The Parenting Without Tears

GUIDE TO SAVING FOR CHILDREN

compiled by

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Introduction

There are a hundred good reasons to start saving for children. It might be for the short term, such as Christmas, or longer term - such as their gap year before university, their wedding day, a deposit towards their first home or simply to help them to get a head start in life. It could even include saving for *their* retirement!

Before considering the different options available it is important to understand a little about:

- what you are trying to achieve
- how to get there
- what may influence your decisions along the way.

Saving or investment is not a one-time operation; it is something that develops and needs to be monitored.

If you're thinking about building up some savings or investment on behalf of your child, there are few things to think about:

1. What **type** of investor are you?

2. How **long** do you want to save for?

3. How much **risk** can you take?

4. What is your **tax** position?

5. How can **inflation** affect my savings?

1. The **type** of investor you are will help determine the type(s) of account you want to consider. This depends on the reasons you are saving. Are you looking for **growth** to provide a lump sum at a particular age, or do you want it to provide an **income** for regular expenditure?

- **Growth** investors may want to consider investments in the stock market or unit trusts. These have provided greater returns, over a longer period, than bank and building society accounts or national savings products.

- **Income** Investors may do well to look at bonds, which can provide a tax efficient income over a period of time.

2. The **length** of time you intend to invest will help determine which products are most appropriate. There's not much point in investing in the stock market, for example, if you are a low risk investor or if it is for less than, say, three to five years. On the other hand, relatively large sums left on deposit in a normal savings account can be seriously reduced by tax and inflation.

3. How much **risk** you are prepared to take with your child's savings usually depends on your own attitude to risk. Over the longer term, you may feel able to take more risk and accept that values can fluctuate (down as well as up) and have the potential of greater growth. However, if you feel that absolute security is paramount, a low-risk but solid investment like government securities, national savings or bank and building society deposit accounts could be more appropriate.

4. Your **tax** position can have a bearing on the type of saving or investment you consider. Sometimes the plan may be in the child's name and other times it may be in the name of the person making the gift (the donor) - a parent or grandparent, for example.

5. When you consider how much you are trying to save for the future, the reality is that we also need to include an allowance for **inflation** in the future. For example, inflation at four per cent means that an item which costs £100 today will cost £220.00 in 21 years time.

Saving or Investing?

Savings are usually defined as short-term or more accessible capital that is put into deposit accounts with banks and building societies.
Investment usually involves some level of risk in a wider range of plans over a longer period.

Whatever your ultimate goals, there are many different products on offer. There should be something suitable to match your needs – the only problem is choosing from the hundreds of products on offer.

Short-term Investing

Instant Access Accounts

This is usually a deposit-type account with a bank or building society (it is also likely to be online), which provides you with instant access to your money. Most institutions offer these accounts for children, and they often offer more attractive rates of interest than adult accounts. They usually don't have tax deducted at source, and pay any interest gross. They can be in the name of the child but controlled by the donor until the child is 18. Then the benefits legally become theirs to do with what they will (as opposed to what you would like them to do!).

Notice Accounts

These can, but not always, offer higher rates of interest than a normal instant access account. They have stricter terms and conditions on minimum deposits, number of withdrawals, and limit withdrawals by notice periods of 30, 60 or 90 days for example. They don't usually have tax deducted at source, paying any interest gross. They can be in the name of the child

but controlled by the donor until the child is 18 when the benefits legally become theirs.

Fixed Interest and Growth Bonds
Fixed interest bonds are like notice accounts but tend to tie up your money for longer periods of time. They are usually fixed-term deposits from one to five years. Growth bonds are also a fixed-term investment, but the rate of interest is guaranteed to increase every year. They don't usually have tax deducted at source, paying any interest gross. They can be in the name of the child but controlled by the donor until the child is 18 when the benefits legally become theirs.

National Savings & Investments
This is a government-backed agency which offers a variety of savings accounts, some of which are tax free. It would be difficult to find a more stable savings institution than the government. For example, children's bonds don't have tax deducted at source, paying any interest gross. They can be in the name of the child but controlled by the donor until the child is 18 when the benefits legally become theirs.

Medium-term Investing

If you are happy to invest over a longer period of time and take a higher level of measured risk, there are a variety of medium term investments that can reap handsome rewards, including:

Guaranteed Equity Bonds
These offer you the choice between growth or income. They are typically offered by life insurance companies and investment companies. They tend to have a fixed life of five or six years. Most bonds promise to protect your growth and/or your original capital in some way. They are usually set up in the name of the donor and are controlled by the donor until they feel the time is

right to give the benefit to the child. They are often written under a trust, which just means the donor notes down exactly what will happen to the money in the event of their death.

