Investing for children

A guide to planning the financial futures of the children in your family.

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

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What are you saving for?

The first step is to decide the investment goal or goals and the timeframe. Do you want to help a child or grandchild onto the property ladder, support them through higher education, help with a major expense, such as a wedding, or even start a pension pot for them?

Higher Education

Higher education costs, including loans for tuition fees, living costs and maintenance, are estimated to cost in excess of £50,000, for a three-year university education.

Getting onto the property ladder

Is another major expenditure. For an average first-time buyer, a deposit of over £50,000 could be required, more than the average annual salary.

Retirement provision

May seem a very long way off, but as with all planning, the sooner you start, the better. The full State Pension is currently £175.20 a week and is certainly not enough on its own to achieve a comfortable retirement.

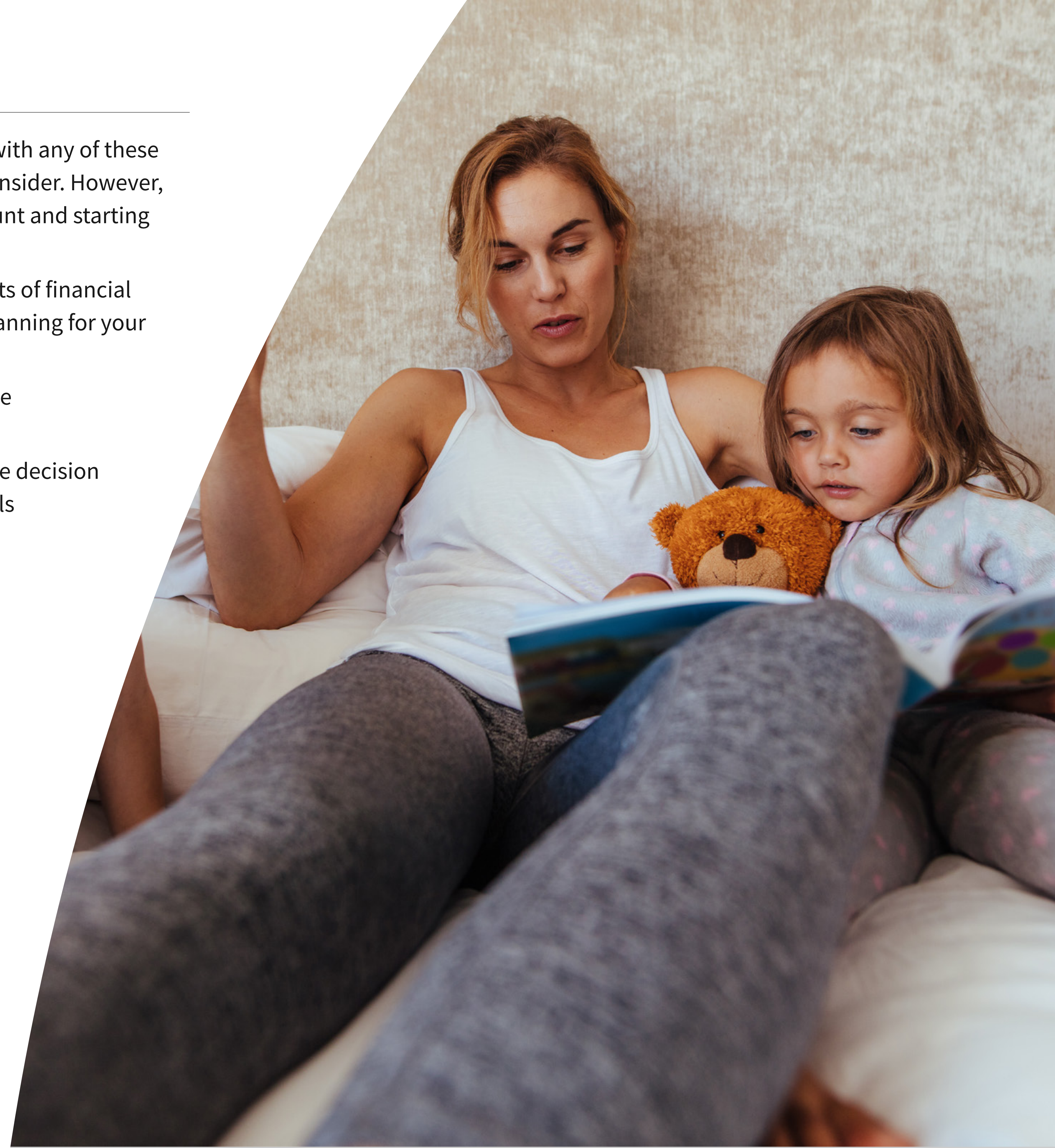
Getting started

Happily, if you do want to help your child with any of these expenses, there are plenty of options to consider. However, it isn't as simple as just setting up an account and starting to save into it.

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

— The longer the timescale, the more scope there is for your investments to grow

— Taking expert advice will help you get the decision right first time and avoid potential pitfalls



Making your plan

A bit of forethought will make finding the right solution a lot easier

Making your plan

When considering the best way to save for your children, there are three main points to consider:

Ownership of the investments

Giving ownership of a significant investment to a child under the age of 18 is not usually recommended and it is advisable to retain guardianship over at least some of the money until they are over 18. Otherwise, a child could turn an investment into cash and spend it, on the very date of their 18th birthday (16th birthday in Scotland).

Choosing the investments

If you make the decision while your children are still quite young, then you have the benefit of being able to take a long-term view to maximise the potential for growth. While a long-term perspective means a broad choice of options, it also means you should review your choice of investments on a regular basis.

Tax

Tax should never be the driving force behind your investment decision. You only pay tax if you are making money – whereas, making an inappropriate investment just to save tax could end up with you losing more. However, once you have decided on the most suitable investment, it then makes sense to invest via the most tax-efficient route.

