

Investing for children

A guide to planning for their future

This guide seeks to provide some answers to questions you may have about investing for children.

If you want to learn more and receive advice tailored to your personal circumstances, please get in touch.

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The next generation

A 'good start in life' is what all parents want for their young children.



The next generation

A 'good start in life' is what all parents want for their children. That goal is usually shared by grandparents, aunts, uncles and close friends too.

Initially, that aim often translates into a surplus of toys but, give or take technology fads, this stage eventually passes. At that point, thoughts start turning towards the future and the transition from child to adult – and beyond.

The longer term perspective raises the possibility of making investments for the child, which they can call on in adult life.

The next generation

Inevitably this leads to a variety of issues:

- Are there particular needs which should be targeted, or is flexibility more important?
- Which investments would be appropriate?
- Can some parental (or other) controls be put in place to restrict when the child can gain access to the investments? Normally children are given access to the money aged 18 or 21, but will they have an adult attitude to their finances?
- What is the impact of tax (Income Tax, Capital Gains Tax and Inheritance Tax) and how can it be minimised?

Save for what?

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Higher education is more important than ever for gaining a reasonable job, but it comes at a much higher cost than in previous decades.

Before the introduction of student loans (for student maintenance in 1998 and for tuition fees in 2006), you may have left university with a bank overdraft, but the sum owed probably paled into insignificance compared to the five-figure debts faced by the coming generation of graduates. You could come away from university after a three year course with up to £50,025 (plus interest) to pay back in student loans¹.

Marriage can be a costly option for those who choose it, with the average cost estimated to be around £30,000².

¹ Which? University, 1 January 2017

² Brides Magazine, September 2016

Save for what?

Getting onto the property ladder is another growing cost for the next generation. Before buying or even looking at properties, you will need to save for a deposit. The deposits are generally between 5% and 20% of the cost of the house. For example, a £150,000 house will require at least a deposit of £7,500 (5%).

The average age of a first-time buyer is 30 years old, which is an increase from 29 back in 2011. Regionally, the average age of a first-time buyer is highest in London, at 32 years old.¹

¹ Halifax Press Release, January 2017

Save for what?

Planning for their adult future

Once they have the degree, the job and the home (and the associated mountain of debt), there is another long-term financing requirement that today's children will encounter: retirement provision.

The new state pension will of £159.55 a week provide some income through your retirement, but will certainly not be enough to rely on for a comfortable retirement. The average income this will provide each year is around £8,000.¹

Auto-enrolment has helped many employees to build up their pension funds. This is not a mandatory scheme to join, but is a good chance for you to add more income for your retirement. Plus, your employer will pay into the fund as well. The below table demonstrates the State Pension Age depending on when you were born.

Born after April 6...	but before April 5...	Current Rules	33.3% scenario	32% scenario
1961	1962	67	67	67-68
1962	1972	67	67	68
1972	1973	67	67-68	68-69
1973	1974	67	68	69
1977	1978	67-68	68	69
1978	1985	68	68	69
1985	1986	68	68-69	69-70
1986	Onwards	68	69	70

¹ MoneySavingExpert - New State Pension, June 2017
Source: The Telegraph, March 2017

Save for what?

The value of your investments and any income from them may fall as well as rise and is not guaranteed. You may get back less than you invest.

Avoiding the pitfalls

If you want to help a child progress through this financial landscape, there are plenty of options to consider. But there are also a number of tax traps to be wary of, particularly if you are the parent of the child.

Two principles which apply to many aspects of financial planning are particularly relevant when planning for your children's financial future:

1. **The sooner you start, the better.** The longer the timescale, the more scope there is for investments to grow.
2. **Take expert advice before making any decisions.** The right investment set up in the wrong way can be worse than the wrong investment set up in the right way. DIY planning is not to be recommended, given the potential pitfalls.

Principles of planning

The approach to planning for children's investments has three main elements:

- 1. Ownership of the investments*
- 2. Choosing the investment*
- 3. The impact of taxes*



Principles of planning

It's worth bearing in mind that these three main elements can conflict too. For instance, the optimum choices for ownership and tax structure may actually pull in opposite directions.

