840 ^(f) / £4,000 ^(g)
2015/16	£4,080	£4,080
2016/17	£4,080	£4,080
2017/18	£1,428	£1,428
2018/19	£4,260	£4,260
2019/20	£4,368	£4,368
2020/21	£9,000	£9,000
2021/22	£9,000	£9,000
2022/23	£9,000	£9,000
2023/24	£9,000	£9,000

(a) Applicable to those aged under 50.

(b) Applicable to those aged 50 and over from 6th October 2009.

(c) Limits until 30th June 2014.

(d) The cash and overall subscription limits were raised to £15,000 from 1st July 2014 with the introduction of the New ISA (NISA).

(e) Applicable from 1 November 2011.

(f) Limits until 30th June 2014.

(g) These limits were raised to £4,000 from 1st July 2014.

Can you do better with your clients ISA holdings?

ISAs are great for many people but for those in cash, approaching or in retirement or falling into the ever expanding IHT net better outcomes can be achieved.

There is no no-risk investment and swapping inflation risk for a little investment risk could see better outcomes. But if you would still rather be in cash with inflation risk why not let some good tax planning generate your return for you?

Eligibility, ISA Options and What Happens to an ISA on Death

For information on this, please refer to our **Individual Savings Accounts (ISAs)**: the facts in **PruAdviser**.

The risk of inflation – or is this the risk of holding cash?

As the stats have shown most ISA subscriptions are in cash, it's an easy way to make savings tax free. But with the starter rate for savings and Personal Savings Allowance (PSA) available are subscribers getting that much of a tax saving?

For basic rate taxpayers the PSA is £1,000, higher rate taxpayers get a PSA of £500, additional rate taxpayers have a PSA of £0. So, is the cash ISA only of use to additional rate taxpayers to save money on their bank interest?

A basic rate taxpayer earning 0.5% on their savings would therefore need savings of £200,000 before the PSA is used up.

Cash is viewed as safe, and we will be talking about inflation soon, but there's another potential issue with that much in cash, has it been spread around enough institutions as this would be above the FSCS limits, so if all the cash ISA holdings are with one bank institutional risk is also in play here. Of course, there are NS&I cash investments that are 100% protected.

There's also the issue does a basic rate taxpayer need that level of cash holding? On the face of it this seems above most people's emergency fund and short-term holdings.

But holding that £200,000 in cash over ten years can have a devastating effect on the true value of that money. Using our **[inflation modeller](#)**, £200,000 held over ten years in cash (the tool can be used for cash equivalents too) with an annual return on that cash of 0.5% and in inflation assumption of 2%, after ten years that money is now worth £171,946. Whilst the value of the savings will have reached £210,228 in real terms that money is now worth £171,946, so the client has effectively lost spending power on that money of £28,054.

The modeller will allow users to put in a percentage of assets to then be invested, and users can choose the net return on that investment after charges to show what this can do. Playing about with the figures on an assumed after charges return of 3.5% the client would need to invest 46.63% of that money just to keep that value of £200,000 after ten years.

Of course, how much to invest would be a decision between client and adviser, but if the client only needed short term cash holdings of £30,000, and invested the rest, if all these assumptions come in then they will have a real return of £23,084 and the spending power of the cash has only reduced by £4,208.

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Projected values

Category	Invested (Orange)	Cash (Purple)	Cash (No investment) (Green)
Initial split	£100,000.00	£100,000.00	£200,000.00
Before inflation	£130,000.00	£120,000.00	£210,000.00
After inflation	£110,000.00	£90,000.00	£180,000.00

Real Return

Category	Value
Real Return	(£28,054)
£0	£0

This calculator allows you to demonstrate the impact of inflation on your client's investment and cash holdings over a set time period. It also demonstrates the overall returns achievable before and after inflation is taken into account.

The inflation modeler is not a personal illustration and the values presented do not suggest any recommendation and should not be taken as offering advice from Prudential. The figures represent only potential growth over the term shown and is not an indicator of future performance.

Every care has been taken to ensure the accuracy of this calculator, but it must be appreciated that neither Prudential nor its representatives can accept any responsibility for loss, however caused, suffered by any person who has acted or refrained from acting as a result of material contained in this calculator.

The value of an investment can go down as well as up. Your clients may get back less than they have paid in.

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Projected values

Stage	Invested (£)	Cash (£)	Cash (No investment) (£)
Initial split	170,000.00	30,000.00	200,000.00
Before inflation	230,000.00	20,000.00	210,000.00
After inflation	210,000.00	20,000.00	170,000.00

Real Return

Stage	Invested (£)	Cash (£)
After inflation	(£28,054)	£23,084

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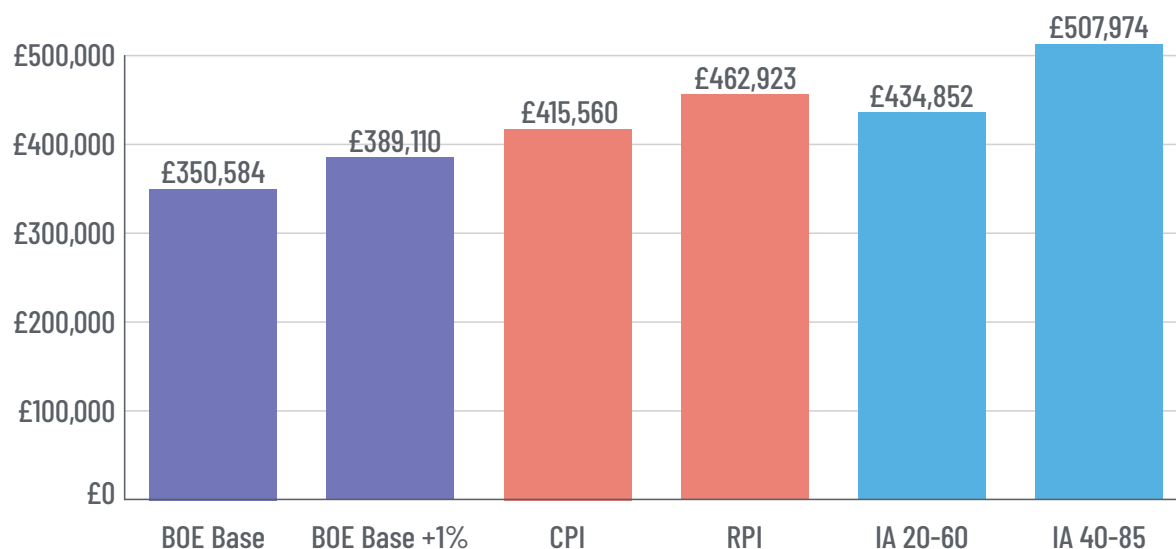
As another way to highlight this issue of cash and the effects of inflation, if we assume that the maximum ISA allowance from 1999 to 2023 could all be invested in cash (which was not the case, this is just for comparative purposes) or all in stocks and shares, what happens when you compare these to two of the major inflation indices?

We'll assume that the cash was invested and either got the Bank of England (BOE) base rate, or in a tracker that was 1% above BOE base. We'll then also compare how much each annual subscription would need to grow to

keep pace with inflation (e.g. if inflation was 2% then the money would need to grow by that to keep its real value) using the Consumer Prices index and the Retail Prices Index. Lastly we'll then compare these to the to the Investment Association (IA) 20-60% and 40-85% indices.

Based on the ISA allowance being invested each year detailed, then a total of £286,560 has been invested, the results for the BOE Base and IA sectors are nominal and therefore have not been adjusted for inflation (as inflation is shown in the chart too!).

Maximum ISA Funding Year on Year from 1999 to 2023



As can be seen, the results show the general theory that investing in equity based investments can provide a better return over the longer term (despite the shorter term volatility in comparison to cash). This also then backs up the information in the statistics section that highlights that most subscriptions have been to cash ISAs, but most holdings are in stocks and shares.

The important thing to note though is that depending on your CPI measure, you are still “losing” money by being invested in cash. If RPI is the measure that’s more relevant to your client, then neither the BOE base or Base+1% has kept pace with inflation.