Investment Bonds
These plans are most often offered by life companies and can be invested in a wide range of funds including unit trusts, shares, property, fixed interest and cash. As they invest in a variety of different investments, they are considered less risky than a pure equity (share) investment, but are more risky than deposit accounts. They are usually set up in the name of the donor and are controlled by the donor until they feel the time is right to give the benefit to the child. They are often written under a trust which just means the donor notes down exactly what will happen to the money in the event of their death.

Long-term Investing

If you are saving over the longer term (five years or longer), you should consider the potential boost that a stock market investment can give to your capital. However, where there is a potential for extra reward there is also a higher associated risk. Nevertheless, stock markets have served investors well for hundreds of years and if you are willing to take the extra risk, the benefits can be great.

Stock market investments come in a wide range of shapes and sizes. In order to choose the type of investment that most suits you, you'll need to think, as before, about the following: whether you want to put away a lump sum or make regular savings; what **type** of investor you are (growth or income?); how **long** you want to invest; how much **risk** you are prepared to take; your **tax** position. However, not all of us have the large amount of capital required to instruct a stock broker, so there are ways

of limiting the amount or risk and investing smaller sums by utilising a collective investment vehicle.

Collective Investments
Many keen savers and investors will have heard of unit trusts and investments trusts, especially in the form of ISAs – the most common and popular collective investment vehicle. But not everyone understands the special benefits which these collective types of investment offer. Your money is pooled with that of other investors, and then invested in stocks and shares by experienced fund managers who monitor your fund on a regular basis. This means you can enjoy the benefits of investment expertise at a greatly reduced cost.

Unit Trusts
Unit trust ISAs are the most popular. Investors' money is pooled and invested in stocks and shares. The total value of the investments is split into 'units', and each investor knows how many units they hold. The buying and selling prices of each unit are quoted in the papers every day (and on web-based sites), and their value will rise and fall in direct relation to the performance of the underlying fund.

OEICs
Open Ended Investment Companies or OEICs (pronounced 'oyiks') were introduced in 1998, and many unit trusts have since converted into OEICs. They have the simple structure of a company, and have an arrangement of underlying within the company. Each fund has a single share price. The share price rises and falls in line with the value of the underlying assets within the portfolio, like a unit trust.

Investment Trusts
Investment trusts are the oldest type of collective investment – in fact they have been around for more than 130 years. Investment trusts are companies which exist to invest in other

companies shares. You can save in an investment trust by buying shares, and the value of these shares can go up or down depending on how much they are in demand. This means that you can have a situation where the value of the shares is worth more or less than the value of the underlying fund they represent. The structure of investment trusts gives them several advantages. First and foremost, an investment trust has an independent board of directors whose role it is to oversee the proper management of the trust and to protect shareholder interests. Secondly, because of the way in which they are run, investment trusts often have lower initial charges than other collective investments.

Packaged Collective Products
Many companies package their unit trusts, OEICs or investment into other tax-efficient and investment savings product. These include:

Stocks and Shares Individual Savings Accounts (ISA)
An ISA is a tax-efficient wrapper within which you can invest in collective investments or stocks and shares. You have no personal income tax or capital gains tax to pay on the proceeds of your investment. The maximum contribution level for a stocks and shares ISA is £7,000 (until April 2008 when the limits change). ISAs cannot be held in the child's name and you have to be over 18 to take one out. However, you may decide to earmark the money in your own ISA for your child's future.

Personal Pensions
Pensions have never been more versatile than they are today. Traditionally they are seen as inflexible, overpriced and inaccessible – hopefully all that has changed. Many institutions now offer access to their funds in a flexible and easy-to-understand plan. A Pension also has the associated tax benefits, tax relief on premiums you pay in - at your highest rate! With the recent changes to pension legislation, for the first

time ever you can open a pension on behalf of your child or grandchild, so that they can benefit from the tax advantage too. The benefit of taking out a pension on behalf of your child is that it gives their fund much more time to grow; a drawback is that they cannot access the money until their earliest retirement date, this is currently at age 50, but after 2010 this will rise to age 55.

Gifts & Saving Information

If you gift money to your child, there may be income or inheritance tax implications which you will need to consider. Although children have their own personal income tax allowances which are the same as adults (£5,225 for the 2007/08 tax year), if the income generated is from money that was given or invested by parents, then tax will still be due upon it.

