EQ investors

Investing for children

It's never been so necessary

Why invest for children?

Parents and grandparents have tried to provide a financial boost for their offspring for many generations - it's part of our DNA. Today, the need has never been greater: our children are facing a perfect storm of financial adversity.

In contrast, those who are grandparents today have enjoyed a generally favourable environment for accumulating wealth. Here are some of the issues:

1 High cost of further education

Following the recent rise in university tuition fees, UK students now graduate with the highest levels of debt in the English speaking world.[1]

2 Property prices have never been so out of reach

In London the house price to earnings ratio is now over 9, compared with less than 3 in 1991. First-time buyers typically get onto the property ladder at 32 years of age, and nearly half of which have a mortgage of 30 years or more.[2] Were it a corporation, the 'Bank of Mum and Dad' would now be the 12th biggest UK mortgage lender![4]

3 Much lower employer contributions to pensions

Compared to the generous final salary schemes of the past, employers contribute less than half as much into pensions today.[5]

4 Likely lower investment returns over the next 30 years

The exceptional economic and business conditions responsible for stellar returns over the past 30 years are unlikely to be repeated.[6]

£50,000[1]

Student debt

£44,653[2]

Mortgage deposit for a first time buyer

£27,000[3]

Wedding costs

1 *UK reviews impact of student debt on financial stability*, Financial Times, January 2019
2 48% as at 2018, according to *Can you buy a home now?*, Which, February 2019
3 *How much does an average wedding cost?,* The Money Advice Service, June 2018
4 *The Bank of Mum and Dad*. Legal & General, May 2018
5 *Contributions cluster at minimum levels*, Office for National Statistics, May 2018
6 *Why Market Returns May Be Lower and Global Diversification More Important in the Future*, Schwab, February 2019

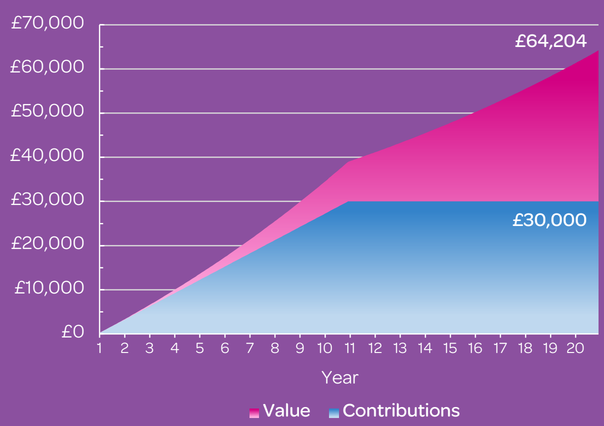
Risk warning: past performance is not a guide to future performance. The value of investments and the income derived from them can go down as well as up, and you might get back less than you originally invested.

Why start early?

In this guide we explain the best ways to help children secure their financial future. One of the key messages is: start early.

The power of compounding (even when returns are lower) means that £1 saved today should be worth much more in the long term.

The chart opposite shows the power of investing £250 per month for 10 years and then letting it accumulate for another 10 years, assuming a steady growth rate of 5%.



Your options at a glance

In the table below we show the main vehicles that can be used to save for children in the UK. Each has its own advantages and disadvantages:

	Pros	Cons
Own investment account → p.4	✓ Retain full control ✓ Simple to set up & lots of choice	× No tax advantages × Money could be used for other purposes × Subject to Inheritance Tax (IHT)
National Savings & Investments - Premium Bonds → p.5	✓ Tax free ✓ 100% Government backed ✓ Instant access (Premium Bonds only)	× Most children are not taxpayers × NS&I interest rates are relatively low
Junior ISA (JISA) → p.6	✓ Tax free ✓ Simple to set up & lots of choice ✓ Can save up to £4,368 in 2019/20 ✓ Potential IHT saving	× Most children are not taxpayers × Child has unrestricted access at 18 × No access before age 18
Bare Trusts → p.7	✓ Simple to set up & low cost ✓ Make use of child's tax allowances ✓ Retain control and access until age 18 ✓ Potential IHT saving	× Gift is irrevocable × Child has unrestricted access at 18 × Need for a trustee (usually the parent) to control access before 18
Bequeath your pension → p.8	✓ Tax free growth ✓ No IHT ✓ Where subject to income tax, withdrawals can utilise personal tax allowances	× If you are over 75 when you die, beneficiaries pay income tax as they draw down from the fund × Unpredictable timing!
Junior Self-Invested Personal Pension (Junior SIPP) → p.9	✓ Tax top-up on annual contributions up to £2,880 ✓ Tax free growth ✓ IHT saving on regular gifts	× No access before retirement age × The gift is irrevocable × 75% of the proceeds will be taxed as income
Investment Bonds → p.10	✓ Retain full control ✓ Up to 5% annual tax deferred withdrawals ✓ Can assign the bond to a lower rate taxpayer before encashment	× High charges × Tax becomes due on all previous withdrawals when bond is encashed × Subject to IHT
Discretionary Trusts → p.10	✓ Can include a number of beneficiaries ✓ High level of control ✓ Potential IHT saving	× Requires ongoing commitment from trustees × More complex arrangement may require financial and legal advice
Investing in property → p.11	✓ Asset-backed investment ✓ Provides somewhere to live ✓ Tangible	× Property prices are high/high maintenence × Children's needs will change × Illiquidity