However, investing in a diversified portfolio of investments has had many studies showing that this reduces volatility and produces better returns over the longer term. This can be seen by using the IA sectors that have diversification in the sectors, and the long term results can be seen. Although as always, we have to remember that the value of the investments can go down as well as up so your client might not get back the amount they put in.

With the amount held in cash, are clients aware that holding large amounts in cash is not without risk? Cash securely holds its value if you ignore inflation, but if your interest/return is less than inflation all that means is you are losing money securely.

Investing, what do you choose?

Are you investing to accumulate or decumulate?

Just like we see with pension holders entering retirement the same issues are seen with ISA accumulators entering the decumulation phase. The stats show the older you are the less likely you are to be subscribing so, therefore potentially a decumulator.

The investment process for saving up and taking out should be two different things or they might not be delivering best outcomes

Are the funds suitable for decumulation? Decumulation and accumulation needs are different with the additional risks caused by volatility and sequencing risk. These have been hot topics since pension freedom with the increased use of drawdown. There is often read across from one area of financial services to others, and this is an easy one to make that leap

The issues are investment-related during decumulation and not to do with the tax wrapper. A Centralised Retirement Proposition should include all decumulators regardless of tax wrapper. Remembering that medium risk (for example) during accumulation, may be a higher risk fund during decumulation.

Are holdings in cash?

The fact that 62% of accumulated funds are in stocks and shares ISAs when they have been the minority of subscription tells us the age-old story if you have no defined short term need for cash then, if you invest it, all things being equal you will end up wealthier.

Then there is inflation risk. Holding money in cash may be necessary for emergency, other short-term needs or as a planned strategy to manage the volatility and sequencing issues for decumulators (see case studies 1 and 2).

But holding anything in excess of this will see money fall in real terms. For more information on comparing cash versus investments please refer to this guide on **[your longer term investment plans](#)**.

Are accumulators saving for retirement?

Many accumulators will be saving for retirement. They may also be currently subscribing. Active subscribers fall as age rises. Is this perhaps because people are seeing that retirement is in sight and the lack of access to their pension pots becomes less of an issue and so they are using their pension allowances instead? (See case study 3 for more).

There will be some subscribers approaching and in retirement who simply can't pay any more to their pensions for one reason or other. This will probably only be higher net worth individuals. Most people will have the ability to further fund their pensions.

Could simply moving cash held in an ISA to cash in a pension – with no increased investment risk be beneficial. Also remember that you can also invest in stocks and shares in a pension, so for those with stocks and shares ISAs can they “boost” their retirement savings by utilising this? (See case study 4 for more).

Accumulated pots could be used to maximise pension contributions as retirement approaches. It may seem non-sensical and to convince people that it's too good to be true could be an issue. But taking the money from an income tax free environment and only leaving 25% of it tax free, (pension commencement lump sum) can produce better outcomes. Case study 5 has more details on this

Are decumulators in retirement?

In the same way that accumulators should really be considering moving their contributions and accumulated funds into the pension system where possible, flipping ISA holdings into a pension as investors decumulate will bring you more funds in the long run due to the tax relief boost.

Clients may not have relevant earnings if in retirement but can still pay in £2,880 per annum regardless of their earnings up to age 75 with the government topping it up to £3,600. A withdrawal in basic rate tax gives £3,060. This extra income boost means more can be spent or income sustained for a longer period by using both wrappers at the same time.

180 isn't just a good score in darts, it's also the extra income an ISA decumulator can generate by continuing to feed their pension into retirement (£3,060 – £2,880).

But does there come a time when the money would be better in the ISA (or at least 25% of the pension), that can depend on when the individual is likely to die. If death is likely to be before 75 the pension benefits are usually income tax free, after 75 they become taxable. See case study 6 for more on this.

Case Study 1 – Managing Volatility with Cash

Using cash to manage volatility is often not a bad idea, this can be in any investment that is being used for decumulation. A common financial plan is to hold one (or more) years desired income in cash, to avoid crystallising losses in the markets. But do you need to hold the money in cash in your pension if you have a cash ISA that can be used for this?

Let's look at the case for a client, who goes into drawdown and after taking tax free cash there is a drawdown pot of £500,000, he also has a cash ISA of £50,000.

For their decumulation they need £1,200 a month net from this pension, and they are a basic rate taxpayer. So, from the pension he needs to take £1,500 gross each month.

But bad timing can always be a curse, and just after the client enters drawdown the markets take a 20% fall, as does their pension fund.

Falls like this can always make peoples uneasy, the client's initial reaction is to move the money to cash in their pension as their planned withdrawal rate on the initial investment was only 3.6% so even with no growth in the pension that would have lasted over 27 years.

However, that 3.6% has now become a withdrawal rate of 4.5% thanks to the market fall so with no growth now that money would only last just a smidge over 22 years. Five years' worth of no growth income gone in one fell swoop.

But before any knee jerk reaction the client seeks advice. It's spelled out to them that they have a few options (there will obviously be more than listed here, but let's cap them at three.

1. Switch the pension to cash and keep taking the income
2. Just stick with the original plan and take the income from the pension fund
3. Stop the income, let the fund recover and take the money from the cash ISA (only £1,200 a month needed as all tax free)

Markets can be cyclical, so the adviser does some calculations and assumes that the market will recover at 6% for the next three years what would that do? The other main assumption is that there is no return on cash in or outside the pension.

Well, here's the position at the end of each year;

Here's the position at the end of each year:

	After one year		
	Option 1	Option 2	Option 3
Pension Fund	£382,000	£406,168	£424,671
Cash ISA	£50,000	£50,000	£35,600
Total	£432,000	£456,168	£460,271

	After two years		
	Option 1	Option 2	Option 3
Pension Fund	£364,000	£412,716	£450,864
Cash ISA	£50,000	£50,000	£21,200
Total	£414,000	£462,716	£472,064

	After three years		
	Option 1	Option 2	Option 3
Pension Fund	£346,000	£419,668	£478,672
Cash ISA	£50,000	£50,000	£6,800
Total	£396,000	£469,668	£485,472

Whilst the fund doesn't get back to where it was pre-fall, you can see that based on the assumptions option 3 will give the client just under £90,000 more total wealth than the initial reaction to switch to cash.

Taking three years' worth of income from the Cash ISA and letting the pension fund recover has made this client over £89,000 richer. If the recovery after the 20% fall had been more substantial, how much richer would they be?

There's also the benefit of holding the cash outside of the pension, as this can be taken income tax free. Which leads to the question, why have cash in the pension that's then taxable?

Case Study 2 – Pound Cost Averaging and Ravaging

Volatility has to be accepted when investing in real assets (i.e., Anything other than cash) the values can fluctuate.

Now this can have varying effects on investments, so let's have a look at how volatility can average or ravage investments.

As an example, we have three funds, there were ISA investments of £275,000 in each of the three funds, and the funds went on quite separate volatility journey as illustrated by the annualised returns below.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
A	25%	5%	20%	-15%	-20%	-5%
B	-5%	-20%	-15%	20%	5%	25%
C	25%	-5%	5%	-20%	20%	-15%

Now if these funds were simply invested with no further payments or withdrawals, it's surprising to know that all of these funds would produce the same result. It doesn't matter the order of the multiplication in this instance, the mathematics produces the same outcome, the below assumes that the interest growth is monthly and added at the end of the month.

	No Income					
A	£352,201	£370,220	£451,444	£388,194	£317,291	£301,785
B	£261,561	£213,787	£183,834	£224,166	£235,635	£301,785
C	£352,201	£334,989	£352,128	£287,812	£350,956	£301,785

The real change comes depending on if you are still investing, when pound cost averaging can help, or taking an income where pound cost ravaging is now in play.

Pound Cost Averaging

Pound cost averaging is the effect of regular investing which can help smooth out market volatility, if the markets increase you would buy less units, if the market increases then you buy more.

If we map this out for fund B above and assume that the starting point was £1 a unit, buying £250 at the start of the year an investor would get 250 units of the fund. But as the fund drops 5% over the course of the year, the unit price will be 95p. Therefore, at the end of the year that £250 will buy 263 units. Mapping this out below you can see the units bought for that £250 at the end of each year;

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Unit Price	£0.95	£0.76	£0.65	£0.78	£0.81	£1.02
Units bought	263	329	387	322	307	246

So, in the earlier year's investors are buying more units and the fund can then benefit in the later years when the returns increase. This can be borne out in the below where we start with the same £270,000 in the ISA, but £250 is added per month.

