

# Individual Savings Accounts: proposed reforms

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December 2006



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ISBN-10: 1-84532-223-3

ISBN-13: 978-1-84532-223-9

Printed by The Stationery Office 12/06 353152

Printed on at least 75% recycled paper.

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# FOREWORD

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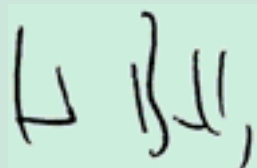
The Individual Savings Account (ISA) is the Government's primary vehicle for tax-advantaged adult saving outside pensions and is at the heart of our efforts to promote saving and asset ownership for all throughout the lifecycle.

We have now come to the end of the internal review of the ISA that was promised when the regime was introduced. I am grateful to the many stakeholders who worked with the Treasury in contributing to this process.

The conclusion of our review is that ISAs have been successful in meeting their objective of extending the saving habit and spreading the benefits of tax relief more widely across the population. Take-up of ISAs is greater than their predecessors: 16 million people now have an ISA, more than twice the number who ever held a TESSA or PEP, and the proportion of savers with an ISA among both lower-income groups and the young is also much higher.

The Government is keen to build on this success. I announced recently that we would make the ISA a permanent feature of the savings landscape. I also announced a package of reforms, based on representations received from savers and providers, designed to simplify the ISA regime and increase its flexibility for savers. Taken together, this will provide stability for savers, certainty for the industry and a firm platform on which to promote saving in the future.

This document sets out more detail on this package of reforms and seeks views from stakeholders about the best way to implement these measures. I look forward to hearing your views on these issues.



**Ed Balls MP**  
**Economic Secretary to the Treasury**



# INDIVIDUAL SAVINGS ACCOUNTS: PROPOSED REFORMS

## INTRODUCTION

**1.1** The Government seeks to support saving and asset ownership for all across the lifecycle: from childhood, through working life and into retirement. Within this lifecycle framework, the Individual Savings Account (ISA) is the Government's primary vehicle for tax-advantaged adult savings outside pensions.

### The ISA Review

**1.2** The Government has concluded its review of the ISA, which was promised when the regime was introduced in 1999 as a replacement for Tax-Exempt Special Savings Accounts (TESSAs) and Personal Equity Plans (PEPs).

**1.3** The objective of ISAs has been to develop and extend the saving habit and to ensure that tax relief on savings is more fairly distributed. The evidence shows that ISAs have been successful in meeting these objectives: over 16 million people now have an ISA – more than double the number holding TESSAs or PEPs in 1999; one in four people from low-income groups have an ISA, compared to one in seven who had a TESSA or PEP; and the proportion of young people with an ISA is now three times as high compared to TESSAs and PEPs.

**1.4** The Government is keen to build on this success. Representations received from stakeholders during the review indicated that the regime could be improved in various ways. Key themes that arose from these representations included the benefits of: certainty about the future of the ISA; simplification of the regime for savers and providers; and greater flexibility for savers.

### Proposed reforms

**1.5** In announcing the conclusion of the ISA review in November, the Economic Secretary to the Treasury proposed the following reforms to the ISA regime:

- make ISAs a permanent part of the savings landscape;
- guarantee an overall annual investment limit for ISAs of at least £7,000;
- bring PEPs within the ISA wrapper;
- remove the Mini/Maxi distinction within ISAs;
- allow Child Trust Fund accounts to roll over into ISAs on maturity; and
- allow transfers from the cash into the stocks & shares component of ISAs for past tax years without affecting the current year's investment limits.

**1.6** The Government intends to implement this package of reforms as soon as possible and all at once, with the exception of the Child Trust Fund measure, for which there is more time. This document sets out how the Government intends to implement these reforms and seeks stakeholder views on a range of practical issues.

**1.7** A Partial Regulatory Impact Assessment is contained at Annex A.

## PROPOSED REFORMS

### Bringing PEPs within the ISA wrapper

**1.8** PEPs were closed to new subscriptions in 1999, although the funds previously invested in them continue to receive tax advantages. PEPs and ISAs have separate reporting systems, so PEP managers who provide ISAs currently maintain two separate systems to support the regimes.