The approach to planning for children's investments has three main elements:

- 1. Ownership of the investments.** Even in instances where it is possible, outright ownership by a minor child is generally avoided, not least because that normally means the child can turn the investment into cash immediately when they turn 18 (16 in Scotland).
- 2. Choosing the investment.** Investment for children often means investment for the long-term. As a result, the investment chosen may be significantly different from what you would choose for yourself. While a long-term perspective means a broad choice of options, it also implies the need for regular financial reviews.
- 3. The impact of taxes.** Tax should not be the main driving force for any investment decision. However, it will always be a consideration once the choice of investment is made. Successive Chancellors have created a variety of ways in which the same investment can be held with differing tax consequences. As tax laws can, and do change, this is another area which requires expert monitoring.

Ownership of the investments

There are three main ownership options to consider:

- 1. Retain personal ownership*
- 2. Investment in the name of the child*
- 3. Discretionary trusts*

Ownership of the investments

There are three main ownership options to consider:

1. Retain personal ownership

If you are making an investment for a minor child, in theory you can simply invest in your own name and say to yourself “this money is for the benefit of my son/daughter/grandson/niece, etc.”

As a result, actual ownership never changes, which has the advantage of maximum flexibility. If, at a future date, your financial needs are greater than those of the child, then the investment is readily accessible because it is still yours. Equally, until you actually transfer the investment or its value to the child, there has been no gift, so the issue of Inheritance Tax (IHT) cannot arise.

Ownership of the investments

The downsides of retaining personal ownership are significant:

- As you own the investment, it is your tax rate(s) that applies, not the child's. If you are a parent, this may not matter (see *The impact of taxes*). But, if you are not the child's parent, it could mean an unnecessary contribution to the Exchequer.
- Even if the intention is investment for the child, when you retain ownership, the original investment and any increase in its value remain in your estate and you would need to consider if there is a possibility you could exceed any personal allowances over which you could attract an Inheritance Tax (IHT) liability.
- When the investment is later transferred to the child, it becomes a potentially exempt transfer, meaning IHT may become payable if you die within 7 years of the transfer being made.
- You may end up using the value of the investment simply because you have access to it. Removing yourself from ownership can be a useful discipline.

Ownership of the investments

2. Investment in the name of the child

As a general rule, minor children cannot own investments themselves because they do not have the legal power to make a valid contract or deal with the investment. Simple deposit savings accounts are treated differently, although banks and building societies may impose their own minimum account opening age.

There are two main solutions to the child ownership restrictions: *bare trusts* and *designated accounts* (see next page). Both allow you to retain some control over the investment, but potentially with very different tax consequences.

Ownership of the investments

Bare trusts

A bare trust is a fixed trust set up for the absolute benefit of the child. The trust is a way of holding the investment on behalf of the child. Once the age of 18 (16 in Scotland) is reached the child has full access to the investment.

A bare trust will usually be created using a 'Deed of Bare Trust'. This is a special document which will normally involve the appointment of trustees, one of whom can be you (if you are making the gift).

Outside of Scotland, a bare trust can also be created using a simple declaration and/or a designation (see *Designated accounts*). Until the child reaches 18 (16 in Scotland) the trustees (or the nominee under a designation) have control and can switch between investments if necessary. However, they cannot change the beneficiary.

You are making an outright, irrevocable gift to the child when you place money in a bare trust, so tax on the investment is based on the child's tax position, not yours (unless you are the child's parent – see *The impact of taxes*).

Ownership of the investments

Designated accounts

A designated account is often used to hold collective funds, such as unit trusts or company shares in a pooled fund, for the benefit of a child. The investment is made in your name, but designated with the name or the initials of the child (eg. John Smith a/c FPS). This will amount to an irrevocable gift to the child.

HM Revenue Customs & Practice (HMRC) recognises that, under English law, it is possible for one person (you) to be the legal owner of an investment, while another person (the designated child) is the beneficial owner. The child is the owner for tax purposes in such instances while the legal owner is acting as trustee.

The structure, in effect, represents a bare trust even though there may not be any formalities complied with. Nevertheless, it is recommended that some evidence of the gift should exist to make this clear to the parties involved – and to the taxman. To achieve this, you should complete and sign a simple trust declaration.

This simpler ‘evidenced designated account’ option is not available in Scotland, where a formal trust deed should be used.

Ownership of the investments

3. Discretionary trusts

A discretionary trust can be as flexible as the bare trust is rigid. It is set up for a number of potential beneficiaries, usually chosen by you as the creator of the trust. The trustees can then select who, if anyone, will receive the income the investment generates and the timing, size and recipients of any capital payments.