Paying £250 a month						
A	£355,570	£376,831	£462,796	£400,758	£330,300	£317,090
B	£264,493	£218,924	£191,053	£236,260	£251,417	£325,366
C	£355,570	£341,125	£361,648	£298,333	£367,076	£318,449

As can be seen the poorer performance at the start for fund B produces a better outcome for the monthly investor. Ideally if investors could time the market would of course invest at the end of three years when the unit price is 65p, but that takes knowledge that may require a crystal ball. Which is where pound cost averaging can benefit clients.

Pound Cost Ravaging

Simply put this is the reverse of pound cost averaging and is the effect of taking money out the fund factoring in its volatility.

Using the same table above, but simply changing units bought to units sold tells you a different story for fund B's use for decumulators. And to keep the comparison the same we will assume that £250 a month is being taken out of the ISA.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Unit Price	£0.95	£0.76	£0.65	£0.78	£0.81	£1.02
Units sold	263	329	387	322	307	246

Investors have to sell more units to maintain a payment of £250 from the ISA, and that will be detrimental to the growth we see in fund B in the latter years.

Taking £250 a month						
A	£348,832	£363,610	£440,091	£375,630	£304,282	£286,480
B	£258,629	£208,651	£176,616	£212,073	£219,853	£278,204
C	£348,832	£328,853	£342,608	£277,291	£334,836	£285,121

As can be seen by comparing the tables, fund B produced the best outcome for accumulators, but the worst outcome for decumulators. When accumulating, especially if making benefit of pound cost averaging, poor performance at the start can benefit clients by enabling them to buy more units.

But when decumulating, that poor performance at the start can be crippling to the performance of the investment and limit any upside recovery by the fact that more units had to be sold.

Perhaps the cash hedging in case study 1 could be of benefit for those decumulating, of a fund with less volatility (a lower beta in investing terms) may also mitigate this?

Case Study 3 – Funding for decumulation

If an investor is funding for their retirement (so they are accumulating to decumulate) a drawback to pensions or LISA is access. Pensions can't usually be accessed until age 55 (which is rising to age 57 as of 2028), and a LISA cannot be accessed penalty free before 60 (unless for a house purchase). For both pension and LISA, access can be permitted early for those with a life expectancy of less than 12 months.

But can an ordinary ISA be built up as the 'just in case fund' and further premiums be better deployed to a LISA or pension? Both have the effect of adding 25% to the payment, pay £800 into a relief at source (RAS) pension and you have a pot of £1,000, and it's the same deal you get in a LISA.

But if retirement saving is the aim, then which is best, the LISA or a pension? To keep it fair let's, assume access is required at age 60.

If £4,000 is paid into a LISA and assuming no growth at age 60, thanks to the government top up you will have £5,000. That's tax free and job done, it doesn't matter what tax rate you are, that money is not subject to income tax.

For non or basic rate taxpayers, getting £5,000 into a RAS pension costs them £4,000. So, a similar story to the LISA. The big difference is when they come to take benefits, 75% of the pension will be taxable (assuming that there are no Lump Sum Allowance (LSA) issues).

If they are non-taxpayers in retirement (i.e., they can get the pension income out within their personal allowance) then the net benefit is the same as a LISA. They get £5,000.

However, if they are basic rate in decumulation, they'd net £4,250 after basic rate tax has been deducted. Higher and additional rate taxpayers would net £3,500 and £3,313 from £5k in a pension in retirement.

So, on the face of it, a pension only matches a LISA if you are a non-taxpayer when you retire.

However, we have to factor in the true net cost of getting that £5,000 into a pension. For non and basic rate taxpayers £5,000 in a pension does cost £4,000 the same as a LISA. You also have to assume here that they have the relevant earnings to make this contribution, as pensions are limited to 100% of relevant earnings of £3,600 if that is higher.

However, for higher and additional rate taxpayers (assuming the contribution is fully within that tax band) the net cost is £3,000 and £2,750 respectively. So that can alter the argument. What is the net return on the investment compared to the net cost?

We know that for the LISA assuming no growth (and no penalties) you get back 125% of what you put in. For a normal ISA this would be 100%. But for the pension it then depends on what tax rate you are when you take the benefits. An additional rate taxpayer paying into a pension now, who is a higher rate taxpayer in retirement would see a 27% return on their investment, beating the LISA by 2%. They net £3,500 from the pension in retirement, for a net cost of £2,750.

All things being equal if that same person paid the equivalent of the net cost to get into the LISA of £4,000, they'd have £7,272 in a pension, the net payment to a RAS scheme would be £5,818 with a further £1,818 back in their tax return. A net cost of £4,000. If they took that in the higher rate the net benefit would be £5,090, so just beating the LISA.

The below table shows the effective return based on net cost of a pension, where this is marked as red the returns would be less than a LISA, where green, the pension is the winner in terms of net benefit. Bearing in mind that the LISA has the 25% return.

Blanks make no difference either way (although remember that pensions are usually IHT free on death, a LISA will be IHT Table, unless it has invested in shares that attract business property relief and has been invested for two years prior to death.

Pension – £5,000 gross contribution

		Total out at differing tax rates			
Tax Band	Net Cost	Nil Rate	Basic Rate	Higher Rate	Additional Rate
Nil Rate	£4,000	25.00%	6.25%	-12.50%	-17.19%
Basic Rate	£4,000	25.00%	6.25%	-12.50%	-17.19%
Higher Rate	£3,000	66.67%	41.67%	16.67%	10.42%
Additional Rate	£2,750	81.82%	54.55%	27.27%	20.45%

So as detailed in the table above for a basic rate taxpayer (now and in decumulation) who can fund a LISA (as remember you have to be under 40 to start one, and contributions have to stop at age 50) then all things being equal the LISA provides a better return.

It's horses for courses, but for the retirement accumulator, knowing their likely tax band in retirement is the key to getting the right outcome.

Case Study 4 – Putting contributions in the right place for decumulation

If investors are subscribing to their ISA when decumulation is in sight (or if they are in retirement) then are they spending your money wisely? A basic rate taxpayer gets a 6.25% return from the pension tax system – pay in £200 net into a pension (£250 gross) get £212.5 back.

The return is higher where the difference between tax relief on entry and tax payable on exit widens. The classic higher rate taxpayer now and basic rate in retirement pays £60 to get £85 pounds back or a 41.66% return. That's 7.39% after tax per annum over five years.

So, for those still funding a pension over age 50 (which rules out the LISA) is the pension a better bet?

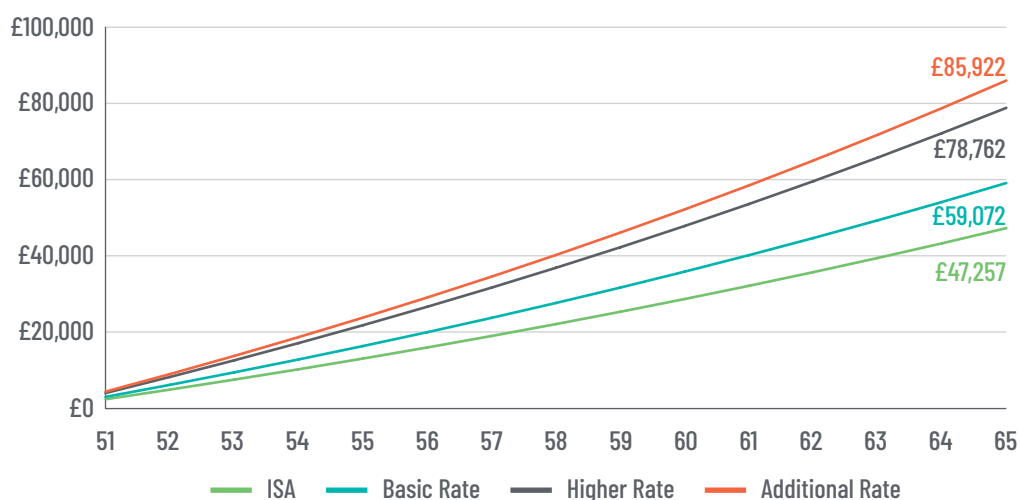
Let's mix things up and assume we have someone with access to a net pay pension scheme, would the £200 that goes into the ISA worth it in this instance? The ISA

payments in are after tax has been taken from income. So, for a basic rate taxpayer, they have to earn £250 to place that money into a pension (ignoring National Insurance). So, which is better, £200 in the ISA or £250 in a pension, well the first paragraph showed that if you are basic rate in retirement you would net £212.50. Depending on the number of years to retirement this difference can be huge.

