THE INDEPENDENT

March 29, 2009

Use it or lose it – and how to beat the ISA blues

Amid the savings rate wreckage, Kate Hughes looks at the best tax-free deals before the end of the financial year

You have a week left to protect your money from the taxman. The individual savings account season is reaching its climax and some people will now be rushing to wrap their cash in tax-free ISA protection. But if, like thousands of others, you've left it to the last minute, what should you think about when choosing your cash ISA

Every UK national over the age of 16 can save up to £3,600 in one of these accounts each financial year – hence the rush to make arrangements for 2008-09 before 6 April.

Sadly, the average interest rate you can earn on your savings this year will not set the pulse racing. With the Bank of England base rate at just 0.5 per cent, the average cash ISA offers just 2.09 per cent. That's substantially down from 5.31 per cent this time last year when the base rate was 5.25 per cent, and less than half the average 4.52 per cent rate offered in 2006 when the base rate was 4.5 per cent.

David Black, banking consultant at research firm Defaqto, says: "These deals don't take into account the latest base rate cut earlier this month. Next week, as we go into April, I would expect those rates to drop to an average of around 1.9 per cent."

So you will have to search hard for a good deal and, with over 230 different cash ISAs to choose from this year, the range is daunting.

There are two basic types of cash account – those where you can gain access to your money instantly, and ISAs that specify fixed terms or notice periods before you can get your hands on your cash.

Of the instant access accounts, the Barclays Golden ISA currently offers 3.61 per cent, NatWest 3.51 per cent and Abbey 3.5 per cent.

But many of the top-notch rates include introductory bonuses, usually of an extra 1 per cent, in order to come near the top of the "best buy" tables, The bonus disappears after 12 months. The Barclays deal, for example, includes a 1 per cent bonus, and Abbey's offer includes a 2 per cent introductory incentive. Savers should review their accounts, and the variable rates, on a regular basis, particularly at a time like this when deals are being squeezed.

"In general, ISAs offer standard savings account features but with the added benefit of a tax-free wrapper," says Kevin Mountford, head of savings for price-comparison site Money-supermarket.com. "This means that you need to look out for the same pitfalls you would normally – in particular, short-term bonus rates and limited access to money".

Of the top fixed-rate deals on offer, Principality building society is offering a two-year deal at 3.30 per cent, while Nationwide's top offer is 3.25 per cent for three years. Elsewhere, locking your money away for five years will earn you 3.5 per cent from Leeds building society.

"It could be worth fixing for one or two years," says Mr Mountford, "but that's really as far as you can go without losing out in future. Meanwhile, if the product is fixed or offers a bonus then when this matures or ends, savers should check the default rate to ensure they maintain the best return possible."

Keeping a close eye on rates is particularly important for those who have built up several years' worth of ISA savings, he adds, while those moving cash between ISAs must be careful to make the transfer directly, rather than shifting the money temporarily into a regular bank account. This would mean the money no longer has the tax-free wrapping.

But in spite of the complexities and the low rates, experts suggest cash ISAs are must-have products. "They are for such a relatively small amount that even if you just use them as tax-free places to park your emergency savings, it's worth it," says Peter Chadborn of independent financial adviser CBK Colchester. "There are few reasons why a cash ISA wouldn't be appropriate and almost everyone should have one, even if they are just putting a few pounds in there, because they'll save either 20 or 40 per cent of the interest earned by wrapping it up out of the grasp of the taxman."

And once you've exhausted this year's £3,600 limit, there are other tax- efficient savings options out there.

National Savings & Investments, backed by the Government, offers a range of tax-free certificates for savings of between £100 and £15,000, and these don't affect your ISA allowances. For example, index-linked savings certificates track the retail prices index, plus 1 per cent, and you can invest for three or five years, or both.

Alternatively, fixed-rate savings certificates, held for two or five years, currently offer up to 1.9 per cent annual interest. Premium bonds, which offer savers the chance to scoop a tax- free prize rather than receiving interest, are also a handy way of sheltering money from the taxman.

"NS&I offers savers plenty of security, but you have to keep an eye on the rates," says Mr Chadborn. "They tend not to fluctuate as much as bank rates, so sometimes they will be more attractive than the rest of the market, and sometimes they won't. These are also good options for those who aren't comfortable with internet banking as you can access them via your local post office."

And that's not all. Few people are aware that friendly societies, of which just a few dozen remain, can also offer small-scale tax-free savings plans that again don't affect your ISA allowance.

Foresters friendly society's tax-exempt savings plan is open to children and adults saving between £10 and £25 a month for 10 to 25 years, and pays a lump sum exempt from income or capital gains tax at the end of the term. The underlying investment is, in fact, in the society's with-profits fund, so bonuses are intended to be added every year to the sum assured, with the possibility of a final bonus payout.

But be warned that, particularly in this economic climate, there is no guarantee you'll get a bonus, as recent with-profits scandals have demonstrated. For more information, go to www.forestersfriendlysociety.co.uk, or for a list of societies go to www.afs.org.uk.