Strategy Paper: Investing for Children

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Overview

There are several different investment vehicles for savings and the preferred option, along with who will own the investment (the name the investment is in), will vary from individual to individual.

The range of options includes

- Term deposits and savings accounts
- Managed funds
- Direct shares
- Insurance bonds
- Education plans/Scholarship funds
- Pay off non-deductible debt (home mortgage)
- Pre-pay school fees
- Family trust
- Super
- Child maintenance trusts

Unfortunately, this is an area where there is no right or wrong investment solution or preferred structure. It depends on the many variables including:

- The investment horizon
- Number and age of children
- Desire to send children to private schools and assist with first car/home purchase etc.
- Marginal tax rates of the parents, including planned work intentions for the future

The most important message is to start saving early and save regularly!

Term Deposits and Savings Accounts

This is perhaps the easiest option, but also the least tax effective and also most likely to deliver the poorest outcome over the long term. They include ordinary savings accounts, cash management accounts and term deposits.

These types of accounts can be held either in the name of the child, the parent’s name or the parent as trustee for the child (formal or informal trust).

These accounts are generally accessible. However, fees or penalties may apply where the number of transactions (withdrawals/deposits) exceed specific product limits. Penalties such as fees or reduced interest rates will generally apply if term deposits are drawn upon prior to the end of the term.

Advantages

- Ease of investment
- Simplicity
- Accounts are readily accessible – available directly or through on-line banks, building societies, credit unions and other financial institutions.
- Can be used for building up a sufficient lump sum/minimum investment amount for another of the investment options outlined above.

Disadvantages

- Returns are generally low – as a result it can be eroded by inflation
- No tax concession – all earnings (interest) are fully accessible for taxation
- Penalties may apply – where cash withdrawals are made prior to the end of the term

Taxation

In order to determine the tax payable on interest earned on a savings account it is important to determine who is to declare the interest, the child or the parent?

Who declares the interest depends on who owns or uses the funds of that account (no matter what type of account it is or the name of the account holder).

The parent owns the money if they provided the money and they spend it as they like. This is the case regardless of whether the parent spends the money on resources for the child. The parent needs to include the interest in their income tax return.

When an account is held in trust for the child by the parent and the parent controls the income and expenditure in the account, interest earned in that account is included in the parent's income tax return.

Interest income that is deemed to be income of the child is considered unearned income and is subject to minor penalty tax. Interest income deemed to be attributable to the adult parent is tax at the parents' marginal tax rate.

Any expense incurred in earning the interest (for example, bank fees) is an allowable tax deduction.

Managed Funds

Managed funds may be an attractive option for parents wishing to save and invest for their children.

Managed funds generally have lower fee options compared with products such as insurance bonds and scholarship plans. They offer a much wider range of diversified or asset specific investment options.

Most funds do not allow children to invest in managed funds in their own name, so generally the parent will have to act as trustee for the child and the parent (trustee) provides their own TFN. Where possible, it is better for the investment to be in the name of a non-working or low income earning spouse.

Advantages

- Generally a very tax effective option if there is a non-working or low income spouse and imputation credits
- Great deal of flexibility with regards to contribution amounts, access to capital and the use of investment funds
- Wide variety of investment options across all asset classes, allowing diversification
- Potentially provides higher returns than term deposits and savings accounts
- Eligible for the 50% CGT discount
- May also allow the use of gearing if appropriate
- Fees are generally lower than insurance bonds and education savings plans

Disadvantages

- Investment in a child's name may not be allowed
- Annual distributions may generate an annual taxation liability and hence inclusion on the investor's tax return.
- If the non-working or low income spouse returns to paid employment, may not be the most tax effective option going forward
- CGT implications
- Generally higher fees than term deposits and savings plans

Taxation

Most managed funds do not pay tax for themselves because they distribute all the income earned in any one year to the investor. The investor is usually the parent. The income is taxable to the investor personally at their marginal tax rate. Even if the investor opts to reinvest all income back into the fund, tax is still payable. As well as the tax payable on income distributions when units are redeemed the investor must pay CGT on the profit made (where there is an increased value in the unit price.)