We'll compare this one, showing what can be put into a pension for the relevant tax bands that would have generated £200 of take-home pay. As detailed earlier, this is £250 for a basic rate taxpayer, for higher and additional rate taxpayers this is £333.33 and £363.64 respectively.

We'll assume growth after charges of 3.5% in both the pension and ISA, the growth is calculated monthly in arrears.

ISA Vs Net Pay Pension



The simple fact of getting more in the pension initially and the compounding of that growth can give quite a big differential. As before though we have to assume tax rates to extract that money, so let's; look at how each of these results compare the ISA which net Benefit of £47,257;

		Pension (Tax rate on entry)		
Tax Rate on exit	ISA	Basic	Higher	Additional
Basic	£47,257	£50,211	£66,948	£73,034
Higher	£47,257	£41,350	£55,133	£60,146
Additional	£47,257	£39,135	£52,180	£56,923

As can be seen, only in the unusual circumstance of a basic rate taxpayer being higher or additional rate in decumulation would the ISA be the better bet for retirement.

So, the net pay pension seems to be the winner. But as a reminder, there is also an issue with non-taxpayers being in net pay scheme called the "net pay anomaly". For those that are non-taxpayers in a net pay scheme there is no further relief applied to their pension.

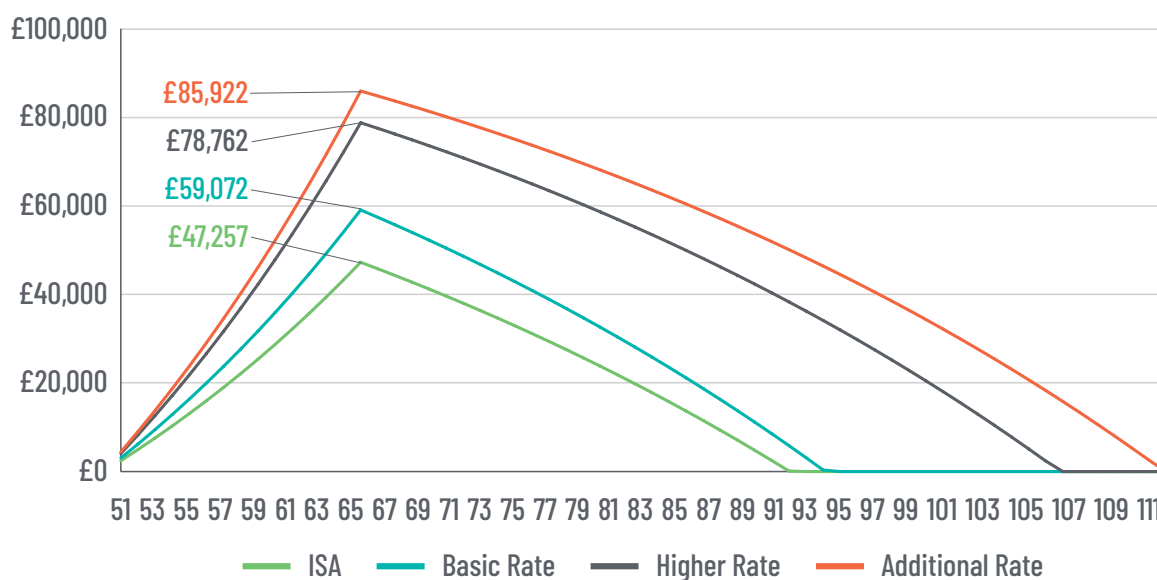
So, to get £100 in a pension costs them £100 from take home pay. For the non-taxpayers then they'd only ever match the IA performance at best. If they were basic rate taxpayers in retirement, then only 25% of the income would be tax free and therefore they'd only get back 85% in comparison to the ISA.

Whilst this may seem to make the ISA (or even a RAS pension a better bet for non-taxpayers, don't forget that there may be employer matching that will greatly change the net benefit to then. And this employer matching could also greatly increase the differential for those paying basic rate or higher in a net pay scheme.

But the key driver here is then what happened when this accumulator becomes a decumulator. We'll assume that the decumulator is basic rate in retirement, if they need £200 net a month from the accumulated pot, how do these stack up?

Assuming that as they are decumulating they have dialled down the risk in the portfolio and the after charges return is 2%, which is applied monthly, £200 from the ISA is taken and £235.29 is taken from the pension pot (as factoring in 25% of this being tax free and the rest at basic, that generates £200 net). Just how long would the pot last?

ISA Vs Net Pay Pension – Accumulation AND Decumulation



As per the chart above, for a basic rate taxpayer they are able to eke out a couple of years more income by using the pension, the money would last for 25 in the ISA and 27 years using a pension. But for the higher or additional rate taxpayer it's 40 and 46 years that the money could last, for the same net loss to take home pay?

Whilst this used a net pay scheme, there could be more saved in a pension using salary sacrifice, which can become extremely beneficial if the employer passes on some of their National Insurance savings.

Whilst ISA's may be used because they are simple, when clients see the difference in the pot longevity will that not simplify the decision?

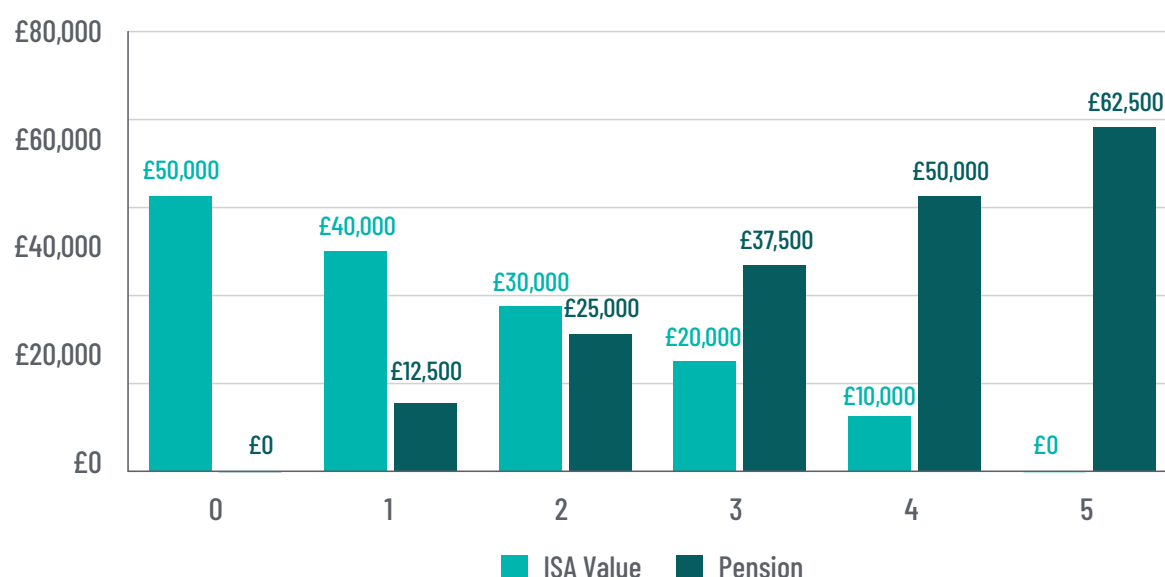
Case Study 5 – Putting capital in the right place for decumulation

Accumulated pots could be used to maximise pension contributions as retirement approaches. Using the same principle, someone with a £50,000 ISA pot could switch £10,000 per year into their pension which would see an ISA pot of £0 in five years' time but a pension pot of £62,500. Higher rate taxpayers will have received £12,500 of tax relief on top. That could be £50,000 turned into £65,625 for a basic rate taxpayer after taking the benefit.