Note: it is worth bearing in mind that the three above mentioned issues can sometimes conflict. For example, your choice for ownership may not fit with the most desirable tax treatment. Be prepared for the need to compromise.

Ownership of the investments

Ownership of the investments

There are three main ownership options to consider:

1. Keep the money in your name

The simplest way to get started is to invest money in your own name and make a pact with yourself that you will keep it for your child.

The advantage of this approach is you have maximum flexibility. If you ever need the money more than they do, for example, you can cash it in and use it appropriately. Unless and until, you actually transfer it to them (as a gift) there are no Inheritance Tax (IHT) consequences to consider.

The downsides, however, can be significant:

— You pay Income Tax and/or Capital Gains Tax on the investment at your own marginal rate. If you are their parent, this might not actually make much difference to your situation anyway, but if you are a grandparent or not a relative, it could mean an unnecessary contribution to the Revenue

— While you own the money, its value, and any growth it achieves, remain in your estate. If you are close to, or above the Inheritance Tax threshold you run the risk of attracting an additional liability. Even when transferred, the gift becomes a Potentially Exempt Transfer, which means that IHT may be payable if you were to die within seven years of the transfer

— Your circumstances might lead you to use the investment simply because you have access to it. Removing yourself from ownership can sometimes prove a useful discipline.

2. Invest in your child's name

As a rule, children under 18 (16 in Scotland) cannot 'own' investments because they do not have the legal power to either make a valid contract with a provider or manage it on an ongoing basis. Simple deposit savings accounts may be an exception to this rule – but even then, different banks and building societies impose their own minimum ages.

Ownership of the investments

3. Designate the money or place it in trust

Both a designated account and a formal trust deed can allow you to retain control over the investment without incurring any tax liability on its growth. These are explained in more detail here:

Designated accounts

A designated account is another method often used to hold investment funds for the benefit of a child. The investment is made in your name but designated with the name or the initials of the child.

Like a bare trust, designating an account in their name also amounts to an irrevocable gift to the child and they will receive the money at maturity. In the meantime, the child is the owner for tax purposes, with you (the legal owner) acting simply as its trustee.