A discretionary trust can therefore be useful for a gift to a group of beneficiaries, such as grandchildren, and can even cope with subsequent additions to the pool.

The flexibility offered by a discretionary trust comes with some potential drawbacks:

- The Income Tax and Capital Gains Tax treatment is often less favourable than using a straightforward bare trust.
- The IHT treatment of discretionary trusts can be complex, particularly if large sums are involved.
- There may be more administrative work involved, such as completion of trust tax returns.
- The investment and benefit distribution decisions are taken by trustees (of which you can be one).

Choosing the investment

In many respects, investment for children involves the same considerations that apply to adults.



Choosing the investment

The value of investments and the income from them can go down as well as up and you may not get back the amount you originally invested.

Past performance is not a reliable indicator of future performance.

Investing in shares should be regarded as a long-term investment and should be appropriate to the investor's overall attitude to risk and financial circumstances.

In many respects, investment for children involves the same considerations that apply to adults. Choosing investments has four main stages:

1. Risk considerations

All investments are subject to risks. If you are investing for yourself, we will spend some time discussing and assessing your attitude to risk and your ability to absorb capital losses at the start of the investment process.

This approach is not practical when the investment risks are effectively taken on by a child. Nevertheless, investment risks must be considered and the assessment should be focussed on the beneficiary of the investment, rather than you as the supplier of the capital. Investing for children will frequently involve a longer-term investment strategy, allowing them to (unwittingly) ride out the fluctuations in the markets.

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2. Goal setting

Setting a goal or goals is an important part of the investment process and can determine what the investment strategy should be. For example, setting a target of £10,000 at age 21 is not the same as providing a fund that the young adult can draw on as and when necessary. Once a goal is established, there is a yardstick against which the performance of the chosen investments can be monitored. Goals, once set, should be adhered to as far as possible. Changing target mid-stream may be difficult or end in poor overall returns.

3. Asset allocation

Once risk factors and goals are determined, the broad outline of investments (asset allocation) can be decided. Some experts think this is the key stage of the investment process. The right asset choice is usually more important than the choice of a particular fund in that asset class.

Choosing the investment

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4. Fund/investment selection

There is a wide range of funds in virtually every asset category these days, meaning that choosing funds involves more than simply opting for the top three performers. Funds may achieve their results in different ways and, as investors are aware, past performance is not a reliable guide to the future. Table-topping funds can often be the highest risk because they are often based on fund sectors; for example, funds where their portfolios may be concentrated in a limited number of holdings.

The impact of taxes

The primary rule of tax for children is simple: a child is no different from an adult for tax purposes.



The impact of taxes

The effect of these rules means children are normally outside the scope for tax, with one proviso: the source of the investment capital.

HM Revenue and Customs practice and the law relating to taxation are complex and subject to individual circumstances and changes which cannot be foreseen.

The Child

The primary rule of tax for children is simple: a child is no different from an adult for tax purposes. That means:

- Each child has their own personal Income Tax allowance, worth £11,500 in 2017/18. Income covered by the personal allowance is normally free of UK tax, but tax credits on dividends cannot be reclaimed.
- Each child also has their own Capital Gains Tax annual exempt amount, covering £11,300 of gains in 2017/18. Beyond that, a tax rate of 10% applies for gains falling within the basic rate band (once added to income) and 20% in the higher and additional rate bands.

The impact of taxes

HM Revenue and Customs practice and the law relating to taxation are complex and subject to individual circumstances and changes, which cannot be foreseen.

The Parent

You may already be thinking that investing in your child's name appears to be a tax efficient option. However, there is an anti-avoidance rule that says a parent is liable to tax on their child's investment income (including investment made via a bare trust or designated account outside Scotland) if all of the following rules apply:

- The child is under 18 and unmarried.
- The investment capital originated from the parent.
- The gross amount of income generated in the tax year by all capital given by the parent exceeds £100 (or £200 if both parents give money)¹.

The result of this is that if the parent making the gift is a non-taxpayer, then there will be no Income Tax until the parent's personal allowance is exhausted.

Gifts from grandparents, other relations and friends are not caught by this rule, but HMRC may require evidence that such gifts are genuine and not a diversion of parental money via a third party.