So what's missing?

In many cases the JISA or Bare Trust will be the preferred choice for parents. But both suffer from the inability to restrict access to the funds once the child becomes an adult at 18. We see this as a serious weakness of the current system.

We would like to see the 'Lifetime ISA' be made available to children with an earliest access age of 25, except for the provision of education fees.

We would also like to see a facility to allow children to make small contributions themselves to such a scheme and to be kept informed of its progress. This would help to provide an element of financial education as well as engender a sense of financial responsibility.

Choosing your approach

As most children are non-taxpayers, they are likely to be better off by investing in a child savings account at a bank or building society. However there are options for both investing and saving, and we'll help you decide which is best for you and your child.

Investing in your own name

One of the simplest ways to start saving for children is to keep the funds in your own name. This gives you total control over when and how the money is accessed.

If you are concerned about how the child will use the money or you think they might need access before they are 18, then this could be the best solution. The downside to keeping the investment in your own name is that you cannot make use of the child's tax allowances so you will be personally responsible for any tax due.

If you don't use your own ISA allowance every year then it makes sense to use this tax shelter first. If you are already using your ISA allowance you may also have your Dividend Allowance and Capital Gains exemption available.

With this approach it is worth making a longer term plan to dispose of assets in a timely fashion, as any investments left in your name when you die (plus any gifts given away in the previous seven years) will be subject to IHT.

CASE STUDY:

Covering the cost of education

Dan and Meena have recently had their first child, a son called Ted. Dan is an architect earning £90,000 a year. Before taking maternity leave Meena was an accountant, but she has decided not to return to work for a few years. Dan continues to fund his and Meena's annual ISA allowance, but they want to save for Ted's education. They considered using a Junior ISA, but they think they might want access before Ted turns 18.

They decide to invest £500 a month into a portfolio in Meena's name in order to keep control of the money and have access whenever necessary. The portfolio is managed on a discretionary basis, so the manager sometimes sells an investment which results in a capital gain. As Meena does not have any other investments, she can use her annual capital gains exemption and does not have to pay any tax.

Ted goes to his local state school, but when he turns 16 they decide to send him to a private sixth form college to complete his A levels. As the investments are in Meena's name, they are able to draw on the funds before Ted's 18th birthday.

Investing in their name

Something to consider is that the child will have complete access to the money once they are 18 years old, and as such you will have to be confident in their pendent financial responsibility.

Children have the same personal tax allowances as adults, so there is not usually any tax to pay on their investment income or capital gains.

The exception is the 'parental settlement' rule. If money gifted to a minor child generates more than £100 of interest in a year, then the parent must pay the tax due on this. So if a parent gives a child £4,000 and they receive 2.5% interest a year, then the parent will have to include the tax as part their own income. This rule doesn't apply to other relatives, such as grandparents, and is intended simply to prevent parents from using their children's tax allowances to avoid paying their own tax.

CASE STUDY:

Junior ISA or cash savings?

Jerome and Kate have set aside £4,000 which they want to put into a savings account for their daughter May. They compare the rates available and find a Children's Saving Account paying 2% interest a year and a Junior ISA paying 1% a year. Because the rate is so much better, they open the Savings Account.

After a year May's account has received £120 of interest. Because this is more than £100, Jerome and Kate are liable for the tax on this under the Parental Settlement rules.

Investing vs. Saving

Selecting an investment strategy

In almost all cases an investment for a child implies a long timescale. It also usually involves regular contributions rather than a single lump sum.