Although there are no formalities, a designated account is effectively a bare trust. To be certain, however, you should maintain evidence of the gift in a way that is clear to all the parties involved – and also to HMRC. A simple trust declaration should suffice.

Please note: this 'evidenced designated account' option is not available in Scotland. There, a formal trust deed is always required.

Bare trusts

A bare trust is the simplest type of trust which gives the absolute benefit of whatever it holds to a child. In this case, the trust would hold your investment and when the child reaches 18 (16 in Scotland) they would get full access to the money themselves.

A bare trust is usually set up using a 'Deed of Bare Trust'. This is a specific document that normally involves the appointment of trustees, one of whom can be the person making the gift. The trustees (or the nominee under a designation) would then have full control over the money until the child reaches maturity – enabling them to monitor and switch investments as required.

In setting up a bare trust, however, you are making an outright, irrevocable gift to that child. You cannot then change the beneficiary, so they will get the money whatever happens. Unless you are the child's parent, tax is based on the child's own tax position, not your own.

Ownership of the investments

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 the creator of the trust. The appointed trustees then decide who, if anyone, of those potential beneficiaries will receive any of the income it generates and how often.

A discretionary trust can therefore be useful when you want to make a gift to a group of beneficiaries, for example, your grandchildren. This type of trust allows you to include grandchildren who haven't yet been born, to give more help to those in greater need or to cut someone out completely if you so decide.

But as you would expect, this flexibility comes with some downsides:

— The Income Tax and Capital Gains Tax treatment can be less favourable than for a bare trust

— The Inheritance Tax treatment of discretionary trusts is often complex, particularly where large sums are involved

— There may be more administrative work involved – for tax and other reasons.

Choosing a suitable investment

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Choosing a suitable investment

Choosing an investment for your child is no different to choosing an investment for yourself and involves four main stages:

1. Risk

As investments incur some risk, this is where we start any investment conversation with our clients. We spend time with our clients to understand not only how you will react to the ups and downs of markets, but also to assess your financial capacity to absorb any capital losses.

This approach isn't practical when the investment risks are effectively taken on by a child. Nevertheless, investment risk must still be considered, but bearing in mind this is all being done for the child's benefit and not your own.

The timescales when investing for children are likely to be longer term and could span 18 to 21 years for example. This longer-term strategy allows the investment to ride out fluctuations in the markets and consequently, when saving for your children, you may find a broader range of options opens up, some of which may carry a greater risk (and greater potential for growth) than you might consider for yourself.

2. Goals

Setting a goal or goals is an important part of the investment process and can help you determine how much risk you need to take. We can help you be confident in setting your goals, once set, you need to stick to these where possible. Making changes once the investment is in full flight can incur administrative and cost issues – which may result in poorer overall returns.

3. Allocation

Once risk factors and goals are determined, you can start to work out what type of assets you want to invest in. Getting an asset allocation arranged is vital and is considered a key stage in the investment process.

4. Fund choice

When it comes down to choosing investment funds, there is a vast choice and selecting funds is much more complicated than just picking the three top performers. In any event, past performance is not a reliable guide to the future.

Even within what might seem quite small and defined categories, different funds can achieve results in quite different ways. For example, table-topping funds could carry the highest risk because they may be concentrated in a limited number of holdings.

The impact of taxes

A child's tax position is really no different to that of an adult.

Child's tax position

- Each child has their own personal Income Tax allowance, which is currently £12,500 in the 2020/2021 tax year. Income covered by the personal allowance is normally free of UK tax and on top of this, there is a tax free 'savings allowance' enabling receipt of up to £1,000 of interest p.a. as well as a dividends allowance of up to £2,000 p.a.
- Each child also has their own Capital Gains Tax annual exemption, which is £12,300 of gains in the 2020/2021 tax year. 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 in the additional rate bands.