Direct Shares

For those with an appropriate risk profile and situation, direct shares may offer an attractive option.

Generally children cannot buy shares in their own name and instead would be purchased by the parent as trustee for the child, or alternatively by the parent in their own name, e.g. in the name of a non-working or low income spouse. In both of these instances the parent (trustee) provides their own TFN.

Advantages

- Can be very tax effective where you can take advantage of a non-working or low income spouse and imputation credits
- Allows you to take a high level of control over investments and ability to avoid fund manager fees
- Transaction costs (brokerage) can be quite cheap if using an online broker
- Eligible for the 50% CGT discount
- May also allow the use of gearing if appropriate
- Potential for higher returns

Disadvantages

- Investments in a child's name may not be allowed
- Hard to drip feed small amounts each month into more shares over time.
- Tend to favour larger lump sum investment amounts to achieve a suitably diversified portfolio of shares
- Annual dividends may generate an annual taxation liability and hence inclusion on the investor's tax return (but franking credits may be refunded)
- Dividends are taxable to the investor
- CGT implications

Taxation

Shares distribute either franked or unfranked dividends (generally) twice a year. Franked dividends have been levied with tax at the marginal tax rate of 30%, which gives the investor an imputation credit to the same value. The grossed up value of the dividend (grossed up by the 30% tax rate) paid to the investor is included towards their assessable income. The imputation credit works as an offset against tax payable.

The rightful owner and controller of the shares is generally responsible for declaring the dividend or the net capital loss from the sale of the shares. Where the shares are owned by the parent or by the parent as trustee for the child or of the child is the holder of the shares who declares the shares is based on:

- who provided the money to buy the shares
- who makes the decisions, and
- what is done with the dividends

If the child is deemed to be the holder of the shares the dividend income (and any subsequent capital gain) is deemed to be unearned income and subject to minor penalty tax. Where the parent is deemed to be the holder of the shares the dividend income (and any subsequent capital gain) is taxed at the adult marginal tax rates.

Tax Return

A child who owns shares and earns more than $416 must lodge a tax return. This threshold was higher ($3,333) prior to 1 July 2011 - before the elimination of the low income tax offset for minors.

A child will also need to lodge a tax return if PAYG tax has been withheld in order to obtain a refund. Where a refund of franking credits is due and no tax is payable a refund can be claimed by filling a 'Refund of franking credits form".

Insurance Bonds

Insurance bonds also known as investment bonds are provided by life insurance companies and friendly societies. Although the term "bond" is used, they are essentially like managed funds and receive special taxation treatment.

Insurance bonds have a range of investment options ranging from the more conservative fixed interest type assets right up to funds that include growth style assets such as property, local and overseas shares.

The type of bond referred to here is usually held by the parent/s as trustee for the children, with actual ownership of the policy transferring outright to the child upon reaching a certain age that is determined at the outset (generally between age 16 and 25). This type of insurance bond is called a "child advancement policy" and has specific protective provisions under Division 6 of the *Life Insurance Act 1995.*

Advantages

- Simplicity and no need to include earnings in the tax returns of either parent or child
- No minor penalty taxes if investment held in the name of the child
- Choice of underlying investments including growth assets
- There are no capital gains tax consequences where the policy owner decides to switch from one investment option to another under the bond
- Tax paid by the provider at 30%, so may be an attractive option where both parents have a marginal rate above this percentage
- Fully tax paid after 10 years, providing the 125% annual contribution limit has been complied with
- Upon death of the parent, the bond does not form part of the estate and it goes directly to the child
- Child can continue to make contributions to the bond after it has transferred into their name
- The bond can be assigned or used as security for a mortgage or charge subject to the terms of the policy
- Higher returns than term deposits
- Can accept regular or lump sum contributions