**1.9** In response to representations received, the Government will bring PEPs within the ISA wrapper. The aim is to: enable investors to integrate their stocks & shares investments within the ISA wrapper and so manage their funds more effectively; reduce administration costs for providers; and rationalise the savings landscape.

**1.10** In order to provide the maximum simplification for investors and providers, the Government proposes to align the rules for the two schemes. This will involve changes in two areas: the qualifying investments regime and the treatment of interest earned on uninvested cash.

**1.11** There is a range of investments that are permitted within the ISA regime that are not permitted within PEPs, including stakeholder products and insurance. In addition, the ISA Regulations contain a restriction that is not present for PEPs – that an eligible investment trust should have no rental income. The Government will align the qualifying investments regime by allowing investment trusts with rental income to be held in ISAs and will also allow funds that were held in PEPs to be invested in the full range of ISA qualifying investments.

**1.12** Whilst PEPs and stocks & shares ISAs are primarily vehicles for equity investment, savers are allowed to hold some uninvested cash in their accounts. Providers are required to advise investors that if the cash is not invested, Her Majesty's Revenue & Customs (HMRC) may require the provider to return the cash to the investor. There are differences in the way the interest earned on uninvested cash is treated in PEPs and the stocks & shares component of ISAs. In a PEP, such interest is only subject to tax if more than £180 of interest is withdrawn from the PEP per tax year, whereas all interest earned on cash held in a stocks & shares ISA is subject to a 20 per cent flat rate charge. The Government is minded to apply the ISA treatment to interest earned on all uninvested cash held in former PEPs. The majority of representations received have been in favour of this approach on the grounds that the ISA treatment is simpler and more straightforward to administer. Moving to the ISA treatment will also provide an extra incentive for accountholders to reinvest their cash.

**1.13** The Government also proposes that, on a given date, all PEP accounts will become stocks & shares ISAs. As such, PEPs will cease to exist. However, providers that currently offer both PEPs and stocks & shares ISAs will not be required to amalgamate individual clients' accounts into one account. This will be a matter for each provider.

**1.14** The Government is aware that this reform will require systems changes and is keen to work with providers to achieve this in the most cost-effective manner.

**Question:** Are there any practical difficulties with applying this approach and, if so, how might they be overcome? How long will providers need to make the necessary changes to their systems?

## Removing the Mini/Maxi distinction

**1.15** At present, in each tax year an individual may invest in one Mini cash ISA (up to £3,000) and one Mini stocks & shares ISA (up to £4,000), which may be held with either the same or different providers, or one Maxi ISA (up to £7,000, of which up to £3,000 can be in cash). A Maxi ISA must be held with a single provider.

**1.16** In response to representations received, the Government will remove the distinction between Mini and Maxi accounts. The aim is to simplify the ISA regime, making it easier to understand and administer, and increase the flexibility for savers.

**1.17** Under the proposed new regime, the Mini and Maxi labels will cease to exist. Savers will instead be able to contribute to two components: cash and stocks & shares. They will be able to hold one of each component per year, with either the same or different providers. The overall annual investment limit will remain at £7,000: savers will be able to invest up to £3,000 in cash and the balance in stocks & shares. For example, an individual will be able to save £1,000 in cash with one provider and £6,000 in stocks & shares with a different provider.

**1.18** Providers will still have to monitor the £3,000 cash limit and the £7,000 stocks & shares limit on their accounts. However, investors who use different providers for each component will have to check that they are within the limits. HMRC will continue to monitor the subscription limits. The details of subscriptions made, which are reported by providers, will be matched by HMRC to identify investors who over-subscribe.

**Question:** Are there any practical difficulties with applying this approach and, if so, how might they be overcome? How long will providers need to make the necessary changes to their systems?

## Allowing Child Trust Fund accounts to rollover into ISAs

**1.19** The first Child Trust Fund accounts will mature in 2020. The Government will allow funds held in Child Trust Fund accounts to rollover into ISAs on maturity. The aim is to encourage young people to maintain a saving habit into adulthood. The Government will consult in due course on the best way to facilitate this rollover.

