



SIGNET FINANCIAL SERVICES

INDEPENDENT FINANCIAL ADVISORS

*Investing
for children*

16-16a Accommodation Road, Golders Green, London, NW11 8EP

Tel: 020 8455 8555

info@signetfinancialservices.co.uk

www.signetfinancialservices.co.uk



Investing for the future

Most parents want to help their children financially, whether it is making sure there is enough money for their education or helping them to buy a property. An early objective may well be to help children understand the value and importance of money.

Tax will be a major factor to consider, as will the risks of giving children too much too soon. It is therefore important for parents and others to appreciate the basic tax and legal rules and also some of the investment products that are suitable for their children.

You should think about the reasons why you are setting aside money for children, as they can have a major bearing on your investment decisions. Timescale is likely to be an important factor in choosing the appropriate investments. In particular, investment risk is a key issue that you need to think about carefully before taking any action. The best approach to handling these matters is to consult a competent financial adviser.

Very broadly, the shorter the timescale, the more you should focus on cash and similar types of investment. But if you are looking at a time horizon of five years or longer, you should be more prepared to consider investments that can keep their value in the long term – such as shares or property. They involve more risk, but historically these types of investments have tended to give superior returns over the longer term.

The tax position of children

Children – even babies – are not exempt from tax. If they have enough income or capital gains, they will be subject to a tax bill just like adults. But like adults, they are generally entitled to have a certain amount of income without paying tax. This is the personal allowance and it is £11,500 in the 2017/18 tax year. In addition, each child has a 0% starting rate band covering £5,000 of savings income and, both a dividend allowance of £5,000 (probably falling to £2,000 from 2018/19) and, assuming they pay tax at no more than basic rate, a personal savings allowance of £1,000. Children also have their own annual capital gains tax (CGT) exempt amount of up to £11,300 of net gains on investments in 2017/18.

But there is a special rule that applies to children's income until the child reaches the age of 18 years or gets married, if earlier. If the child's income is derived from a gift from a parent, it is taxed as the parent's income, unless the income does not exceed £100 a year (£200 if both parents have contributed jointly).



Action point

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Example – gifted income

If Mary gives her 14-year-old son Jake £20,000 and this generates for him an income of £400 a year, this will be taxed as if it were Mary's income at her rate(s) of tax. It could not be set against Jake's personal tax allowance of £11,500 and thus in the past would not normally have been tax free. However, the personal savings allowance and/or the dividend allowance may mean that there is no tax payable by Mary.

Fortunately, a child's income that is derived from non-parental sources is taxed as the child's and can be set against their personal allowance. This might include income from investments financed by gifts from grandparents or others, or perhaps earnings from a weekend job or other work.

Where a child's income comes from investments funded by grandparents or others, you should identify it carefully to ensure that it does not suffer tax unnecessarily. It is a good

idea to keep investments that parents have provided separate from the money the child has received from other people.

Banks and building societies no longer deduct tax at the basic rate of 20% from interest payments, following the introduction of the personal savings allowances on 6 April 2016. This change has meant that non-taxpayers no longer need to register to receive interest gross or go through the process of tax reclaim.

For 2017/18 onwards collective funds, such as unit trusts and open-ended investment companies (OEICS), which pay interest rather than dividends, are also making gross payments.

Parents can still invest on their child's behalf without potentially giving themselves a tax liability by using special tax-efficient financial products.

Tax-efficient investments for children

Several financial products enable parents and others to invest tax-efficiently for children. Of course, tax is not the only factor to take into account. Another important factor apart from investment risk and reward is the matter of costs of investing; some investments can be significantly more costly to buy and hold than others.

Junior ISA The Junior ISA (JISA) is like the adult ISA. It is a wrapper that protects the investments and savings held within it from income tax and CGT. The JISA allows up to £4,128 to be invested on behalf of a child in cash and/or a wide variety of stock market-based investments. These range from individual shares in companies to UK authorised unit trusts, OEICS and investment trusts.

Children can also have one cash JISA and one stocks and shares JISA, but the combined total yearly investment must not exceed the annual maximum. To qualify, children must be under 18, live in the UK and not be entitled to a Child Trust Fund account. Children aged 16 or 17 can open their own JISA or take over management and be the registered contact for their existing JISA, but parents or adults with parental responsibility must open and manage these accounts for younger children.