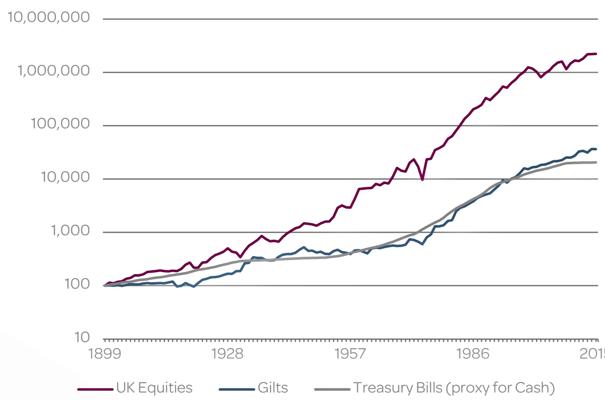
This situation is ideal for adopting an adventurous investment strategy, where you accept the greater volatility that comes with the potential for greater returns in the long term.

Fluctuations in stockmarket values can be advantageous to regular investors as a result of the phenomenon called 'pound cost averaging', whereby your money buys more when markets are depressed.

This all suggests that a child's portfolio should be invested largely in equities (shares in companies) and property, since these are the types of asset that, historically, have produced the highest returns, over the long term. This is shown nowhere more clearly than in the following chart from Barclays, which tracks UK markets since 1899[1].

Going forwards, most commentators expect returns to be lower over the next 30 years than in the past. This is because we are starting from a level of extraordinarily low interest rates. The 'risk free' return available now for investing over the next 10 years in the UK is less than 2%, whereas in 1981 it was 10%.

We still expect a diversified portfolio consisting mainly of equities and property to deliver the best returns over the next 15+ years. However, it is vital that it is carefully monitored and regularly rebalanced. As the time for realisation approaches it will make sense to reduce the risk by holding more lower risk assets such as cash and fixed interest bonds.



1 *Equity Gilt Study 2016*, Barclays, March 2016

Cash savings

If you will be saving for less than five years then a cash deposit is likely to be the best option for you.

In comparison to standard deposit rates, there are some attractive interest rates available for children's accounts, but the amounts you can pay in are usually relatively small.

Despite the attractive savings rates available to minors, saving in cash over a longer time period doesn't make sense. Unless the interest rate you receive on deposits is higher than the rate of inflation, then the value of your money is reduced.

In recent years interest rates have been very low, which has meant the purchasing power of money in bank accounts has been reduced over a 10 year period. If you're investing over an 18 year period the returns from a bank account won't keep up with inflation.

Premium Bonds

Rather than a fixed rate of interest, Premium Bonds allocate interest via a monthly lottery.

The total monthly prize fund is based on an assumed interest rate (1.40% from June 1st 2019) and the odds of each bond winning a prize in any month is 24,500 to one. The more bonds you hold each month, the more chance you have of winning, but in any month many people won't win anything at all.

Prizes are tax-free, which means that premium bonds are a better option for higher or additional rate taxpayers. And as Premium Bonds are backed by the government they are very safe investments. However all bank accounts are now guaranteed up to £85,000 per institution via the Financial Services Compensation Scheme, so for many there is little advantage to Premium Bonds from a risk perspective.

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Junior ISAs

One of the most popular ways to save for children is to open a Junior ISA. These are tax-free savings accounts that allow you to save up to £4,368 each year in a cash deposit or by investing in stocks and shares. There is no tax to pay whilst the money grows inside the JISA account, and all withdrawals are tax free.

JISAs are a simple way to save for a child's future – there are lots on the market to choose from and they are usually easy to open, either by depositing a lump sum or setting up a direct debit. Parents or guardians need to open the account, but once open anyone can contribute.

The Junior ISA is the successor to the Child Trust Fund (CTF). If your child already has a CTF then you have the option either to keep it and continue to make contributions, or to transfer the CTF into a JISA. You cannot hold both.

Junior ISAs now offer a number of advantages over CTFs, including more choice in the market, access to a wider range of investments and lower fees. Sadly, at the time of writing few providers offer the option to transfer. We hope that the Government introduces legislation to make this more widely available.

CASE STUDY:

Benefit from starting early

Pete and Eliza decide to start saving early for their newborn son Ben, so they open a Junior ISA and invest £250 per month into a managed portfolio of investment funds.

Over the next 10 years, they invest a total of £30,000 into Ben's JISA. While markets go up and down, the portfolio grows at an average rate of 5% each year.

When Ben is 10 they stop making contributions but keep the portfolio invested. It continues to grow at 5% each year. By the time Ben is 20, he has an ISA portfolio worth £64,000.