¹ Which? Children's savings accounts; Children and income tax

The impact of taxes

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Discretionary Trusts

Discretionary trust taxation is different from individual taxation.

- Trusts do not benefit from a personal allowance. Instead there is a 'standard rate' band of between £200 and £1,000 depending upon how many trusts have been created by the person making the gift into the trust. Basic rate tax (7.5% on dividends, 20% on all other income) applies in this band¹.
- Beyond the standard rate band, the top rates of Income Tax apply: 38.1% for dividends and 45% for other income¹.
- If income from a discretionary trust is distributed to a child rather than accumulated within the trust, some tax reclaim on behalf of the child may be possible. However, the parental tax rules will come into play if the child's parent created the trust.
- Discretionary trusts have an annual Capital Gains Tax exempt amount of £5,650 and £11,300 if the beneficiary is disabled. Beyond the exempt amount a tax rate of 28% applies¹.

¹ GOV.UK - Trusts and Taxes. Correct as at April 2017

The impact of taxes

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Inheritance Tax

Gifts to children, whether or not trusts are involved, fall within the IHT net. In practice, annual exemptions and the nil rate band (currently £325,000) mean that there is unlikely to be any tax to pay at outset. However, a gift not covered by regular exemptions will be taken into account when calculating the IHT on your estate if you die in the following seven years.

Discretionary trusts can also be subject to IHT charges every 10 years and when assets are passed out of the trust.

The investment and tax blend

The choice of funds is the end of the pure investment process, but not the end of the entire exercise.



The investment and tax blend

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The choice of funds is the end of the pure investment process, but not the end of the entire exercise. After fund choice, a decision then has to be made on the structure – or ‘wrapper’ – in which the funds are to be held, bearing in mind tax rules and any specific wrapper rules. The choice includes:

Junior ISAs and ISAs

Children living in the UK and under the age of 18 can have a Junior ISA (JISA), with a maximum total investment of £4,128 in 2017/18. Income and gains within a JISA are free of UK tax and not subject to the parental tax rules. However, dividend tax credits cannot be reclaimed.

Children aged 16 and 17 can also have a cash ISA (ISA), with a maximum investment in 2017/18 of £20,000. Unlike the JISA, which can have stocks and shares and/or cash components, this ISA can only consist of the cash element. The parental tax rules do apply in this instance, so it is best to avoid interest payments before age 18. Both JISAs and ISAs can be controlled by the child from age 16, but withdrawals normally cannot be made before age 18.

The investment and tax blend

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Child Trust Funds

Child Trust Funds are no longer available for application. If you already have a CTF active, the same rules as before still apply; children get control at age 16, but can't access any funds until 18. Since April 2015 parents can transfer from CTFs to JISAs.

Collective funds

Unit trust and investment accounts are pooled investments that can be held directly, via JISAs and CTFs, through investment bonds, pension arrangements or in trusts. They can be established offshore, as well as in the UK. Tax deducted from interest (but not dividend) distributions made by UK funds can be reclaimed if the appropriate conditions are met. Offshore funds will usually pay interest gross.

The investment and tax blend

Investment bonds

Investment bonds are single premium policies offered by onshore and offshore life assurance companies. Their underlying investments are usually collective funds, but the overall tax treatment is based on life assurance tax rules.

Bonds can be particularly useful for trust investments because any investment income is accumulated within the bond, minimising administration and tax issues. This is especially the case for offshore bonds through which tax on capital gains and income, other than withholding taxes, can be avoided throughout the investment period.

The investment and tax blend

Personal pensions

There is no minimum age for a personal pension. Total contributions to a child's plan are usually limited to a maximum of £3,600 per tax year, with contributions paid net of basic rate tax (ie. a maximum of £2,880 net), regardless of the tax rate of the child or the person paying the contributions. Within a pension there is no UK Income Tax or Capital Gains Tax, but dividend tax credits cannot be reclaimed. Benefits cannot currently be taken before age 55, although this minimum is likely to increase in the future.

National Savings & Investments

National Savings & Investments (NS&I) has a limited range of accounts suitable for children. An example would be the 'Children's Bonds'.



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Next steps

We hope this guide has given you a broad insight into investing for children. To explore the specific options for your circumstances, please get in touch.

We can help you through the ownership, investment and tax issues, not only now but in the years ahead, as the child grows to become an adult.