Money in a JISA belongs to the child and cannot be withdrawn until they are 18 unless there are exceptional circumstances.

ISAs Children who are 16 or 17 can also invest in a full ISA, but only in the cash component. The contribution ceiling for this component is £20,000. In December 2015 the Help to Buy ISA was launched for those aged 16 and over. This offers a 25% government tax-free bonus on savings of up to £12,000, provided the proceeds are used to purchase a first home. There is a maximum initial contribution of £1,000 and maximum monthly contributions of £200. The Help to Buy ISA counts as a cash ISA, so generally contributions cannot be made to both in the same tax year.

It is possible to transfer the funds in a Help to Buy ISA into a Lifetime ISA (LISA). The LISA permits a maximum investment £4,000 a tax year (plus up to a £1,000 government bonus) for those aged 18-39. A transfer to a LISA would not mean any loss of potential Help to Buy bonus, as a 25% LISA bonus will be granted in its place, provided the transfer is made before 6 April 2018.

Child trust funds (CTFs) are very similar to JISAs, and were set up for children born between 1 September 2002 and 2 April 2011. If a child has a CTF, they cannot have a JISA (and the reverse is also true). Originally, CTFs were set up to hold funds that the government granted to these children, so every child born between those dates has a CTF to which parents and others can contribute up to £4,128 in total. It is worth checking



Action point

Transferring ISA funds in a Help to Buy ISA into the Lifetime ISA would not mean any loss of potential bonus, as the 25% Lifetime ISA bonus will be granted in its place, provided the transfer is made before 6 April 2018.

to see if a child's CTFs are invested in suitable funds; they can usually be switched if necessary.

The tax advantages and rules governing CTFs and JISAs are very similar. The funds are essentially free of UK tax and so are the proceeds on encashment. It is possible for CTFs to be transferred into JISAs, but once the transfer is completed, future contributions can only be made to the JISA.

Collective funds If your child's JISA allowance has been used up for the tax year and you still want to invest more in stocks and shares on their behalf, you could consider collective funds – i.e. unit trusts, investment trusts or OEICs. Investments in funds for children are usually held in a designated account, which is administered by the parents and belongs to the child, but which they cannot normally access until they are 18. Parental settlement rules apply to the income of funds financed by parental capital.



Action point

Investment bonds in trust are very useful for larger investments for children, but their tax position can be complicated in some circumstances and it is especially wise to seek advice before either making or encashing such investments.

Offshore funds The main feature of some offshore funds is that income and gains can roll up free of UK tax until the investor disposes of them. At that point they become subject to income tax in the investor's hands. Among other uses, this facility can allow parents to invest for a child without the income being subject to tax at parental rates. Then when the child reaches the age of 18, the investment can be sold and set against the child's personal allowance, which would allow them to receive (in 2017/18 terms) up to £11,500 free of income tax or up to a further £33,500 to be subject to just 20% tax.

Life assurance investment bonds These investments can also be used to postpone the potential tax liability on investments until a convenient time for their encashment. Parents or others can invest in these bonds for the child – usually within a trust for the child. The investment bond produces no income for the trust itself and the funds within the bond are subject to tax at the life insurance company's rates. When the child reaches the age of 18 or some time later, the trustees can pass over the bond to the child who can encash it at the rates that apply to them that year.

In the case of offshore investment bonds, there is little or no UK tax, but the proceeds are potentially subject to starting rate (0%), basic rate tax as well as the higher (and additional) rates. Gains will also count towards the new personal savings allowance. UK investment bonds suffer some tax on the income and gains of the underlying funds, but they benefit from a tax credit for any basic rate tax that would be payable on the bond gains.

Investment bonds in trusts are very useful for larger investments for children, but their tax position can be complicated in some circumstances and it is especially wise to seek advice before either making or encashing such investments.

Personal pensions The generous tax breaks and long investment term make pensions an effective way to invest for children. Anyone can contribute up to an aggregate of £3,600 gross in a tax year into a personal pension for a child. Contributions automatically benefit from basic rate tax relief, so this means only £2,880 is paid into the scheme and the government will make up the balance. Ultimately up to 25% of the pension fund can be taken as a tax-free lump sum with the rest of the fund drawn as taxable payments.