Disadvantages

- The issuer is not eligible for the 50% CGT discount on assets supporting the bond
- Inflexibility in relation to the 125% annual contribution rule - it remains even after a ten year period has been attained
- If the bond is redeemed before 10 years, some or all of the income will be taxed, but the individual will receive a tax offset
- Fees can be relatively high on these products
- Restrictions are placed on the age that a child can own an insurance bond:
    - Under 10 – not available
    - Between 10 and 16 – only with parents/grandparents approval
    - Over 16 - no restriction

Taxation

Shares distribute either franked or unfranked dividends (generally) twice a year. Franked dividends have been levied with tax at the marginal tax rate of 30%, which gives the investor an imputation credit to the same value. The grossed up value of the dividend (grossed up by the 30% tax rate) paid to the investor is included towards their assessable income.

Education Savings Plans/Scholarships Funds

These products are offered only by friendly societies and are purpose built to provide for the child's future education expenses. These products are taxed concessionally if the funds are used for education purposes and include features similar to both insurance bonds and managed funds. Education expenses include uniforms, travel costs, fees, books, living away from home allowance and residential boarding expenses.

Advantages

- Can be a tax effective way to save for children's future education costs. If proceeds are used for education expenses, it allows recovery of tax paid (up to 30%) on investment earnings.
- Investment earnings can be paid to the student to meet education expenses, while the contributions can be returned to the investor or parent
- No annual tax return required

Disadvantages

- Not eligible for the 50% CGT discount on assets supporting the fund
- Underlying investments are typically skewed to non-growth type assets such as fixed interest. A greater proportion of assets could generally be allocated to shares and property when you consider the time frame involved.
- Earnings and/or tax concessions may be lost if the child does not go onto relevant education/studies.
- Can be relatively high fee products

Taxation

Educations saving plans offer a rare tax advantage. The government does not like to give tax concessions unless it is going to encourage people to save for retirement through superannuation or a child’s education through an education savings plan.

The earnings withdrawn are taxable income to the child but if the child is under age 18 and withdraws less than $3,000 ($15,000 for a child aged 18 or older) no tax is payable. This can make education funds a tax-efficient option as the earnings can be effectively “tax-free”.

Pay Off the Non-Deductible Debt (Mortgage)

The strategy of paying off the home mortgage is one that can be very effective, offers a 'guaranteed' return, but also requires a disciplined approach that might be out of reach of many.

It quite simply involves directing any surplus savings into paying off the home mortgage, then using a mortgage redraw to pay for school fees and other purposes.

Parents on the top marginal tax rate would need to make nearly 15% after tax and fees on an alternative investment, assuming a home loan rate of 8% to be in a better financial position than paying off their home loan - and remember, this is effectively a 'risk-free' return equal to the home loan rate.

Advantages

- Very simple savings option
- A known 'risk-free' after tax return equal to the home loan rate
- Access to capital generally very good with most home loans offering readily available re-draw facilities

Disadvantages

- Requires planning and discipline to make it work
- Some may not like the idea of having to make re-draws from their home loan down the track
- Some may prefer to set aside identifiable investments that are for the specific purpose of their children's future (even if that decision means a sub-optimal investment over the long term)

Taxation

Tax-free

Pre-Pay School Fees

Some private schools allow parents to pre-pay tuition fees by up to 10 years in advance, often allowing for a discount in actual fees. When you consider that private school fees have been increasing by a premium over inflation, the ability to save money by prepaying school fees could be attractive for some.

By paying contributions or lump sums into the plan, you can receive a discount on school fees payable in future years. Discounts are based on a pre-determined rate of return and the further the payments are made in advance, the greater the discount.

Pre-payments would usually be made from after-tax dollars and may be made by parents, grand-parents and other parties. Payments can be made regularly or one-off. If the student leaves the school the contributions made are refundable.

Advantages

- Allows a discount in future school fees
- Payments can commence to be made as soon as enrolment has been accepted (minimum contribution amounts may apply)
- Parents, grandparents and others may contribute
- If the child does not end up attending the school, payments made can be refunded

Disadvantages

- Only available to participating schools
- The longer the pre-payment period, the better the outcome that may be available from alternative investment options

Taxation

A discount arising from a prepayment of school fees is not assessable income of the parent responsible for payment, and the payments will be non-deductible to the parent.