See chart on Page 2.

There are two disadvantages to using a JISA:

- The money belongs to the child, who can't withdraw it until they are 18. You cannot get back the payments once they have been made
- Once the child turns 18 they have unrestricted access to the fund

If you are confident your child will use the money to fund their education and put down a deposit on their first property, then this will give them a great start in life. However, not every child will be this sensible and you cannot prevent them accessing the funds. On their 18th birthday the fund will be converted to a standard ISA in their name.

"Once the child turns 18 they have unrestricted access to the fund."

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Bare Trusts

An account owned by a child, but overseen by an adult until the child comes of age, is usually seen as a 'bare trust', and benefits from favourable tax treatment. A Bare Trust is the technical term for an account that belongs to a minor but is controlled by an adult. A Junior ISA is an example of a Bare Trust.

At 18, the child is able to request access to the whole fund without restriction but up until that time the adult makes the decisions about how the money is invested. Beyond a JISA, a bare trust can usually hold any asset. However normally it forms a selection of market linked investments.

You can also appoint other trustees to help manage the account by drawing up a trust deed. However, there is no requirement to do this and a simple trust is created automatically when you set up such an irrevocable account.

Setting up a Bare Trust can be very effective for grandparents, particularly those looking to reduce the potential IHT bill on their estate.

CASE STUDY:

Saving Inheritance and Income Tax

Sarah has recently retired from her role as CEO of a publishing firm with a pension of £55,000 a year, cash deposits of £500,000 and over £1million of property assets. Her normal expenditure is around £1,700 a month, but she does not want to accumulate further savings which will be subject to IHT. Her nephew wants to educate his two year old son Alfie privately and Sarah agrees to help cover the costs.

She sets up an investment account designated into Alfie's name and invests £500 each month on his behalf. The gift is made every month and has no impact on Sarah's standard of living so there is no IHT to pay on the gift.

The contribution is invested into a portfolio of UK and International equities. The dividend income generated by the portfolio is less than Alfie's Personal Allowance so there is no tax to pay. Sarah authorises withdrawals to be made when Alfie's school fees are due. If any funds remain once Alfie turns 18, he can withdraw these to help with his university costs.

With the exception of the parental settlement rule, the child is responsible for any tax.

If you die within seven years of making a gift, then all or part of the value could be subject to IHT. There are two exemptions which are relevant if you are contributing to a savings plan for a child.

Up to £3,000 a year can be gifted each year without any IHT liability. If you don't use this allowance it can be carried forward to the next tax year, so a maximum of £6,000 can be gifted in this way.

There is a second exemption for 'gifts out of income'. Provided a gift is part of your normal expenditure and does not affect your standard of living, it will not be subject to IHT. This is particularly useful for anyone setting up a regular savings plan for a child.

If you intend to rely on these exemptions it is very important to keep accurate records.

It is important to understand that the money will be in the child's name. When appropriate, discuss with your child how to use the money responsibly.

Using pensions

Bequeathing a pension is one of the most effective ways to provide financial help for your children or grandchildren. Pension freedom rules have made it much easier to use your pension fund in this way.

It is unlikely that Inheritance Tax (IHT) will be due on the money left in your pension when you die. Your beneficiaries can decide whether they want to take lump sums or income from the remaining pension. Alternatively they can leave some or all of the fund invested in order to pass it on to their own children or grandchildren. Pension money can be passed down the generations without any IHT.

> ***"Pension freedom rules have made it much easier to use your pension to help your children or grandchildren."***

If you are under 75 when you die, it will be unlikely your beneficiaries will have to pay any tax on the money they draw from your pension. If you are over 75 then they pay income tax as they draw down from the fund. If you are leaving money to children who do not have taxable income of their own they would be able to draw up to their Personal Allowance each year without paying any tax.

In contrast, money outside of a pension will be subject to IHT at 40% if total assets are in excess of the nil rate band. From an IHT perspective, if you have a choice between drawing income from your pension or from other investments, it's usually better to draw money from the pension last.

If you are paying the maximum into your own pension you could consider making contributions into a pension for a non-working spouse. Everyone under 75 can receive tax relief on a gross contribution of £3,600, even if they don't have any employment income. These contributions will benefit from tax free growth whilst invested in the pension and can be left as an IHT free lump sum to grandchildren.

CASE STUDY:

Tax free income

John dies age 78 with a pension fund worth £450,000. His widow Irene has pension income of her own which is sufficient for her needs so John's fund passes to their grandsons Mark (age 18) and Peter (17) without any IHT liability.