Using a relief at source pension can better deploy that capital by benefiting from the tax relief that is added. If we factor in someone that after emergency funds, short term spending etc. have been factored in can simply using tax relief make retirement richer?

If we assume a cash ISA has been built up to that value of £50,000, how could this be better deployed? We'll also assume that this goes into cash inside a pension, so keeping it nice and simple we'll assume no growth in either.

Switching ISA Capital to a Pension



As you can see, this can easily turn the £50,000 of ISA into £62,500 inside the pension. Taking this within the basic rate would again produce £53,125 in the bank account. There's also the potential for those paying higher or additional rate tax when paying the money into the pension to get more in their tax return. This would give £12,500 of extra capital to a higher rate taxpayer and £15,625 extra capital for an additional rate taxpayer. Whether or not this is then put into a pension would be another discussion worth having.

The results can be seen in the table below:

	Tax Rate out			
Tax Rate in	Non	Basic	Higher	Additional
Non	£62,500	£53,125	£43,750	£41,406
Basic	£62,500	£53,125	£43,750	£41,406
Higher	£75,000	£65,625	£56,250	£53,906
Additional	£78,125	£68,750	£59,375	£57,031

Just to the above results, the only scenarios where the client would end up with less than the original £50,000 is where a non or basic rate taxpayer pays higher or additional rate in retirement. Possibly a rare scenario.

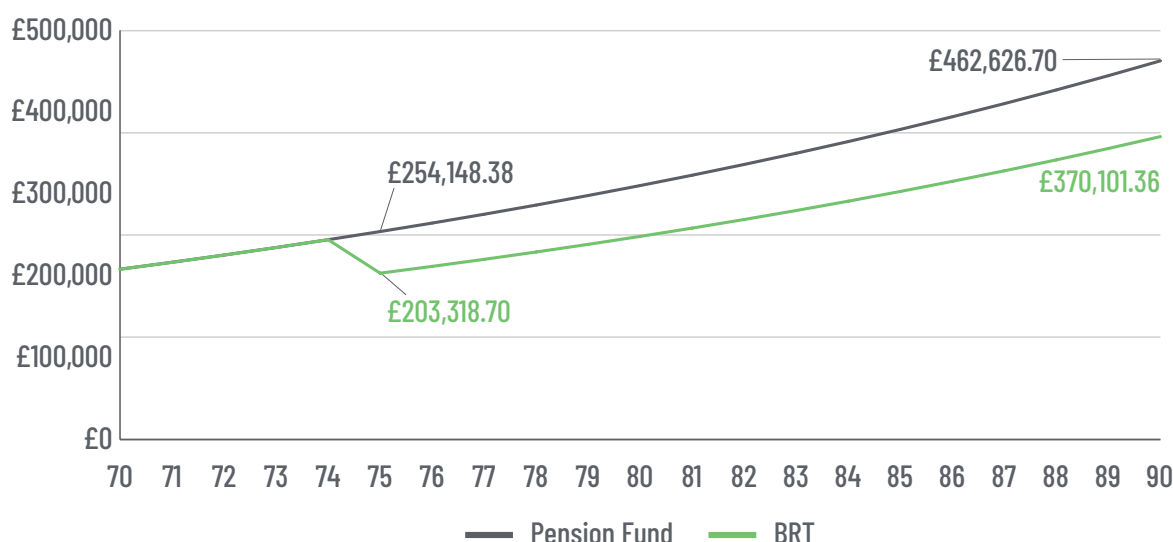
The premise here is moving the cash from the ISA to cash in a pension, so Is this an easy way to create money for clients?

Case Study 6 – Moving pension tax free cash to an ISA?

As stated earlier when age 75 is reached with a pension, the money becomes taxable in the hands of the individual beneficiaries. This is even the case for uncrystallised pensions. During their life (and assuming no LTA issues or charges from the regime that will replace the LTA) they can access 25% of their pension tax free. If they die under 75 the death benefits are usually tax free, so not much of a difference to the beneficiaries. But if they die after 75 that money that was tax free during their lifetime becomes subject to income tax. So, if you are likely to die after 75 and you have uncrystallised pension benefits, why let the tax-free cash become taxable?

If we assume that a member is age 75 and has a pension worth £200,000 that they are not likely to access, no LTA issues (or charges from the regime that will replace the LTA) and no IHT issues. What does this mean? Well, if we assume that there is 4% after charges growth what does this mean at age 75? We will also assume that the beneficiary of the pension is a basic rate taxpayer. Growth has been added monthly.

Death Benefits Uncrystallised Pension



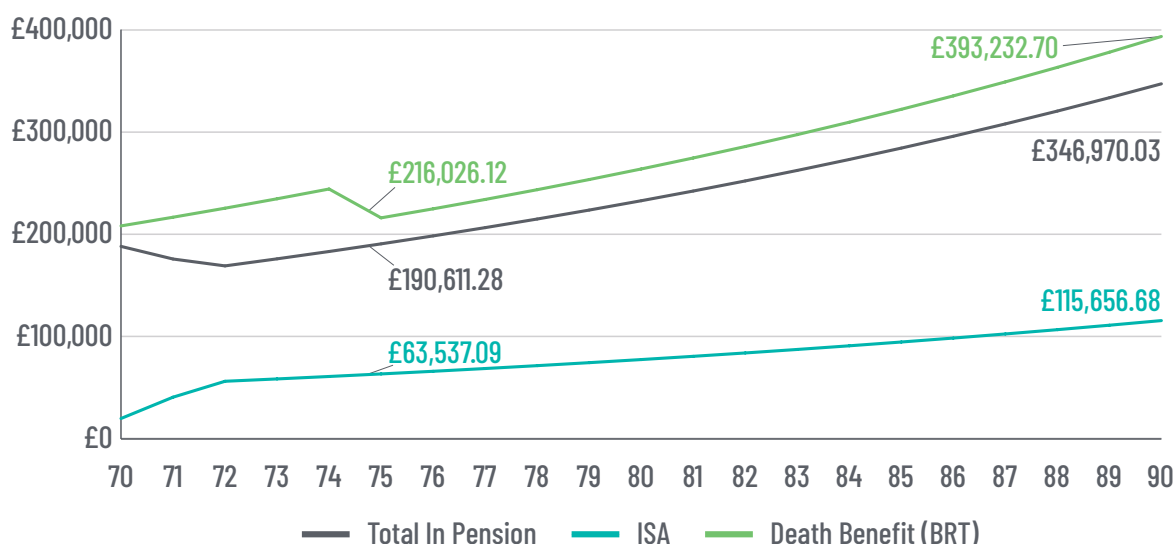
To summarise the above chart whilst the member is alive the net death value in green is the same as the fund value. However, if the member dies at age 75 the value of the death benefits drops by almost £51,000 (and also let's not forget that given the basic rate band, this would need the money taken out over several years). For higher and additional rate taxpaying beneficiaries this problem is exacerbated by their higher rates of tax, at age 75 they would net £101,659 and £114,366 less than the fund value.

The problem only gets worse over time as the pension fund grows, and for even the basic rate taxpayer the death benefits if the member dies at age 90 are over £92,000 less.

So, given the individual has no IHT issue, why don't we take that tax free cash out of the pension and fund ISAs? This has to be done over three years, so in the first two years PCLS of £20,000 is taken and in the third year only £13,885.90 can be taken, as that's the pension used up it's 25% tax free cash.

So, what's left in the pension is now a drawdown fund, and the ISA investment will mirror what's in the pension and produce 4% annual growth which we are adding monthly.

Overall death benefits after putting tax free cash in ISAs



At age 75 the after-tax death benefit for a basic rate taxpayer has increased to £216,026, an increase in the total death benefit of £12,707 by simply stopping that tax free cash becoming taxable. For higher and additional rate taxpayers the increase in the net death benefits is £25,414 and £28,591 respectively.

During their lifetime the individual still has access to tax free cash in the form of the ISA that they have, so they are not losing any control and if the ISA investment mirrors the pension the total value available to the individual never changes (there may be fund value discounts lost in the pension that may have to be factored in).

So, no control is lost for the individual, but the beneficiaries will be substantially richer in this example.