Parent's tax position

You may be thinking that investing in your child's name appears to be a tax efficient option. However, there is an anti-avoidance rule to be aware of which states that a parent will be 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)

Of course, if you are the parent and a nontaxpayer, then no Income Tax will be due until your own Personal Allowance is used, but any basic or higher rate liability will fall immediately.

Gifts from grandparents, other relations and friends are not caught by this rule, but HMRC may require evidence that such gifts are genuinely from the donor and are not an attempt to divert money from the parents via a third party.

The impact of taxes

Discretionary Trusts tax position

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 band

— Beyond the standard rate band, the top rates of Income Tax apply: 38.1% for dividends and 45% for other income

— 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 one of child’s own parents created the trust

— Discretionary trusts have an annual Capital Gains Tax exemption of £6,150, or £12,300 if the beneficiary is disabled. Beyond the exemption, a tax rate of 20% applies

Inheritance Tax

Gifts to children, whether trusts are involved or not, are liable to IHT. In practice, various annual exemptions and use of the nil rate band (currently £325,000) mean there is unlikely to be any tax liability when the gift is made. However, if that gift doesn’t qualify for any of the exemptions and you die within seven years, at least some portion of its value will be included in the final IHT calculation.

Discretionary trusts can also be subject to IHT, with the liability being calculated every 10 years and when assets are passed out of the trust.

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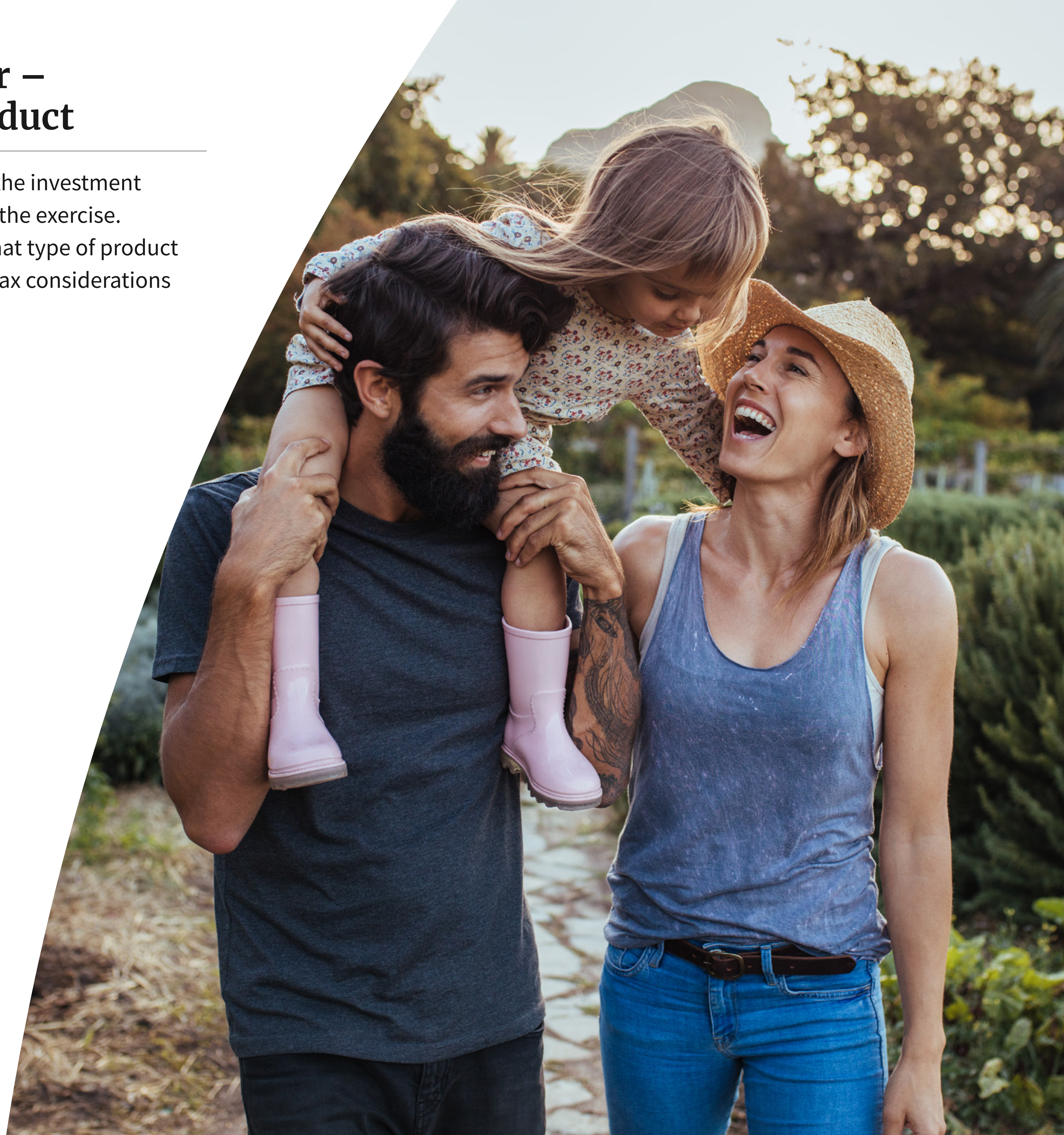
Bringing it all together – the right choice of product