Contributions made to a child's pension do not count against the contributor's own pension contribution annual allowance and they may also help with the contributor's inheritance tax (IHT) planning. However the child will not be able to draw the pension until long after they have grown up – no earlier than age 55 under the current rules, an age which is set to increase over time, in line with, but ten years below, the rising state pension age.

Friendly society bonds Some friendly societies offer tax-free savings schemes for children which can be specifically designed to mature for a significant event, like the 18th or 21st birthday, or starting university or graduation. The maximum investment is £25 a month or £270 a year and bonds must last for at least ten years for the proceeds to be free of income tax and CGT. Although the premiums on these schemes are low, the charges can be high.

National Savings and Investments Children's Bonds Parents, guardians, grandparents and great-grandparents can invest from £25 to £3,000 in total for a child under the age of 16 in each issue of Children's Bonds. The bonds pay a fixed rate of interest – the current issue pays 2.5%. Returns are free of income tax and CGT, but the bond must be kept for the whole five-year term. If it is cashed in early, a penalty equivalent to 90 days' interest applies.



Action point

If you are planning to set aside money for the long term future benefit of a child, you may want to use a trust.

Should you use a trust?

If you are planning to set aside money for the long term future benefit of a child, you may want to use a trust.

A trust is basically a way for one group of people (the trustees – who could include you) to hold investments or other assets for the benefit of some other people – called beneficiaries. Using a trust can also assist IHT planning by allowing you to transfer the assets outside your taxable estate. A trust can also control when the children have access to the funds.

There are several types of trust with different tax and other legal characteristics. They all have different advantages and drawbacks, but there are two main kinds of trust in this context.

Bare trusts

These are sometimes called simple or absolute trusts and are the most commonly used trusts for gifts to children. The beneficiary – in this case the child – is absolutely and immediately entitled to the income and capital held in the trust. The assets are held in the name of the trustees, who manage and make decisions about the trust until the beneficiary reaches the age of 18 in England and Wales or 16 in Scotland. At this point beneficiaries can demand that trustees transfer the trust fund to them.

Discretionary trusts

The trustees can decide how much income and/or capital each beneficiary should receive and when. Discretionary trusts are sometimes used to provide for future needs that might not yet have developed or for beneficiaries who are not capable or responsible enough to deal with money themselves.

Bare trusts are generally more tax-efficient than discretionary trusts, but are rather rigid and inflexible. By contrast, discretionary trusts often involve additional tax costs, but provide greater flexibility. An important advantage of discretionary trusts is that you do not have to pass over assets to children when they reach the relatively young age of 18 (or 16 in Scotland).

Tax position of trusts

Trusts can help ensure your money is used in the ways you intend for the benefit of the children or grandchildren. But they do not necessarily reduce overall tax liabilities and in some cases a trust might increase the amount that has to be paid. For example, you could incur IHT on a large lifetime gift into a discretionary trust.

Income tax and trusts

The beneficiary of a bare trust is liable for tax on income that the trust receives unless the parental settlement rules apply, although the trustees can pay this tax on their behalf. Beneficiaries should notify their tax office of the income and fill in the appropriate self-assessment tax return form.

The rate of tax on the income from investments held in a discretionary trust depends on the type of income and whether it falls within the 'standard rate band' – up to the first £1,000 of income.

The tax band's size varies according to whether the settlor – the person who has set up the trust – has established any other trusts. Where the settlor has set up other trusts, the £1,000 band will be split equally between them subject to a minimum band of £200. So if the settlor has set up five or more trusts, each trust will benefit from £200 of income taxed at the standard rate.



Action point

If you use a discretionary trust you could postpone the CGT tax liability by claiming hold-over relief; the person who receives the asset would then pay tax on the held-over gain when in turn they sell or transfer the asset.

You apply the standard rate band first to non-dividend income and then to dividend income. So if in 2017/18 a trust receives £1,500 of interest during a tax year and £2,000 of dividends, and assuming the full standard rate band is available, the first £1,000 of interest would be taxed at 20%, the next £500 of interest would be taxed at 45% and the £2,000 of dividends would be taxed at 38.1%. The dividend allowance is not available to trusts, but dividends falling within the standard rate band are taxable at 7.5%.