## Allowing transfers from cash into stocks & shares

**1.20** As at 5 April 2006, £111 billion was held in cash ISAs and £70 billion in stocks & shares ISAs. At present, an individual cannot transfer funds invested in previous tax years between the cash and the stocks & shares components of their ISA.

**1.21** The Government proposes to allow individuals to transfer funds from cash subscribed in previous tax years to the stocks & shares component, without affecting their annual investment limit. The aim is to further promote share ownership, by encouraging savers to diversify their assets and benefit from the potentially higher returns offered by stocks & shares over the medium to long term.

**1.22** Under this proposal, a saver with, say, £12,000 accumulated in the cash component in previous tax years will be able to move some or all of it into the stocks & shares component, and still invest a further £7,000 into their ISA in the current tax year.

**Question:** Are there any practical difficulties with applying this approach and, if so, how might they be overcome? How long will providers need to make the necessary changes to their systems?

## STAKEHOLDER VIEWS

### How to respond to this document

Please contact the Saving Incentives branch at HM Treasury:

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- by telephone: 020 7270 6112
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Stakeholder views are requested by close on 31<sup>st</sup> January 2007.

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# A

## PARTIAL REGULATORY IMPACT ASSESSMENT

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### PURPOSE AND INTENDED EFFECT OF THE MEASURES

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#### Background

**A.1** When ISAs were introduced in 1999, the Government undertook to review the regime after seven years. This review has now concluded. Aside from highlighting the importance of certainty about the future of ISAs, evidence collected during the process suggested scope for simplification and greater flexibility for savers and providers.

**A.2** This Partial Regulatory Impact Assessment examines the impact of the following package of reforms compared to the current situation:

- bringing PEPs within the ISA wrapper;
- removing the Mini/Maxi distinction within ISAs; and
- allowing transfers from the cash into the stocks & shares component of ISAs.

#### Sectors and groups affected

**A.3** This package of reforms has the potential to affect the following groups:

- Savers (around 16 million ISA holders and 3.5 million PEP holders);
- ISA and PEP providers (469, of which 353 offer stocks & shares ISAs, 338 manage PEPs, 91 offer cash ISAs only and around 10 offer PEPs only); and
- Her Majesty's Revenue & Customs (HMRC).

### COSTS & BENEFITS

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#### Bringing PEPs within the ISA wrapper

**A.4** The Government will bring PEPs within the ISA wrapper by aligning the rules for the two schemes. The Government will align the qualifying investments regime by allowing investment trusts with rental income to be held in ISAs and will also allow funds that were held in PEPs to be invested in the full range of ISA qualifying investments. In addition, the Government is minded to apply the ISA treatment to interest earned on all uninvested cash held in former PEPs.

**1.23** On a given date, to be specified, all PEP accounts will then become stocks & shares ISAs.

**Benefits A.5** For savers:

- The potential to amalgamate PEP and ISA investments within one tax-advantaged wrapper, enabling more effective management of funds (for example, only having to pay a single set of charges).
- PEP and ISA holders will have access to a wider range of investments.
- Potential for lower account charges.

**A.6** For providers:

- Potential cost savings for those offering both PEPs and ISAs, as they will be able to operate them on the same system.
- Potential cost savings for those offering both PEPs and ISAs, as they will only have to conform to one set of HMRC reporting requirements.
- Potential reduction in the cost of administering the more straightforward ISA treatment of interest earned on uninvested cash.

**A.7** For Government:

- Cost savings for HMRC from being able to shut down the PEP reporting system and run only one system going forward.

**Costs A.8** For savers:

- A different treatment of interest earned on uninvested cash. However, the sums involved should be relatively small given that PEPs were designed for stocks & shares investments, not cash, which should be reinvested at the earliest opportunity.

**A.9** For providers:

- Providers who operate PEPs and ISAs on separate systems will incur costs in having to change to their reporting systems to align them with the ISA reporting requirements. And PEP-only providers will incur costs in embedding a new reporting system. Indications so far from providers suggest that any costs will be outweighed by the benefits.

**A.10** For Government:

- Some cost for HMRC due to required systems changes.