As they are both students without any income, Mark and Peter can both draw £11,000 income a year from the pension fund to pay their tuition fees without paying any tax, as this is within their Personal Allowance.

Junior SIPP

Given the huge costs involved in raising a child and early adult life, it might seem strange to pay money to a pension which cannot be accessed for decades when there are many other expenses to worry about. However, the long term tax benefits of pensions plus the Government top-up can make for a compelling case in certain circumstances.

Money put into a pension for a child has longer to grow in a tax-free environment, and cannot be frittered away in early adulthood. By contributing the maximum allowed to a Junior SIPP each year for 18 years you could provide your child with a retirement fund of over £400,000, even if they make no other contributions as an adult.

The government encourages pension saving by topping up contributions with an extra 20%. The maximum that can benefit from this uplift is your total salary. Where individuals do not have any earnings, the government will still add tax relief up to a maximum of £3,600. If you contribute £2,880 to a child's pension, the government will top this up to £3,600.

CASE STUDY:

Looking after the long term

Liz and Roger are both high earners working in banking. They want to invest tax efficiently for themselves and their children so have already contributed the maximum allowable to ISAs, Junior ISAs and their own pensions.

They decide to open a Junior SIPP for their baby daughter Florence. They pay £2,880 each year until she reaches age 18; in total they pay £51,840. The contributions grow at an average of 4% a year which means the fund is worth c.£96,000 when Florence turns 18.

The fund continues to grow at an average of 4% a year until Florence is 57 and can access her pension fund. The fund is now worth £443,000. Florence draws 25% of the fund as an immediate tax free payment which gives her £110,750 to pay off her mortgage. The rest of the fund remains invested to provide Florence with income when she eventually retires.

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Other options

For families with a higher income, there are other options for you to invest with more control over your money, and ways to reduce the inheritance tax due on your estate.

Investment bonds

Sometimes known as an insurance bond, and investment bond is a way of investing that allows tax to be deferred until the investment is encashed.

When the bond is set up, it can be divided into a number of 'segments', each with an equal value. For example, an initial investment of £250,000 could be divided into 100 segments each valued at £2,500. When you encash the bond, income tax is paid on the profit on each segment. If you are a taxpayer, you can assign segments to someone who pays tax at the lower rate than you, in order to reduce the amount of tax due.

This is helpful for parents or grandparents who wish to retain access to their money, but don't want to pay any ongoing tax. It's also possible to draw up to 5% of the initial investment each year as a regular income. There is no tax to pay on these withdrawals as they are accounted for when the bond is encashed.

This can be useful in situations where ongoing payments are required, such as regular payment of school fees. The amounts withdrawn are added back to the final gain calculation when the bond is encashed.

Charges on offshore bonds are relatively high on investments of less than £100,000.

CASE STUDY:

Minimising tax

Nicola and Ben have received an inheritance they want to invest to pay their son Jack's school fees. As they are both higher rate taxpayers they are keen to invest without adding to their tax bill whilst retaining access to the money.

They invest £300,000 into an Offshore Bond and withdraw 5% of this each year to pay the school fees. When Jack finishes his education there is now a small sum left in the bond. As Jack is a non-taxpayer Nicola and Ben assign the bond to him. He then encashes it with minimal tax and uses what's left to put down a deposit on a flat.

Discretionary trusts

For a more flexible option that allows you to retain more control over how the money is used, you can consider a discretionary trust.

A Discretionary Trust can be set up for the benefit of a group of people, known collectively as the beneficiaries, rather than one specified person. This is particularly useful for grandparents as the trust can be worded to include any future grandchildren as well as those they already have.

Unlike the bare trusts mentioned earlier, the beneficiaries have no automatic right to access the fund at 18. Instead, the trustees (often parents or grandparents) retain total control over the fund. The trustees decide who benefits, how much they should receive and at what time; there is no requirement to treat all the potential beneficiaries equally.

Because the trustees retain such a high level of control over the funds, gifts into a Discretionary Trust are subject to a different IHT treatment. There is usually no initial tax charge on gifts under £325,000 provided there have not been other gifts in the seven previous years.

Once the money is invested the trustees are responsible for any tax arising on the investment, whilst it still owned by the trustees. Trustees usually pay tax at the highest rates with the beneficiary reclaiming some of the tax from HMRC.