Income paid by a discretionary trust to a beneficiary is treated as having already been taxed at 45% – the current rate for trusts. So if the beneficiaries themselves pay tax at a lower rate, they should be able to reclaim some of this. A beneficiary who does not pay tax or who pays tax at 20% or 40% may be able to claim some or all of the tax back. If they pay tax at the 45% rate, there will be no more tax to pay on the trust income.

Capital gains tax and trusts

If you set up a trust you may have to pay CGT tax when you set it up. This could be because you either sell some investments to put cash into the trust or because you simply transfer some of your own existing assets into it. However, if you use a discretionary trust you could postpone the CGT tax liability by claiming hold-over relief; the person who receives the asset would then pay tax on the held-over gain when in turn they sell or transfer the asset.

Trustees are potentially subject to CGT tax on investments if they realise profits by selling them or transferring them to the beneficiaries. The position varies, mainly depending on the type of trust involved.

- In the case of a **bare trust**, the investments are taxed as if the beneficiary owns them. If the trustees realise gains on any investments, these are taxed on the beneficiary and set against their annual exempt amount. If the gains are large enough to be taxable, the tax rate(s) will generally be 10% and/or 20%, depending on the beneficiary's own level of income and gains. Residential property gains attract an 8% surcharge.
- Gains within **discretionary trusts** are not taxed by reference to the beneficiaries. The trustees have an annual exempt amount of up to £5,650, although it will be less if the settlor has set up any other trusts (the minimum is £1,130). Any net gains that exceed the available allowance are taxed at a flat rate of 20% (or 28% for residential property).

A CGT liability may also arise when assets are distributed from the trust. In this situation the trustees would normally be liable to pay the tax. The main exception to this is in

the case of a bare trust, when the beneficiary is 'absolutely entitled' to the trust assets, usually because they have reached the age of 18, or the trust has come to an end. A CGT liability would also arise for the trustees if the trust became non-resident.

Inheritance tax and trusts

There is a possibility of incurring an IHT charge on transfers into a trust. If you make a gift into a bare trust or an outright gift to an individual, there could be an IHT charge of up to 40%, but only if you were to die within seven years of making the transfer.

If you make a transfer into a discretionary trust of more than the amount of your unused nil rate band (until at least April 2021 the full band is £325,000), you will have to pay an IHT charge of up to 20% on the excess. Then if you die within five years of making the gift, there could be a further tax charge to bring the total up to a maximum of 40%. This is less than the usual seven year period, because the taper relief will eliminate any additional tax after just five years. There could also be further relatively small IHT charges for the trust every ten years that the trust continues and then when assets leave the trust.

Trusts and trust investments are not an area for do-it-yourself tax and financial planning. The position is complicated and the law and HMRC practice change frequently.

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How we can help

Planning for your child's future is one of the most important things you will ever do and we are here to advise you about the best way to achieve your aims and to help ensure that your investments produce the outcomes you want for your children. We can help in a range of ways. We are very willing and prepared to work with your other professional advisers. The scope of our work can include:

- Comprehensive financial planning for your family's finances and estate planning.
- Investment planning for yourself, your family and any trusts, from asset allocation to investment selection.
- IHT mitigation.
- Advice on the choice of appropriate trusts.
- School fees and other educational costs planning.

Investing in shares should be regarded as a long-term investment and should fit in with your overall attitude to risk and financial circumstances.

Past performance is not a guide to future performance. The value of investments and income from them can go down as well as up, and you may not get back the original amount invested.

Levels and basis of, and reliefs from, taxation are subject to change and depend on your individual circumstances.

The Financial Conduct Authority does not regulate tax advice and trusts, National Savings and Investments and some forms of inheritance tax planning.

This publication is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking any action on the basis of the contents of this publication. The Financial Conduct Authority does not regulate tax advice, so it is outside the investment protection rules of the Financial Services and Markets Act and the Financial Services Compensation Scheme. This publication represents our understanding of law and HM Revenue & Customs practice as at 26 April 2017.

Thank you for your interest in this Essential Guide. For further information or if you would like to discuss any aspect of the guide, please contact us.

Signet Financial Services
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Golders Green
London
NW11 8EP
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Fax: 020 8455 3388
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