Investment Solutions

ISAs – are they still worth investing after April 2017?

From April 2017, you can earn up to £1,000 interest a year, (higher rate tax payers- £500.00) tax-free. Is it still worth investing in an ISA?

The new Dividend Tax Allowance, enabling Stock Market investors to earn £5,000 of dividends tax-free each year remains.

ISAs will continue to allow you to shelter cash or investments, such as stocks and shares from Income Tax and Capital Gains Tax on profits. The 2017/18 allowance increases from £15,240 (2016/17) to £20,000. For millions of people, the new Allowances will be enough to protect them fully from tax – which raises the obvious question, why bother with an ISA?

In the case of Cash ISAs, a basic rate tax payer saving the full £20,000 would need to earn an interest rate of 5% before receiving any additional protection from their ISA over and above the new Personal Savings Allowance. In today's interest-rate environment, that is near impossible.

With Investment ISAs, your £20,000 annual allowance would need to deliver a dividend yield of 33% to give you any income–tax saving, given the new Dividend Tax Allowance. That is out of the question, even with the most generous dividend-paying companies.

Long Term Benefits

So, should savers and investors give ISAs a miss? We say "no", but you need to think about long-term benefits rather than short-term gain.

The case for Cash ISAs is weak, unless you are building up substantial savings as some people are – there are ISA millionaires. The top-paying savings accounts offer about 1.5% annual interest. A basic-rate tax payer would need almost £67,000 in Cash ISAs for the shelters to generate a tax saving at that rate. That said, Cash ISAs sometimes pay higher rates of interest than other types of savings accounts – in which case they are worth considering, irrespective of the tax position.

Jan Kinghorn, Senior Financial Adviser at Investment Solutions, says "One day, interest rates will be higher and many savers will get caught paying tax, which they could have avoided if they had used their ISA allowance".

In fact, the FED has recently raised rates in the US and it's widely expected that British policymakers will follow suit and raise the base rate from its historic low of 0.25%. Increases are likely to be gradual, but there is a glimmer of hope for savers.

As for investment ISAs, there are several arguments to consider. First, while the annual Capital Gains Tax allowance, worth £11,300 looks sizeable for people with small investments, profits mount up over the long term – if you cash in more than the allowance in a single tax year in the future, your tax bill could be “painful”.

“It is a huge advantage of an ISA wrapper that there is no Capital Gains Tax to be paid, however much profit you build up over an extended period”, says David Connor, Director at Investment Solutions. “Why pay tax when you don’t need to?”

Avoiding Tax in Dividends

Regular investors may also find themselves coming up against the £5,000 Dividends Allowance sooner than they expect. “ISAs’ ability to sidestep tax on dividends remains valuable, as do tax-free gains” comments Angus Willson of Investment Solutions.

ISAs do not protect people from Inheritance Tax, but there is now the added incentive that, since April 2015, ISA investors can pass their accounts on to spouses or civil partners without any loss of their tax benefits. That means that heirs will continue to enjoy Income and Capital Gains Tax protection. David Connor believes that this could lead savers and investors to fall into the trap of focussing only on the short term. “The tax benefits of an investment ISA do not provide instant gratification, but they do build up, so you need to assess the value over their lifetime”, he says. “You might not be a higher-rate tax payer when you first invest, or have only small sums to put by, but in 20 years’ time your circumstances may have changed – the ISA tax framework could prove to be very advantageous”.

Hindsight is a valuable thing: Jan Kinghorn fears many savers and investors could discover ISAs are worth having only after having missed several years’ worth of opportunity to use them. Unlike other tax allowances, ISAs cannot be rolled over – if you don’t use this year’s allowance, it’s gone for good.

“It is still really important for savers and investors to continue to use their ISA allowance: ISAs create their own tax havens, regardless of what happens to their owners’ future circumstances”, says Ivan Lyons, a Fellow & Chartered Financial Adviser and Director at Investment Solutions. “An ISA means never having to worry about tax on your savings and investments, or even about having to declare them on a self-assessment tax return”.

Nevertheless, it’s important to recognise that the tax system is changing – and to keep the effect of those changes in mind. Where Cash ISAs offer the best rates in any case, or where Investment ISAs come at no additional cost to the underlying investment, there shouldn’t be much of a dilemma. However, if you’re being asked to pay for an ISA, whether through interest foregone or additional fees, think hard about whether to say yes.

As always, we would recommend that independent financial advice is sought.

Please note that past performance is no reflection of future performance and that investments outside Cash can fall in value as well as rise in value.