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Tax-efficient investing

Investors and savers take note. Tax wrappers can make a huge difference to the value of your savings over time.

You have two main options: invest within an individual savings account, better known as an Isa, or put more money into your pension.

The benefit of an Isa is that you can access the money whenever you want (in most cases) and any money you withdraw will not be subject to tax.

The benefit of a pension is that the government tops up your contributions at your marginal income tax rate when you pay into it, allowing this tax relief to grow over time. If you have an employer they will top up your contributions.

However, you have to pay income tax when you withdraw money from a pension and you can't access it until you are 55 (rising to 57 in 2028).

Isa – key points

- An individual savings account is a wrapper that allows you to grow savings free of tax.
- You have an annual Isa allowance which is the amount you can add to the account in any given year – the current allowance is £20,000 (for the 2020/21 tax year).
- There are different types of Isa but one allowance for all your accounts.
- You have until the 5th of April each year to use up your Isa allowance – if you don't it will be gone.

All UK residents can have Isas. Junior Isas are available for children under the age of 18 and must be set up by a parent or legal guardian before the child is 16. The current Junior Isa allowance is £9,000 a year.

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Types of Isa

Stocks and shares Isas and cash Isas are the two most popular.

Given the current low interest rates, returns on money in cash Isas are poor and inflation can mean that they lose value in real terms. That means long-term savers, seeking to grow their money over time, are likely to be better off investing in stocks and shares.

Stocks and shares Isa

Can be used for:

- Exchange traded funds: [View IC top 50 ETFs](#)
- Active funds: [View IC top 50 funds](#)
- Shares – on as many exchanges as your platform offers
- Government bonds
- Corporate bonds
- Cash (usually interest-free in platform accounts)

If you invest in stocks and shares, it is generally advised that you should have an investment time horizon of at least five years (see guide on 'Why you should invest').

Example

If you put £10,000 into an Isa every year and the investment grows by 4 per cent every year, after 20 years your portfolio would be worth **£273,700**.

That's **£73,700** in returns that would be taxable if the money were not inside an Isa.

Any dividends paid can help the Isa grow faster if they are reinvested as they are not subject to dividend tax, and you do not need to worry about a large capital gains tax bill over time.

Don't underestimate the power of **compound growth**. According to IG, FTSE 100 total returns grew at an annualised rate of 7.75 per cent from 1984 to 2019.

A £10,000 investment would be worth £136,334 after 35 years if it grew at 7.75% per year.

But manage your expectations. Changing market conditions can be difficult to stomach for nervous investors.



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Lifetime Isa

Lifetime Isas were designed to give a boost to people when buying their first property, and to encourage people to save. You can set one up between the ages of 18 and 40, and put up to £4,000 into it each year.

You can keep contributing until your 50th birthday, and the government will add an extra 25 per cent, up to £1,000 a year. As with all Isas, it is free of UK tax. The government will pay the bonus each month (or however often you pay into your account), and your platform or bank should claim the bonus for you.

The maximum bonus is £33,000 (unless the rules change). You'd need to put £4,000 in each year from age 18 up until you are 50 to get that.

There are strict rules about when you can take money out of a Lifetime Isa without paying a withdrawal charge.

You can access your money if you're buying your first home (with a purchase price of up to £450,000), or if you are over the age of 60.

In most other cases, if you want to withdraw your money you will pay the government withdrawal charge of 25 per cent of the amount withdrawn. That means you won't only lose the bonus paid by the government, but some of your initial savings as well.

Lifetime Isas can be held in cash or stocks and shares.

Innovative Finance Isa

These are for peer-to-peer lending – a form of investing where you directly lend money to borrowers and businesses for a fixed amount of time, and they pay you back with interest. Like all other Isas, your money is free from UK income and capital gains tax.

Interest rates can look very generous on these products, but, generally, the higher the rate, the more likely you are to lose money.

It is very difficult to do due diligence on these products so unless you really know what you are doing it is probably best to steer clear.



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Isa summary

ISA type	Description	Key terms*
Stocks & Shares Isa	Investment account	£20,000 allowance, no dividend tax or CGT payable
Cash Isa	Savings account	£20,000 allowance, tax free interest
Lifetime Isa	Savings/ investment towards house deposit or retirement	£4,000 allowance, govt adds 25% to contribution. Bonus paid back if not used for house purchase (first time buyers only) or retirement. Only those aged 18-39 can open. Tax free returns
Innovative Finance Isa	Peer to peer lending	£20,000 allowance, tax free interest
Junior Isa	Savings or investment account for children (up to age 18)	£9,000 allowance, tax free returns
Help to Buy Isa	Savings account for first time buyers	Closed to new savers. Can pay in £2,400 for 25% top up. Tax free interest

*all allowances apply to 2021/22 tax year

Pensions

Pensions can be complex, but the chances are, you're already paying into one.

Defined contribution

Most private sector workplace pensions are 'defined contribution'. This means your pension value at retirement depends on how much you've paid in and how your investments have performed over time.

Under automatic pension enrolment rules, you must make pension contributions of at least 8 per cent of your salary every year, with your employer paying in at least 3 per cent. Some employers are more generous and will match your contribution up to a certain threshold.



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If you are not part of a workplace pension scheme, or if you have maxed out potential employer contributions, you might want to consider a **self-invested personal pension (Sipp)**. Sipp's enjoy the same tax benefits as a standard personal pension, but you can use them to invest in many different assets.

You can pay up to £40,000 into your pension every year under the current tax rules, with the government adding your marginal income tax rate (at least 20 per cent) to contributions paid in. The tax relief is reduced, however, where annual earnings exceed £240,000.

You can take 25 per cent of your total pension pot tax-free when you retire. Further withdrawals will be subject to income tax.

If you have worked for several companies, you are likely to have several pension pots and may wish to consider transferring them into the same scheme. You can do this by contacting previous employers and asking for your pension scheme details.

Defined benefit

You may have a defined-benefit workplace pension if you've worked in the public sector or at a big company. This means the amount you receive on retirement is usually based on the number of years you've been a member of the scheme and your salary (either at retirement or an average of your salary during your years working).

Defined-benefit schemes are generally viewed as more generous than defined-contribution schemes, so it might be worth seeking advice before transferring any money out of a defined-benefit scheme.

Succession planning

Defined-contribution and Sipp pots can be passed down to family members and do not fall within an inheritance tax estate.

If you die before the age of 75, Sipp's are passed on tax-free. If you die after the age of 75, withdrawals by your beneficiaries will be taxed as income at their marginal rate.

How much do I need to save?

There's a general rule of thumb that says you will need about 25 times your retirement expenses if you want to retire at 60. So, if you plan to spend £30,000 a year, you'll need about £750,000 in savings.

You probably need to build up a pot of at least £500,000 to give you a good standard of living in retirement, assuming you are not paying a large mortgage.



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Pension vs Isa

Pensions can be better for:

- Long-term wealth accumulation
- Succession planning

Isas can be better for:

- Access to money
- Flexibility

Under current tax rules, the tax relief you get paying into your pension makes it the more generous vehicle. You do not have to pay income tax on any money that is paid into your pension. This helps contributions to compound over time.

However, you pay tax at your marginal rate on all money coming out of your pension.

With Isas, you do not get any income tax relief paying in, but you do not have to pay any tax when it comes out.

You cannot access pension money until you are 55, rising to 57 in 2028. Isa money can be accessed at any time (charges apply to early redemption in a Lifetime Isa).

When it comes to succession planning, your Isa will form part of your inheritance tax estate. Pensions do not – your beneficiaries will just pay tax at their marginal rate as they draw down the money



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