Choosing your funds may be the end of the investment decision process, but it is not the end of the exercise. After fund choice, you need to decide what type of product or 'wrapper' you need, bearing in mind tax considerations and the requirement for flexibility.



Bringing it all together – the right choice of product

Currently, there are six main options, two of which are specifically designed for children:

Junior ISAs and ISAs

Any child under 18, living in the UK, can have a Junior ISA (JISA). The maximum investment into a JISA is £9,000 a year (2020/2021 tax year) and investment can be by a number of different people. Income and gains within a JISA are free of UK tax and not subject to parental tax rules.

Children aged 16 and 17 can also own a cash ISA. Unlike the JISA, this ISA can only hold cash deposits. The maximum investment for the 2020/2021 tax year is £20,000. Between 16 and 18, any tax liability arising on the interest paid will fall on the parents.

Both JISAs and Cash ISAs can be controlled by the child from age 16, but withdrawals are not normally allowed before age 18.

Child Trust Funds

Child Trust Funds (CTFs) are no longer available for new applicants, having been replaced in 2011 by JISAs. However, some CTFs will still be active and the same rules apply as before. Children can get control at 16 but can't access funds until 18.

Note: No child can hold both a JISA and a CTF. If a JISA is preferred, there is now the option to transfer the proceeds of a CTF into a JISA, usually without penalty.

Investment bonds

Investment bonds are single premium policies which can be useful for the management of lump sums placed into trust. Like collective funds, they are also available from both onshore and offshore providers. The underlying investments are usually collective funds, but the overall tax treatment is different and based on life assurance tax rules.

Indeed, it is that treatment that makes them suitable for trust investment. Firstly, income accumulates within the bond itself, minimising the associated administrative and tax issues. Secondly, offshore bonds enable the deferment of certain income and capital gains liabilities. Which means that, other than withholding taxes, tax can be carefully managed both during the investment term and also over the period in which it is finally redeemed.

Bringing it all together – the right choice of product

Personal pensions

Personal pensions come with no minimum age restriction and contributions are limited to a maximum of £3,600 a year.

Contributions to a personal pension are made net of basic rate tax, meaning you can start to build that £3,600 a year at a net cost of £2,880, regardless of your own tax position. No further Income Tax or Capital Gains Tax will be payable on the investments held in the personal pension, until your child starts taking benefits, which currently cannot be before age 55.

National Savings & Investments

National Savings & Investments (NS&I) also offers a limited range of products suitable for children, with varying tax advantages.