For those that do have an IHT issue then the tax rate of the beneficiary is key. Pensions are usually IHT free, so if death is after age 75 and the beneficiary's marginal rate is less than IHT (so non or basic rate taxpayers) then leaving the money in the pension gives a higher outcome. For higher rate taxpaying beneficiaries, it doesn't make a difference, 40% will be lost to one of the taxes. But if your beneficiary is an additional rate taxpayer, then they save 5% of the value of the funds placed in the ISA only being subject to 40% IHT, as opposed to keeping it in the pension and paying 45% on the lot.

Case Study 7 – Accumulators who are not going to decumulate

This can be a tricky one, but as covered earlier with the exclusion of qualifying BPR investments ISAs fall into the IHT net.

But what about those that have accumulated the pot, but have their decumulation sorted elsewhere? Perhaps they have a generous defined benefits pension scheme that has provided them with all the tax-free cash and income that they need? Well, what do they do if they have an IHT problem?

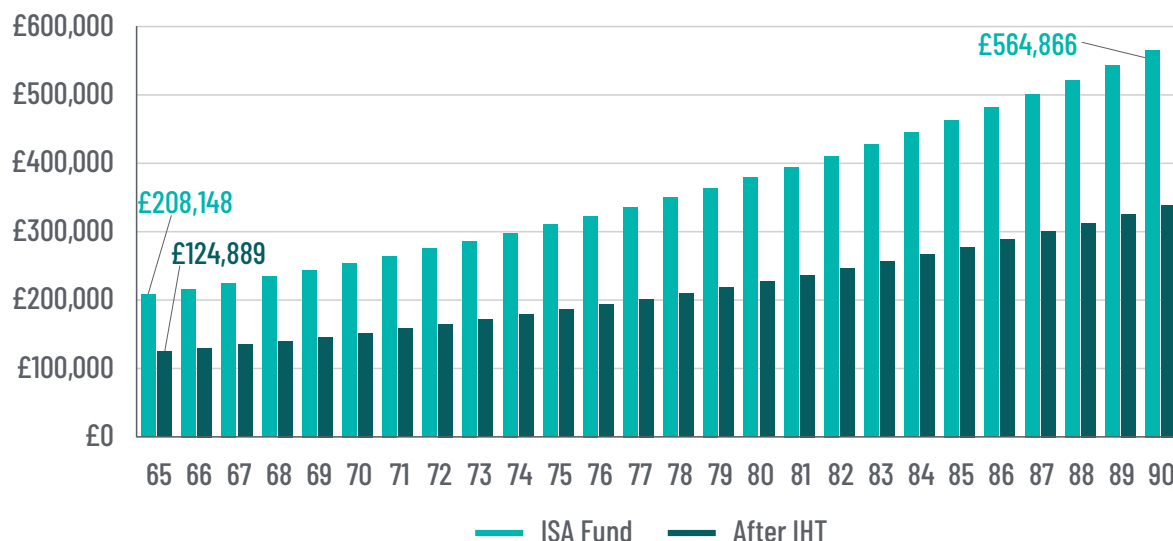
Leave things as they are

To quote the late Roy Jenkins (a former Chancellor of the Exchequer) from 1986 “Inheritance Tax, is broadly speaking, a voluntary levy paid by those who distrust their heirs more than they dislike the Inland Revenue.” Whilst the Inland Revenue now goes by the name Her Majesty’s Revenue and Customs, the principle still applies. IHT can be mitigated or removed from estates with some basic tax planning in most cases.

So, for someone who has built up a sizeable ISA portfolio, and has a IHT problem with no plans or need to take the benefits, what can be done?

Well, if you leave things as they are, the death benefit will always be 60% of the ISA value once IHT has been taken of as can be seen below, this uses 4% annualised growth added monthly;

ISA Subject to IHT



But with our Roy Jenkins hat on, what can we do? Well, that comes down to the individual, and if they are willing to give up the funds, require access to what they have accumulated or need an income from the money that they have built up. That leads us down the usual trust routes, gift, loan, or discounted gift.

Let's start with someone who is 65, has built up £200,000 (with growth this will be £208,148 at the end of year one) in their ISAs but wants to keep access to what they have built up "just in case", but are sure that they don't need any more, so they don't need to build this up. Well, they could switch their ISA to cash and that would do the job, or they could bring trusts into the equation.

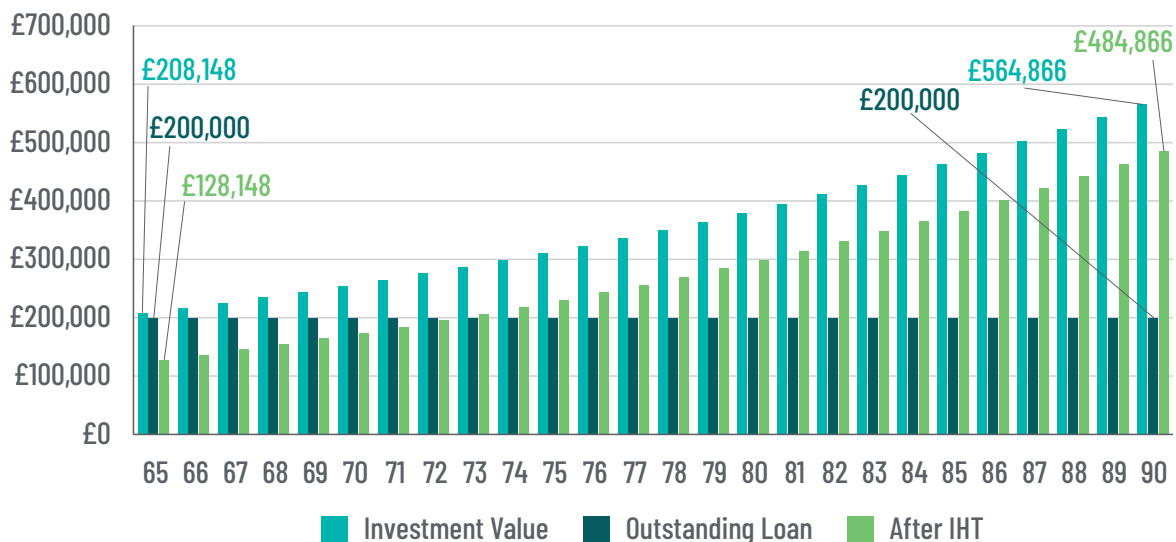
Our article in Pruadviser **Gifting and Inheritance Tax, How does a Loan Trust work?, How does a Gift Trust work?, What is a Discounted Gift Trust?** and our **Adviser Guide to Estate Planning** can be referenced for more in depth information on trusts.

Use a Loan Trust

A loan trust is neither a PET nor a CLT, so no nil rate band is used up by enacting one. It allows clients access to their original capital at any point and in any amount, but the growth will not be included in their estate for IHT purposes. For the avoidance of doubt, the outstanding loan remains in the settlor's/donor's estate for IHT purposes.

If that £200,000 is placed into a loan trust using an offshore bond and still using 4% annualised growth payable monthly what does this do?

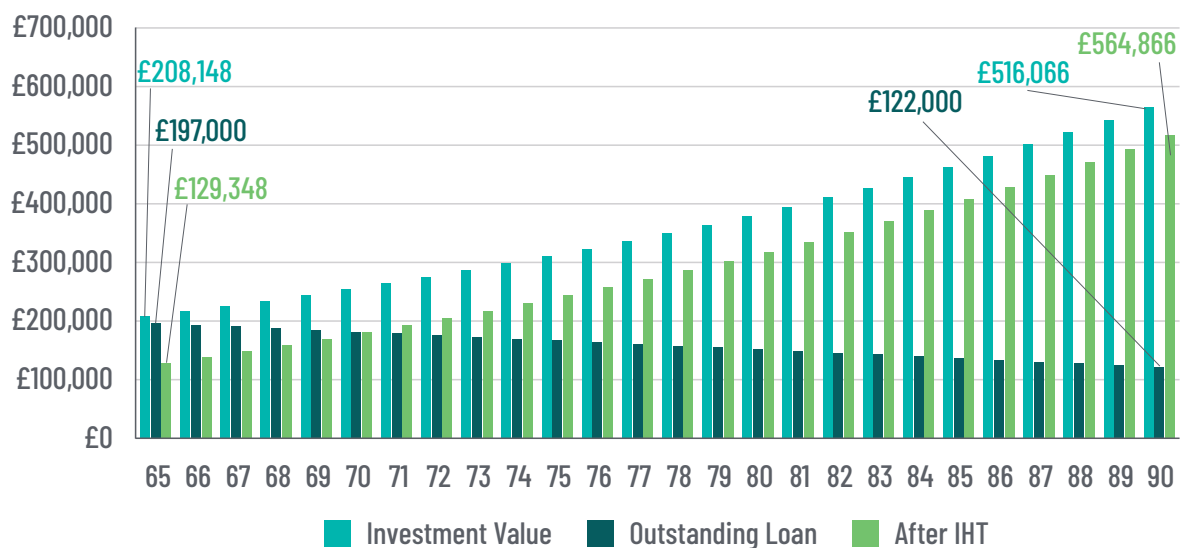
Loan Trust



Just after the first year this would make the beneficiaries £3,259 richer, and if the individual lived to age 90 but hadn't needed to access any of the money then they'd have left their beneficiaries £145,946 more than just keeping that money in the ISA making their IHT situation worse. They keep access to what they have built up but pass on more wealth to their loved ones.