Family Trust

A family trust is a more complex option but may be a viable option for those with other estate or risk planning concerns. Since removal of access for children to the low income tax offset the use of trusts is not very tax-effective for distributing to children.

A family trust would generally allow the trustee to distribute up to $416 (2013/14) to each child tax free, assuming no other income in the child's name. If there is a non-working spouse, they may receive up to $18,200 tax free, then up to $37,000 at 19% plus Medicare (2013/14 rates).

The trust allows flexibility in both types of investments and in the manner of distribution - it can even hold an asset under a fixed sub-trust (if the deed allowed) until the child reaches age 18 so that the child will receive all capital appreciation while the income has been distributed to others during its childhood.

There would generally need to be reasons, other than just investing for children, to commence a family (discretionary) trust.

Superannuation

Superannuation is a long term investment with the primary purpose being to provide for retirement. Therefore it can only be used effectively when investing for children if the investor's retirement is in the short term.

Superannuation investments earnings are concessionally taxed at 15% (and nil when in pension phase - paying an income stream) in the fund. As a consequence, access to monies within super are restricted. Access is only possible if a condition of release is met, commonly reaching the age of 65 or retirement.

Investments into superannuation are made through contributions by the member, the member's employer or the member's spouse. Therefore for any monies intended to cater for expenses relating to a child's education will need to be held in the name of an adult (the member) who can be the parent or grandparent.

Contributions for which a tax deduction is claimed are taxed at 15% when contributed; this includes employer contributions and salary sacrifice contributions. Salary sacrifice contributions are paid into superannuation prior to the deduction of PAYG income tax.

Benefits can be paid as either a lump sum or a pension. For members over the age of 60 benefits are tax-free when paid from a taxed super fund. For those under the age of 60, the taxable component is subject to tax.

Advantages

- Flexible investment options
- Up to 15% taxable payable on investments within the fund
- Salary sacrifice contributions can be made from pre-PAYG income tax or personal deductible contributions
- Tax-free if withdrawn after the age of 60

Disadvantages

- Not readily accessible
- Tax may be payable on taxable component if member is under 60.
- Condition of release (such as retirement) may not co-relate with when the education expense is incurred.

Child Maintenance Trusts

A child maintenance trust is a trust established to receive assets pursuant to a court order as a result of a divorce. It is generally a discretionary trust that operates for the benefit of the children of the marriage.

In this type of trust, assets are held for the benefit of a child or children. Capital can be put into the trust and then all of the income created from the trust can be paid to the child or children in place or usual maintenance obligations. The income is paid to the child or children in a more tax effective manner.

Capital can include anything which makes an income. For example, shares, property, machinery or livestock.

The trust is only available for a family breakdown. A legal obligation to pay maintenance is needed. A family breakdown is the end of a domestic relationship - either a marriage or de- facto relationship. There is no requirement to be actually divorced.

Advantages

- Children can receive tax-effective income
- Small business owners can use trust assets for commercial purposes. A fair market price has to be paid for use of the trust assets. For example, a farmer can put cattle in to the trust. The cattle, through a service trust arrangement back to the business, make a lot of income (using market rates). They are also depreciating items. They eventually become worthless. Therefore after time there is no capital left to give the children.
- If the parent is not a business owner they could purchase an annuity in the name of the trust.
- The trust assets are protected from external creditors in the event of bankruptcy.
- There is a guarantee of the assets in the trust, even in the event of sickness. If they stop work, the assets are still in the trust. There is greater protection.
- At the time of sale of the assets, the 50% CGT discount may apply or the CGT small business concessions may be available to reduce or eliminate any CGT payable.
- Some of the tax savings can be shared with the other partner or more can be provided to the children.