If the trustees set up an Investment Bond there is usually no tax to pay until some or all of the bond is encashed. The trustees can also give 'segments' of the bond directly to the beneficiaries. If the beneficiary then cashes it in, they pay any tax due at their own tax rate (and not the trustees' rate). This is particularly useful in cases where the beneficiaries have no other income so pay very little tax.

CASE STUDY:

Keeping control

Geeta want to reduce her potential IHT bill by making gifts to her young grandchildren. She's worried the children won't be mature enough at age 18 to deal with the money responsibly so decides to set up a Discretionary Trust to retain control over how the money is used. She appoints herself and her two daughters as trustees.

She gifts £325,000 to the trust. As she has made no other gifts this amount will be outside her estate provided she survives seven years from making the gift. The Trustees invest the money into an Offshore Investment Bond; the bond is divided into 100 segments each with an opening value of £3,250.

Over the next five years the bond grows in value to £414,791. Which means each of the 100 segments is worth £4,148. Geeta's eldest grandson Rav requires help with his university tuition fees. The trustees assign him three segments of the bond. As Rav does not have any other income he can encash his segments (£12,444) without paying any Income Tax.

Investing in property

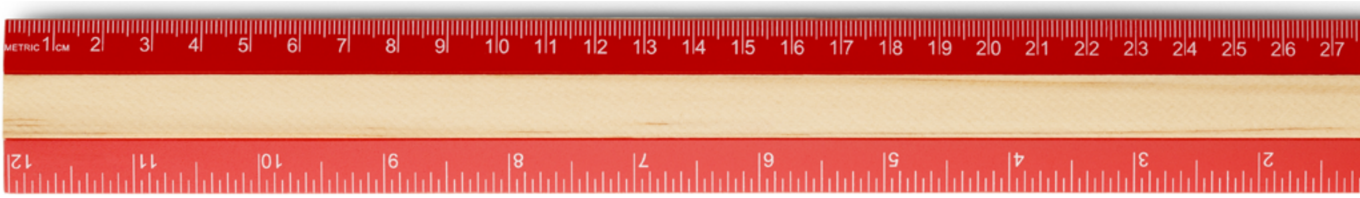
Many parents will be thinking about how best to help their children get onto the property ladder. Buying a second home for your child to live in might offer you the most control over the investment, but that also comes with the greatest tax liabilities.

Any taxable gain on your property would be subject to CGT at the higher residential property rate (currently 28%) and the purchase would attract a 3% stamp duty surcharge. In addition, the home falls within your estate for IHT purposes.

An alternative approach is to either gift or lend money to your child, either to provide them with a deposit or to buy a property outright. Providing the child lives in the property and it is their only home, normal rates of stamp duty would apply and any future gain in value would be tax free. If you live seven years from the date of the gift then it falls outside your estate for tax purposes.

Parents who are not comfortable in making an outright gift can opt to lend money to their children instead. Reserving the right for the loan to be repaid can protect you in the event of your child breaking up with a partner. If you find that you no longer need the money, the loan can be waived and the funds gifted at a future date. As a loan, the money will remain part of your estate.

A potential downside is that if your child needs to take out a mortgage, lenders would take the parental loan into account when considering affordability. And if you really need the loan repaying, in practice it might be difficult for your child to repay.



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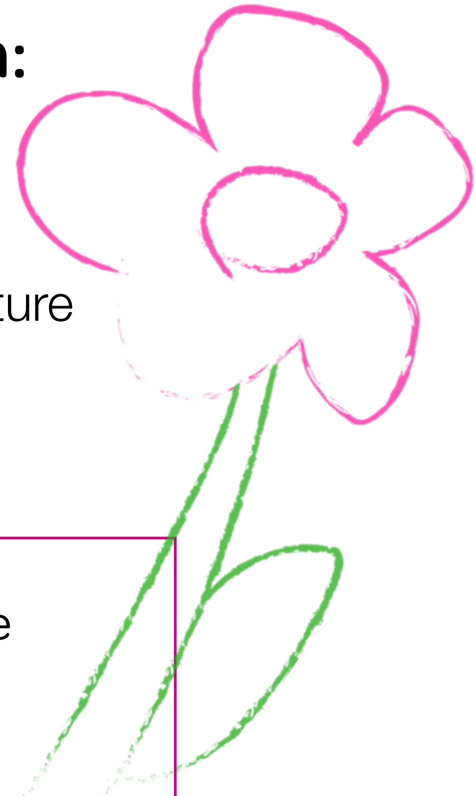
EQ can help you with:

- Financial advice
- Managing your investments
- Planning for your childrens future



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