Child Trust Funds (CTF)

This is listed as a separate product due to the unique nature of the scheme. CTFs were introduced by Gordon Brown as chancellor to encourage all sectors of the community to invest in their children's future by giving a lump sum to every child born since 1 September 2002. From 2005 onwards the amount is £250 for a child from a standard income status family and £500 for a child from a low income family. There is also a plan to give a further boost to these savings when the child reaches seven.

Family and friends can add to the fund up to a maximum of £1,200 per year. CTFs are free from income and capital gains tax. Children will have full access to their accounts when they are 18. This might be a concern for some parents or guardians - what would you have spent it on when you were 18?

Tax Implications
As every individual's tax circumstances are different, if you are in any doubt you should seek independent advice. However, the following is a very brief summary of tax relief available.

If the donor holds an account or makes an investment on behalf of their child which generates an income of more than £100 a year, it will be included as part of the *parent's* income, not the child's, and the donor will have to pay income tax on the full amount earned. This applies until the child is 18, provided they remain unmarried. A possible solution to the income tax problem is to invest in growth funds which do not try to generate an income. However, the fund may still be liable to capital gains tax if it grows by more than a certain amount (currently £9,200 for the tax year 2007/08).

Inheritance tax is a more complicated issue and may be payable by your children on your estate. However, one way of minimising their tax bill is to start giving them gifts now. You are allowed to make tax-free gifts to whomever you want for as much as you want, provided it is an outright gift from which you receive no benefit. If you live for more than seven years after you make the gift, there will be no tax to pay on it by your children.

Gifts that can be given free of tax:

- wedding gifts up to £5,000 for each of your children, £2,500 for each grandchild and £1,000 each to anyone else;
- an annual exemption up to a total value of £3,000 a year, plus any unused part of the previous tax year's £3,000 exemption;
- £250 individual gifts to any number of people.

Gifts from Grandparents, Relations or Friends
If anyone other than the parents makes a gift or an investment on behalf of a child then there is no income tax to pay, as long as the income generated is within their annual allowance. Any income earned over and above this amount will be charged to the parents. In order to register a child's account to be paid interest tax-free, the parent or guardian must complete a form R89 with the child's details and sign it on their behalf. Interest can then be paid gross until the child is 16, as long as the deposit came from someone other than the parents.

Writing your Assets in Trust
People in Britain waste huge sums of money, about £1.2 billion each year, by neglecting inheritance tax planning. When you die, if you leave a substantial amount of your possessions to anyone other than your partner, they may have to pay inheritance tax on what you give them. This can be avoided by writing your assets in trust in your child's name and making them the legal owner.

A trust is a separate legal entity which is set up on behalf of a named beneficiary – usually by a parent on behalf of their child. The assets are protected and managed by trustees on behalf of the child until they are 18. Trusts are extremely simple to set up, which is why it's always wise to consider putting assets, including life assurance policies, into trust. The 40 per cent inheritance tax can be avoided, as the assets already belong to the beneficiary.

Some companies offer specialist savings schemes for children which are automatically written in trust for this very purpose. One or both parents can become trustee to the trust, and retain legal control until the child reaches 18. The parent has no legal rights to the proceeds and the investment is no longer part of the parent's estate – which is why there would be no inheritance tax due upon death of the parent. If you know you

won't need to access your investment, and are prepared to hand over your assets to your child, then there are significant advantages to be had by writing your investment in trust. What's more, some companies even provide these trust facilities at no additional cost.

Next Steps

Given the wide number of options available, and some of the complexities of the tax implications, how can you make an informed decision?

Research: Spend time looking into reports and publications, like this one, then try and narrow down the areas that seem best suited to your circumstances. The internet offers an unbounded amount of information on any subject imaginable, so if you can narrow the field it will help to hone in on particular accounts or investment preferences.

Sites that may help you to do this include:

- www.which.com.uk
- www.moneysavingexpert.com
- www.moneyfacts.co.uk.

Speak to an ***independent*** financial adviser, who you feel you can trust, to give you the correct advice. An adviser's job is to do all this research on your behalf and match solutions to your needs. Yes, there can be a charge if you use their services, but most advisers will not charge you for initial consultations, and it is the first meeting(s) that are important to establish trust and a clear understanding of the "added value" an adviser can bring to your finances before you decide to go ahead with anything.

You can access a list of IFAs in your area at www.unbiased.co.uk.

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