But what if over time they realised that they didn't need as much access to the money? Perhaps each year that they realise that as they are one year closer to the end that they can give up access of say £3,000? Which would be fortuitous as that's their IHT annual exemption and waiving £3,000 per annum can do a lot of good for their beneficiaries, it makes them richer by £1,200 a year, so in the timeframe of the chart above that increases the wealth passed on by £1,200 in year one (obviously!) and £31,200 by year age 90, and there is still £122,000 of the loan there "just in case".

Loan Trust with £3,000 per annum write off

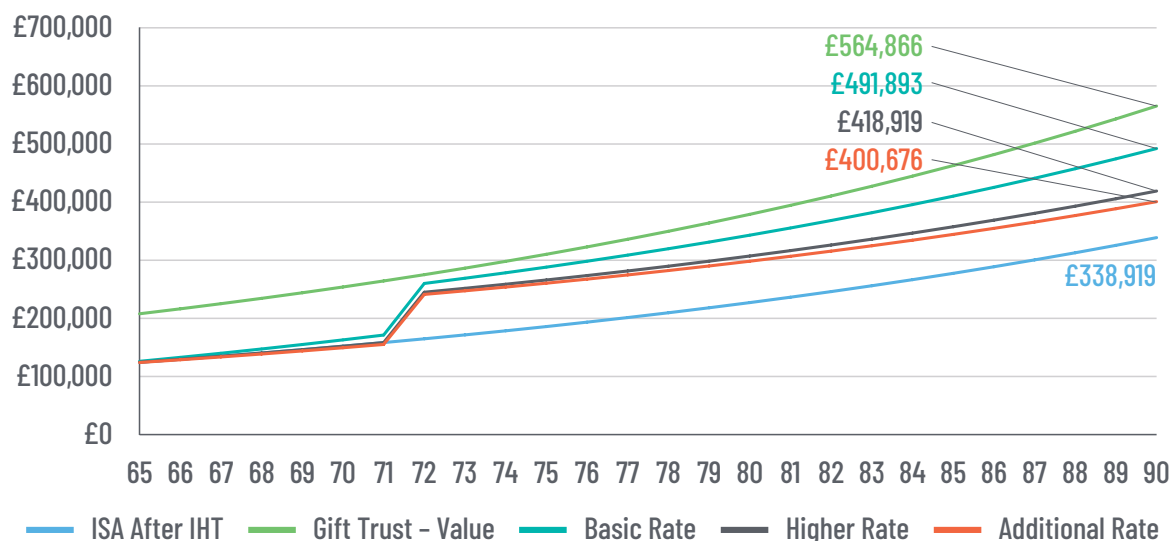


Use a Gift Trust

A gift trust is either a PET or a CLT depending on if the trust created is absolute or discretionary. The key issue here is that unlike the loan trust you don't just give up the growth, you give away the money to the beneficiaries. If this is below the settlor's available nil rate band then there is no immediate tax charge (for a CLT), and the 7 (or 14) year clocks will start.

So, assuming it's just the seven-year clock that we are using, and that the gift trust is absolute, and that the full gain in the trust becomes taxable on the beneficiary, what does this mean to the value of the same £200,000 we used for the loan trust example, with the same growth assumptions?

Gift Trust in comparison to ISA



As can be seen, in the initial seven years there is not much difference in comparison to leaving the ISA subject to the IHT regime when the gift is still using nil rate band. At year seven there are minor gains in comparison to the ISA for basic rate taxpayer (£12,901 richer, assuming all of the trusts gains are taxed), for the higher rate taxpayer then they are in the same position, 40% income tax on the gain and the gift against 40% IHT makes no odds to them. Additional rate beneficiaries would be £3,225 worse of.

But once that seven-year clock is gone and the £200k gift has fallen away from the nil rate band usage then as can be seen the above chart, then the benefits jump up by £80,000 (which is the IHT bill on the £200,000 that was on the estate for the first seven years).

Completely removing that money from the estate after seven years is a clean and simple way to do IHT planning for those that are comfortable giving up their right to that money, so the "just in case" fund from the loan trust would need to come from somewhere else (unless you want to bring gifts with reservation into the equation!).

But with the potential to make a basic rate beneficiary over £152,000 richer if the money comes out of the trust to them after the 25 years detailed in the chart above, would that potentially swing the need for the just in case fund that may be too cautious?

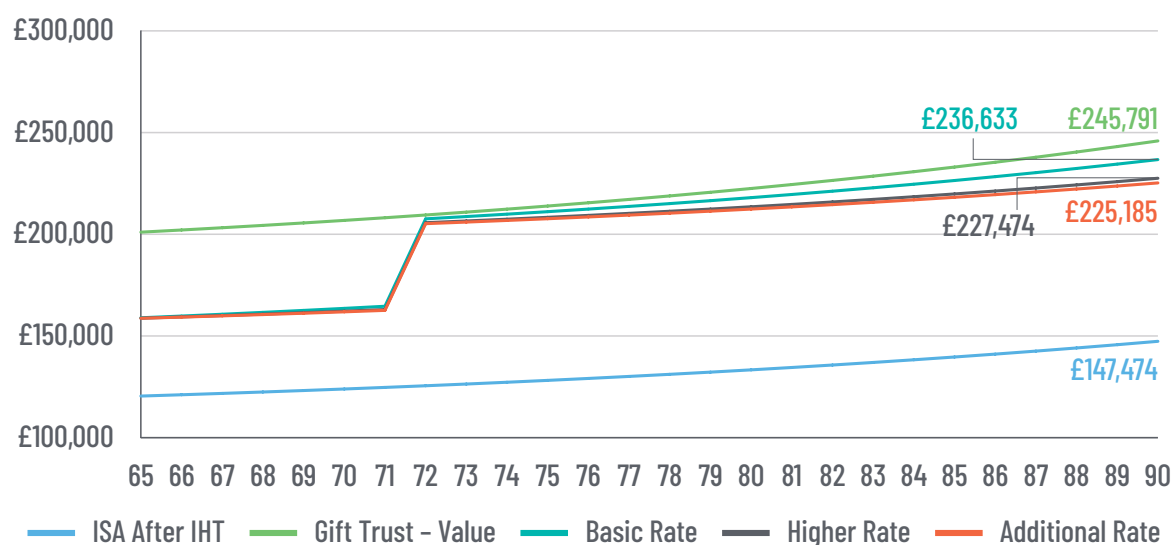
Use a Discounted Gift Trust (DGT)

We've covered those that don't need the growth but need access to the capital (Loan Trust), those that don't need the capital or growth at all. But what about those that don't need the capital but need an "income", so they need the growth (if you like), but they don't need the capital? Enter option three, the DGT.

A DGT can be suitable for those individuals who wish to undertake IHT planning but who are unable to lose full access to their investment. In a DGT, access is typically provided by means of a series of pre-set capital payments to the investor who will be the settlor of the trust.

Looking at a DGT for £200,000, with the same growth assumptions as before, but we also have to factor in what "income" will be returned to the settlor. To help with longevity an initial income of 3.5% per annum (£6,996) is selected, this will be paid out monthly.