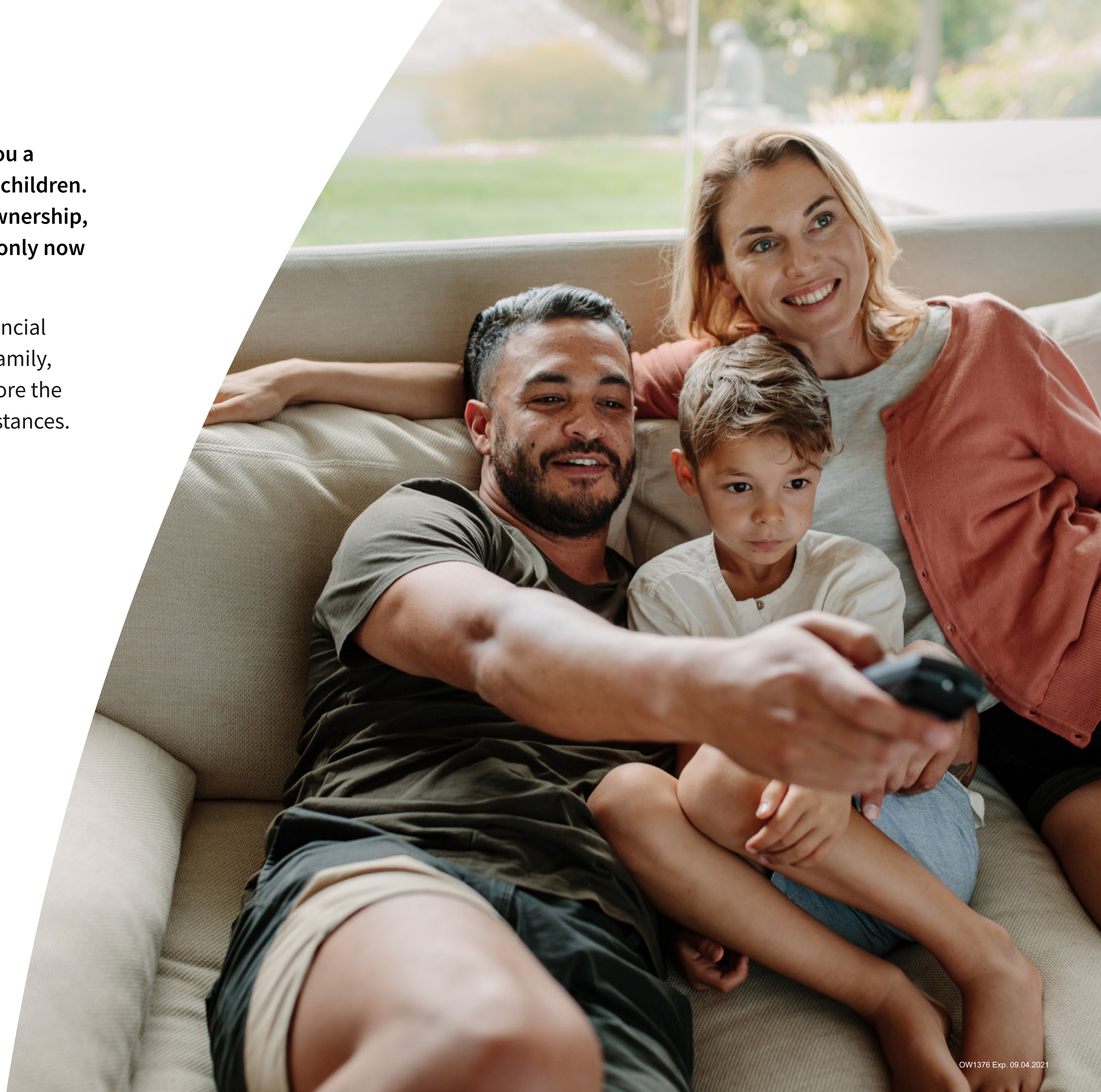
The value of investments and any income from them can fall as well as rise and you may not get back the original amount invested.

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

Next steps

We hope this guide has given you a broad insight into investing for children. We can help you through the ownership, investment and tax issues, not only now but in the years ahead.

To make plans to secure the financial security of the children in your family, please get in touch, we can explore the specific options for your circumstances.



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