Disadvantages

- This may be complicated to set up and administer.
- The capital eventually ends up with the children. This may be when they turn 18, 21 or even 80 years from the date that the trust is set up. This date is called the "vesting age". Some may not want the capital to end up with the child/children.
- This is only available to trusts set up as a result of family breakdown so will only apply in limited circumstances.
- There will most likely be costs associated with setting up and maintaining the trust.
- Both parents must agree to the trust being set up and used. The other parent may not care about saving the other one tax.

Taxation

The individual is taxed at the marginal tax rate and is not subject to the minor penalty tax rates. Income from a child maintenance trust is "excepted trust income" and as a result properly set up Child Maintenance Trust gives the child the more generous adult tax rate threshold.

Summary Table

	Suitability	Investment timeframe	Allowable ownership options	Tax implications	Fees and charges	Risk/ return	Flexibility
On-line savings accounts/term deposits	Individuals with low risk tolerance	Short to medium term	Child's name, parent's name as trustee, or parent's name	Earnings taxed at MTR	Low or nil	Low	Readily accessible
Managed funds	Individuals seeking higher growth as a trade-off for higher risk	Medium to long term	Parent's as trustee or parent's name	Income distributed to the investor and taxed at MTR, with an allowance for imputation credits where applicable. CGT applicable on sale.	Mgmt., contribution and ongoing fees apply. Higher than savings accounts but less than education savings plans	Medium – high (depending on investment selection)	Reasonably accessible, however benefits may only be seen over the medium-long term
Direct Shares	Individuals seeking higher growth as a trade-off for higher risk	Medium to long term	Parent's as trustees or parent's name	Dividends taxed at MTR with an allowance for imputation credits. CGT applicable on sale.	Brokerage costs apply.	Medium – high (depending on investment selection)	Reasonably accessible, however benefits may only be seen over the medium-long term
Insurance Bonds	MTR over 30%	Medium to long term	Parent's as trustees or parent's name	Earnings tax paid at 30%. Tax free to investor if held for at least 10 years	Mgmt., contribution and ongoing fees can be high.	Medium – high (depending on investment selection)	Reasonably accessible, however earnings are taxable if withdrawals occur before 10 years
Education savings plans/Scholarship plans	MTR over 30%	Medium to long term	Parent's as trustees or parent's name	Earnings tax paid at 30%. Tax-free if used for educational purposes	Mgmt. fee can be high.	Low -Medium (depending on investment selection)	Some plans only pay out the original contributions (no earnings) if the child does not attend university or TAFE
Mortgage reduction	Individuals with a mortgage that has an offset account attached	Long	Parent's name	Tax-free (as no earnings)	May have an access account with withdraw fees	No risk. Return seen in reduction of mortgage interest	Readily accessible
Pre-paid school fees	Individuals who choose to send children to private schools and have access to lump sums	Medium – but pre-paid fees are refundable if the child leaves the school	N/A	Paid from after tax monies	Discount in fees provided for advance payment	Low	Accessible if child leaves the school.
Family Trust	Not applicable solely for investing for children, but may be considered where there are purposes. Such as estate planning or risk planning issues.	Medium – long term	Trustee owns in trust for the child	All income must be distributed to beneficiaries. Income splitting options available. Income is taxed in the hands of the beneficiary at MTR for adults, or minor penalty tax for children (if more than $416).	Medium to high – step up costs and on-going management costs	Medium – high (depending on what assets have been acquired)	Accessibility limited to the beneficiaries (with trustee approval) within the terms of the trust deed.
Superannuation	Parent/ grandparent approaching retirement	Long term	Member's name (parent or grandparent)	Up to 15% on earnings within the super fund. Tax may be payable on taxable component of lump sums if member is under 60.	Entry and mgmt. fees	Low -Medium (depending on investment selection)	Poor – access restricted until a condition of release is satisfied – namely retirement
Child maintenance trust	Only applicable where providing for children as a result of a marriage breakdown		Parents in trust for the child	Taxed at MTR to the child	High set up and on-going costs	Depends on investments held by the trust	Beneficiaries have ultimate access to the capital of the trust. This may be at a prescribed age.

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