Junior ISAs

Watch them grow!

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With spiralling tuition fees and hefty house prices, the future looks increasingly debt-ridden for the next generation. We investigate whether the Junior ISA could offer some help for children and parents alike.

In his 2011 Budget statement, chancellor George Osborne announced the birth of the Junior ISA and more details have now been revealed. Encouragingly, the plan became available from 1st November 2011 and the maximum annual investment has been increased from £3,000 to £3,600.

Given the deepening concern that parents will have about the ability of their children to fund a future university education and buy a house, could the Junior ISA be one of the possible solutions for a parent/grandparent to consider as a means of addressing that concern?

In this article we look at how a Junior ISA might help in this regard and look at other possible solutions currently available to parents to provide future financial help to their children.

What is the Junior ISA?

The Junior ISA is a clever government replacement for the Child Trust Fund (CTF). It gives all the tax advantages of the CTF but the big advantage from the government's standpoint is that it does not need to contribute.

The Junior ISA:

- Is available for any child under age 18 who does not have a CTF account e.g. the child was born before 1st September 2002 or after 2 January 2011;
- Permits contributions of up to £3,600 per annum (which will also be the revised limit on contributions to the CTF). These contributions would normally be payable by a relative such as a parent or grandparent;
- Can be invested in cash funds or stocks and shares; and
- Provides tax freedom on capital gains and investment income (although the tax credit on dividends cannot be recovered).

Although the proceeds are not accessible until the child gets to age 18, that can fit in nicely with it being used to fund university costs.

The future financial needs of children

The imminent availability of the Junior ISA comes at an appropriate time, given huge concern about financial provision for children. Firstly, there is the issue of tuition fees. Following the government announcement that universities can charge up to £9,000 per annum for tuition fees there is obvious parental concern. A number of universities have announced they will make this full charge and, of course, maintenance costs of the child must also be factored in.

While there will be an attractive loan facility in place to help university students with these costs, many parents are concerned their children may be leaving university with substantial debt that may take years to repay. Indeed, due to the addition of interest, the outstanding debt will increase for those with higher incomes in later life. And, of course, that outstanding debt may have a significant impact on another important financial issue for children – the desire to purchase a house.

The more onerous borrowing conditions, such as deposit levels and income multiples, when combined with escalating house prices, have made it more difficult for a young adult to borrow money for house purchase. A substantial outstanding student loan will not help the position. Indeed, things have got so bad on this front that the estimated average age of a first-time buyer doing so without parental help was recently reported to be 37.

Parents and grandparents may well be keen to give financial support to their children/grandchildren. And the earlier they can put financial planning in place, the easier it will be to deal with these financial burdens in the future.

How much is needed?

The amount of cash needed to see a student through university can be substantial. Let's take a parent who wishes to advance funds for the university costs of his three-year old daughter. The need (in current terms) is to fund £57,000 – £19,000 per annum (tuition fees of £9,000 per annum and living costs of £10,000 per annum) for three years in 15 years' time.

Based on a growth rate of 5% p.a. net and ignoring tax on any surrendered amounts, this would mean a lump sum of £27,418 would need to be invested today. Alternatively, the parent could pay £215 a month. However, should costs increase by 2% p.a. (not unrealistic), the cash needed in 15 years' time would increase to £76,714!

So what savings vehicle should be used to fund for this? This depends on whether the individual is using a programme of regular savings or is able to make a one-off payment.

For parents, it will frequently be the case that regular saving is the only option. For grandparents, lump sum investment may be an option. We now look at these areas in turn:

Regular savings by parents

As mentioned above, the Junior ISA will enable a parent to invest £3,600 per annum. If the full £3,600 is invested each year for 18 years then, assuming growth at 5% per annum, this will produce a tax-free fund of about £106,340 after 18 years – more than enough to cover the current cost of a three-year university degree course.

The obvious benefits of the Junior ISA are that it is tax free and that parents (and other relatives) can contribute up to a total of £3,600 each year. In the case of parental contributions, because the £100

parental settlor income tax rule will not apply, income arising in the Junior ISA will never be assessed on the parents and will, in effect, accrue tax free.

The downside is that there is no control over the child's ability to access the fund at age 18 and, of course, they may not then be university material.

Parents who are concerned about this point could consider keeping any investment in their own name until the child attends university. Appropriate investments here could be the "adult" ISA, a qualifying life policy and growth collectives.

Parental ISA

Here it is contemplated that the parent would effect the ISA in their own name and therefore keep complete control over when the ISA is surrendered.

For a taxpaying investor, it is still undoubtedly the case that the ISA is still the main method of investing savings with freedom from income tax and capital gains tax without giving up the flexibility of access to the investments.

For the two types of ISA – the cash ISA and the stocks and shares ISA – the overall annual contribution limit for tax year 2011/12 is £10,680, of which no more than £5,340 can go into cash. The balance can be invested in a stocks and shares ISA. This means a couple could, between them, invest £21,360 each year.