**Removing the Mini/Maxi distinction**

**A.11** Under the proposed new regime, savers will be able to contribute to two components: cash and stocks & shares. They will be able to hold these components with either the same or different providers. The overall annual investment limit will remain at £7,000: savers will be able to invest up to £3,000 in the cash component and the balance in stocks & shares.

**Benefits A.12** For savers:

- Investment rules that are easier to understand, which will remove the possibility of breaking the ISA rules without breaking the ISA limits (for example, subscribing to a Mini and a Maxi ISA in the same tax year).
- Greater flexibility and choice: for example, an individual will be able to save £1,000 in cash with one provider and £6,000 in stocks & shares with a different (or the same) provider.

**A.13** For providers:

- Investment rules that are easier to administer.

**Costs A.14** For savers:

- Need to monitor so that they remain within the annual investment limit.

**A.15** For providers:

- Potential for additional administrative costs of unwinding ISA subscription errors if there are more breaches of the investment limit.
- Cost of changing the marketing literature around ISAs.

**A.16** For Government:

- A potential increase in costs for HMRC if there are more breaches of the investment limit.

## Allowing transfers from cash into stocks & shares

**A.17** The Government proposes to allow individuals to transfer funds from cash subscribed in previous tax years to the stocks & shares component of their ISA, without affecting their annual investment limit.

**Benefits A.18** For savers:

- The ability to diversify assets within the ISA wrapper by transferring some or all cash saved in previous tax years and benefit from potentially higher returns offered by stocks & shares over the medium to long term.

**Costs A.19** For providers:

- Some cost for cash ISA providers from adjusting their systems to deal with these changes.

**A.20** For Government:

- Some cost for HMRC due to the systems change that would be required to achieve the additional reporting requirements.

## SMALL FIRMS IMPACT TEST

**A.21** The small businesses that are likely to be affected by this package of measures are small PEP and ISA providers.

**A.22** In order to implement the integration of PEPs into ISAs, PEP providers will need to change their reporting systems and administrative procedures. Although all PEP providers will be affected by the costs that this will involve, those incurring the greatest impact may be the small PEP providers, as they will have to absorb the costs or spread them over a smaller customer base. However, following the initial one-off costs of changing, most providers will make savings from only having to maintain and report on one system rather than the current two. The exception will be PEP-only providers, which currently only run one system. Providers should also benefit from the ability to integrate their systems for managing clients' accounts.

**A.23** Small firms have the opportunity to respond to the questions posed in this document and their views are welcomed.

## COMPETITION ASSESSMENT

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**A.24** This package of reforms will have a positive effect on competition overall as it will remove certain restrictions on savers and providers:

- bringing PEPs into the ISA wrapper should lead to greater alignment of fee structures, as investors will be able to take advantage of the wider range of ISA funds available, often at lower charges;
- removing the Mini/Maxi distinction will increase competition between providers, since savers will no longer be tied into one provider if they wish to save in cash and more than £4,000 in stocks & shares; and
- allowing transfers from cash into stocks & shares will promote competition between cash ISA providers and stocks & shares ISA providers.

## ENFORCEMENT, SANCTIONS AND MONITORING

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**A.25** Bringing PEPs into the ISA wrapper will have a minimal effect on HMRC's compliance regime. The ISA will be subject to the same rules as it is now, and the investments that were formally held in PEPs will be brought under the ISA compliance umbrella.

**A.26** Removing the Mini/Maxi distinction may have an impact on investor compliance with the ISA rules, as the investor will have more responsibility for ensuring that they remain within the annual investment limits. It is possible that this will cause a small initial increase in breaches, with a resulting increase in the number of interventions required by HMRC.

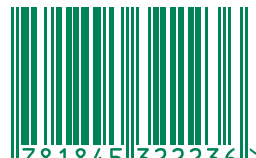
**A.27** Allowing transfers from the cash component to the stocks & shares component of the ISA will have a negligible effect on HMRC's compliance regime. Previous tax years are closed, and no additional investments can be made, so HMRC will not need to monitor subscriptions.







ISBN 1-84532-223-1



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