A brand new Isa age

If you haven't yet got an Isa, perhaps it's time to get one. If you have one already, read on to see how new rules are going to affect you

Individual savings accounts, or Isas, are the UK's favourite savings plan. Following their introduction in 1999, more than 16 million people now have one. Their advantageous tax status makes them an attractive option and new rules, arriving in April 2008, will make Isas nicer.

Currently, Isas come in two sizes – minis and maxis – and two types – cash and stocks and shares. You can have a mini cash Isa and a mini stocks and shares Isa, or a maxi Isa invested just in shares, or a mix of cash and shares. These mini/maxi definitions have proved baffling and the new rules will banish them. There will be just cash Isas and stocks and shares Isas.

The overall Isa investment limit remains at £7,000 a year. You can put up to £3,000 a year into cash, with the balance going into stocks and shares. As long as you don't exceed the £3,000 cash limit, you can split your £7,000 limit between the two types any way you want. Alternatively, you can put the lot into stocks and shares.

Cashing in

Cash Isas are great-value products for two reasons. They generally have higher interest rates than ordinary accounts (see 'Isas vs savings accounts', opposite) and interest is tax-free. So if you have money in an ordinary savings account and you haven't used your Isa allowance, consider switching.

Just like savings accounts, cash Isas don't put your capital at risk. But keep an eye on your interest rate. The enemy of any cash saving is inflation, which erodes the value of your capital. The key with cash Isas is to make sure the interest rate you get keeps ahead of inflation – switch to a new provider if your current provider starts to get mean.

Cash Isas generally have higher interest rates than ordinary accounts

Some cash Isa providers offer top rates to hook you, only to drop them. For example, in January 2000, Smile's cash Isa rate was 6.75 per cent, making it a Best Buy. Over time, the rate has fallen to 4 per cent and it hasn't been a Best Buy since 2002.

You can transfer all or part of any previous years' cash Isas to a new provider without affecting your current year's allowance but the transfer must be done by your provider. If you transfer the money yourself, your Isa could lose its tax-free status.

Taking stock

The main rule change affecting cash Isas is that you will be able to switch earlier years' cash Isas to stocks and shares Isas. Currently you can transfer only cash to cash.

Stocks and shares Isas allow you to invest your money in the stock market and to keep

Isas for beginners

The facts you need to get started on the road to your first Isa

NEW RULES These will take effect from April next year (see 'New rules', opposite).

THE LIMIT The maximum amount you can invest in each tax year is £7,000 but only £3,000 can be in cash.

CASH ISAs These are very much like simple savings accounts. Some are instant access and some have penalties if you take out your money within a certain time.

HIGHER RATES Cash Isas often have better rates than ordinary savings accounts and the interest you receive is completely tax-free.

WHERE TO BUY You can take out cash Isas with building societies, National Savings & Investments and banks.

IN THE STOCKS Stocks and shares Isas are investments in shares. Unlike cash Isas, these aren't totally tax-free as you pay tax on dividends. The value can go up or down, according to the value of the shares.

WHICH PROVIDER If you have a cash Isa and a stocks and shares Isa in the same tax year, they can be with the same or different providers. But you can't have two Isas of the same type in the same tax year.

WHEN TO START The Isa year (and tax year) starts on 6 April.

ADVICE Which? has Best Buy cash Isas in 'Money Monitor' (see p36) or online at www.which.co.uk/money.

More information

To compare charges on stocks and shares Isas, see the Financial Services Authority's comparative tables at www.fsa.gov.uk/tables.

For information on the new rules, visit www.hm-treasury.gov.uk and click on 'pre-budget report summary'.

PHOTOGRAPHY HADDON DAVIES

some of the return tax-free. The most common way of investing is through funds such as unit trusts, open-ended investment companies (Oeics) or investment trusts. With these funds, you pool your money with that of thousands of other investors to spread the risk. The fund manager decides what shares to buy and sell.

Access to compensation

You can buy these investments direct from Isa providers, through an online fund supermarket or through a financial adviser. However, unless you are a confident investor, we suggest you go through an independent financial adviser. If you buy direct or through a fund supermarket, you won't have access to compensation if you buy a stocks and shares Isa that turns out to be unsuitable for you.

An alternative is a self-select Isa, where you choose the shares you want to buy and purchase them through an Isa 'wrapper' (a stockbroker can do this for you).

With non-Isa shares or investment funds, 10 per cent tax is deducted from any dividends paid. Basic-rate taxpayers pay no further tax but higher-rate taxpayers pay an extra 22.5 per cent, unless it's in an Isa.

Originally, stocks and shares Isas were exempt from this tax, but since April 2004, it's been applied to all dividends, whether the investment is inside or outside an Isa.

The good news for higher-rate tax payers is that they pay less tax on stocks and shares ISAs (10 per cent tax as opposed to 32.5 per cent), and no one pays any capital gains tax on any profit the Isa makes (this year, charged on gains over £8,800).

The main advantage of investing in stocks and shares Isas is the potential for higher returns. However, conversely, there is more risk to your investment, as stocks and shares can go down as well as up. These investments have another sting in the tail, as you'll usually pay an upfront charge of up to 5 per cent and then an annual management charge of 1 or 1.5 per cent. Charges can dramatically reduce return, so always shop around (see 'More information', opposite).

Finally, those who have a personal equity plan (Pep) – the precursor to stocks and shares Isas – will be affected by the new rules. From April next year, Peps will be reclassified as stocks and shares Isas and the rules for both products will be aligned. Transfers of Peps to other stocks and shares Isas will be allowed for the first time.

The main advantage of stocks and shares Isas is the potential for higher returns

ISAs BEAT THE PALACE

Tony Legg *57*

Tony is a big fan of both Isas and south London Championship football side Crystal Palace. However, he's the first to admit that his investment has performed better than his team over the last few years. He took out a stocks and shares Isa in 1999 with fund manager Jupiter which, after an initial blip, has done really well. 'It went down between 2000 and 2003 and I was beginning to worry,' Tony said. 'But I had invested for the long term so I hung on and I'm glad I did. It's bounced back really well and has doubled in value.' Tony and his wife Lin also have cash Isas from previous tax years. The new rules will mean they can transfer some or all of the money from old cash Isas into stocks and shares Isas if they want to without affecting their current year's Isa allowance.

Tony added: 'It's a pity my team can't take a leaf out of the Isa's book. Maybe the Palace should consider a couple of transfers.'

New rules

How they will affect you

- **Here for good** Isas are now here to stay and will have an overall annual investment limit of at least £7,000.
- **No more minis and maxis** The old definitions of mini and maxi Isas will go. Instead there will be two types of Isa: cash and stocks and shares.
- **Time is up for Peps** These will become stocks and shares Isas in April 2008 and can be transferred into other stocks and shares Isas.
- **A key transfer** Previous years' cash Isas will be able to be transferred into stock and shares Isas (but stocks and shares Isas still can't be transferred to cash).
- **Isas for your kids** Child trust funds can be rolled over into Isas when they mature.

ISAs vs SAVINGS ACCOUNTS

The graph shows how much interest you would have earned from January 2006 to December 2006 on savings of £18,000 with a range of accounts. The Best Buy Isa beats the interest earned on all the savings accounts even if you are a non-taxpayer. However, savings in a worst buy Isa earn less than a Best Buy savings account taxed at the basic rate.