DGT in Comparison to ISA



As per the graph above, the initial discount (which was valued at 47.76%) makes a big difference in the initial seven years means that there is an immediate IHT saving. It's a handy by-product of how the DGT works, but not really the selling point. If life expectancy was less than seven years then the initial discount is likely to be minimal, if not zero. So, for the initial seven years it's almost accident insurance on your IHT bill!

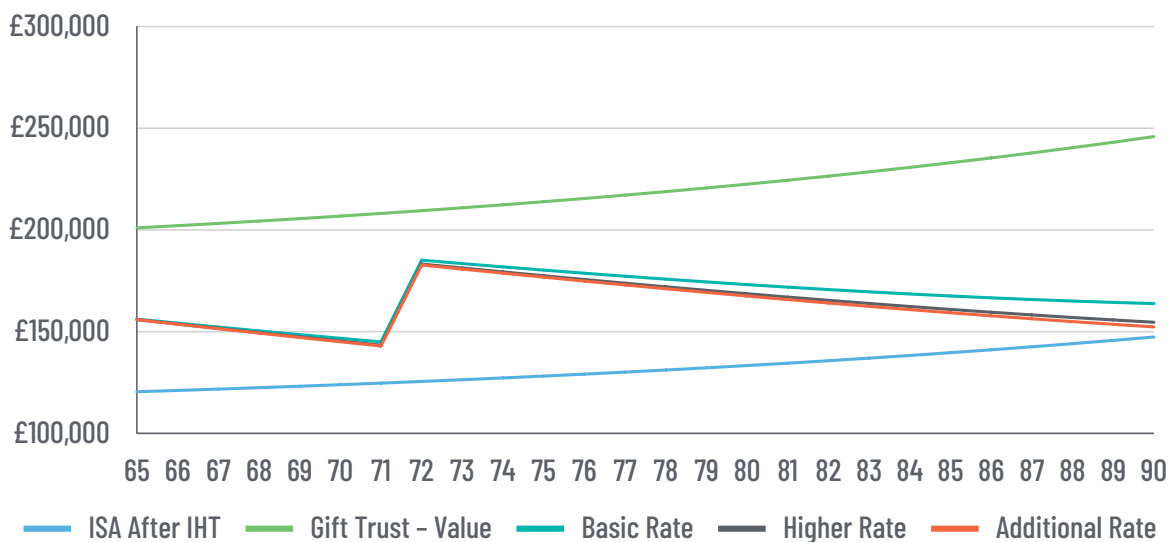
But once the seven-year discount is out of the way, the real benefits can be seen in terms of the overall value passed on to the beneficiaries.

But let's not also forget that this is generating the income that is needed for the settlor, there was a need for the £6,996 per annum, so not only did they get the funds that they needed, but they also reduced their IHT bill. But that income can be key, which is why the initial discount shouldn't be the main selling point of the DGT, as if they don't need that income, it's coming back and staying into their estate.

So, if the £6,996 stays in the estate, then the IHT bill increases by £2,798 a year ($£6,996 \times 40\%$) and that can have a dramatic effect on the effectiveness on a DGT.

Using all of the previous assumptions but having that income then build up in the estate again shows a very different outcome for the beneficiaries.

DGT in comparison to ISA – If the income stays in the estate



As can be seen over time the overall effectiveness of the DGT is reducing, simply from the build-up of repayments not needed in the first place. Whilst that initial discount may look attractive, if income was needed at some point and control was available over when to take it, would a loan trust have served better for the whole amount? Or would part gift trust and part loan trust have delivered a better outcome?

Case Study 8 – Investing for a child, but limiting their access

As detailed in the JISA section earlier, up to £9,000 per annum can be invested for a child, they can begin managing their JISA investments when they are 16 and can have full access at age 18.

If we look at a grandparent, that had retired on their DB pension but has gone back to work for an extra 5 years and will have excess income of £30,000 per annum, therefore the normal expenditure out of income exemption can be used. This excess income will exacerbate the existing IHT problem of the grandparent.

He has two children, and the eldest child has given him two grandchildren (one just about to turn three and the other approaching their first birthday), he's hopeful his younger child will provide a grandchild in the near future.

Contributions

The grandparent would not be able to fully utilise the £30,000 with the JISA allowances (there are only two grandchildren at present), and the parents would need to open the JISA account first to allow him to pay into it. Pension contributions could be made but discounted as the grandparent doesn't want to put this away until the grandchildren are almost his present age!

An offshore bond for each child is unlikely due to minimum investment premium required but it would be possible to regularly invest £30,000 (and make use of all the excess income) in a single bond for the benefit of his intended beneficiaries which leads us nicely to the next key area. Using an offshore bond in a trust.

As bonds are segmented the grandparent understood it would be possible to set it up one bond with a number of segments which could be divided equally between the grandchildren.

The grandparent could invest with a different provider for each gift of £30,000 and still use the same trust (or a new trust).

The key factor here is that the grandparent would like to avoid using a JISA, not only would the premiums not be enough, but he also doesn't know how many grandchildren he will end up with and wants to give them all a "fair share of this wealth". This may be difficult as this excess income is only available for five years and making JISA contribution for the (hopefully) first two grandchildren could put them at an advantage over any subsequent grandchildren.

The JISA also doesn't have the option to withdraw funds before age 18 in case this is needed for the grandchildren (perhaps they may go to private school) and there is also no control once the grandchild reached 18 which could be a worry to most who can remember what their 18-year-old self would have done with full access to a large amount of money.

There can be a wide class of potential beneficiaries so the trust fund could be used for future grandchildren but also his children if they ever required money. He liked how individual segments could be surrendered or assigned to beneficiaries and the ability to take withdrawals within the 5% tax deferred allowance without triggering an immediate liability to tax.

When discussing the discretionary trust, the grandparent liked that the trustees had control over when the funds were used, whether it be before the grandchildren reach age 18 or distributing when they are older. The grandparent can be a trustee too.

Finally, if one of his grandchildren died before reaching age 18, he would like their share to go to the other grandchild(ren) so the intestacy position (his family live in England) is not aligned to his objectives (assuming the money were invested in a JISA, children cannot have a will).

The tax treatment

Investment gains are tax-free with the JISA, but offshore bonds grow in a virtually tax-free environment (withholding tax, which cannot be reclaimed, can apply).

When money is taken out of an offshore bond or certain events happen (such as death giving rise to a pay-out) then a chargeable event occurs. Chargeable event gains are subject to income tax but withdrawals within the 5% tax deferred allowance do not trigger a chargeable event.

When held in a discretionary trust any chargeable event gains could be assessed against the settlor, the grandparent in this case at his marginal rate, against the trustees at the trustee rate of taxation (45%) or against the beneficiaries at their marginal rate depending on the circumstances.

The planning can work best if the gains were to be assessed against the grandchildren while they are non-taxpayers by assigning segments to them directly or appointing via bare trust if they are under 18. As offshore bond gains are treated as savings income the grandchildren can make use of their available personal allowance, starting rate for savings and personal savings allowance.

As an example, to illustrate how this could work, and as future tax rates and allowances are unknown, we'll use the 2023/24 tax rates and allowances which are £12,570 personal allowance, £5,000 starting rate of 0% for savings and £1,000 personal savings allowance.

Assuming £30,000 is invested over the next five years and 4% growth (added monthly again) is achieved net of charges, 15 years later when the eldest grandchild turns 18 and hopefully goes to university the bond is valued at £252,488. The total chargeable event gain is £102,488 (£252,488 – £150,000). There are 100 segments in the bond, so the gain per segment is £1,024.88 (£102,488/100).

The trustees assign 18 segments to the grandchild who has zero income, if they were then surrendered after assignment the gain would be £18,447 and taxed as below. The hope is then that the grandchild will then pay for Uni fees, accommodation and any study material before freshers' week starts!

		Tax Rate	Tax Due
Personal Allowance	£12,570	Nil	£0
Starting Rate for Savings	£5,000	0%	£0
Personal Savings Allowance	£877	0%	£0

In this example, there is still £123 of personal savings allowance available.

Perhaps an elegant solution to the issue of unleashing an 18-year-old into the wild with full access to the money?

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