No tax relief applies on the payments into an ISA but income and capital gains are free of tax. The tax credit on a dividend is not recoverable and so, for the basic rate taxpayer, an ISA invested in equities gives no income tax advantage. However, for a 40% taxpayer, tax freedom means the net dividend income yield improves by 33.3%; and for a 50% taxpayer by 56.5%.

The tax efficiency of an ISA stems from the fact investments have scope to accumulate in value at a faster pace. The earlier a programme of ISA savings is established, the better. Because here we are looking at an ISA in the name of the parent or grandparent, they will automatically be able to exercise control over the timing of any encashment of the ISA and the application of the ISA proceeds.

Qualifying Savings Policies

The main tax attraction of a qualifying savings life policy is that the proceeds after 10 years (or ¾ of the term) are completely tax free, irrespective of amounts. It may also be possible to take benefits as regular tax-free payments. However, the funds are not easily accessible before the expiry of 10 years and there are relatively few providers of the "new breed" of these plans, which became more attractive as personal tax rates increased.

The plans can be systematically encashed over several years to provide a stream of tax-free income. This can be achieved by establishing the plans as a number of individual policies (known as segments) and encashing whole policies each year. Alternatively, if the policy permits, it may be possible to engineer regular tax-free 'income' by utilising full premium recycling each year. Either way, a stream of tax-free capital sums can be generated, which could be used to meet university costs.

The plans can be written under a revert to settlor trust so the benefits payable on death within the first 10 years are free of inheritance tax, yet the settlor can benefit at maturity of the plan. Should the investor (i.e. the life assured) die, the policy proceeds will be paid out under trust to his family but should he survive to

the selected maturity date, he will be entitled to the policy proceeds. Because the gifted benefits would be carved out under the trust, this could be achieved without the IHT gift with reservation and income tax pre-owned assets tax (POAT) provisions applying.

Growth-oriented Unit Trusts/OEICs

Given the relatively high rates of income tax as compared to the current rates of capital gains tax (CGT), it can make tax sense to invest for capital growth as opposed to income. This is particularly the case for the higher/additional rate taxpayer.

Although income (dividends and interest) on collectives is taxable – even if accumulated – if this can be limited then so can any tax charge on the investment. Instead, if emphasis is put on investing for capital growth, not only will there be no tax on gains accrued or realised by the fund managers, it should also be possible to make use of the investor's annual CGT exemption (currently £10,600) on later encashments. This would enable the investor to enjoy a stream of tax-free capital payments that can be used to meet university costs. Gains in excess of the annual exemption currently only suffer CGT at 18% and/or 28% (depending on the investor's income tax position). For couples, it makes sense for each of them to invest, to be able to use both annual CGT exemptions when investments are encashed.

As for all financial planning, a careful balance needs to be struck between investment appropriateness and tax effectiveness. While investment performance through capital growth is obviously tax attractive, reliance on growth at the expense of income can introduce (possibly unacceptable) risk.

Lump sum investments by grandparents

For those who may need to provide help with funding the costs of university in the shorter term, it may be worth asking grandparents for assistance. Frequently, grandparents will have capital available that they do not need and they may be prepared to invest on behalf of a grandchild who aspires to a university education. Also, grandparents are not subject to the income tax anti-avoidance rules that apply to parents.

Clearly, any investment should be made to achieve maximum tax efficiency. The approach to take will depend on whether the grandparent wishes to keep possible personal access to the investment before the child goes to university or whether the grandparent is happy to give up access.

Grandparent keeps complete control

In cases where the grandparent wishes to keep complete control of the investment until the grandchild does indeed go to university it may be worth considering an investment in an Offshore Bond.

In these circumstances, to secure the maximum tax efficiency on the investment, the grandparents could consider investing in an offshore single premium investment bond written on a joint lives last survivor basis. Full access to and control over the bond would remain with the grandparents. The main tax benefit of the offshore bond is gross roll up on the underlying investment funds.

When the child reaches age 18, the decision could then be made as to whether the benefits of the bond should be made available to the child. If the child then goes to university, the grandparents could at that time assign sufficient segments to the child for him or her to encash and use the proceeds to meet the first year's university costs. A similar process could be adopted and used in years two and three.

The transfer of the segments from the grandparents to the grandchild would not give rise to a chargeable event and so no income tax charge will arise at that time. On subsequent encashment by the grandchild, hopefully the chargeable event gains could be absorbed (or substantially absorbed) by his or her personal income tax allowance and so be tax free. The assignment of the segments within the bond to the child would, of course, be a PET for inheritance tax purposes.

An alternative, especially if the investors envisage being able to use their annual CGT exemptions, would be to invest in collectives and encash them when the grandchild goes to university. The cash proceeds could then be gifted to the grandchild. Provided the annual exemption is available when the encashment is made, any CGT may be avoided or minimised.

Grandparent prepared to give up personal access and the use of Trusts

Provided the grandparent is prepared to give up personal access to the investments, a trust arrangement could be considered. The approach to take will probably depend on the grandparent's view on, firstly, the likelihood of the grandchild going to university and, secondly, the degree of maturity the grandchild is likely to show at that time.

In cases where the grandparent is confident the grandchild will have a mature disposition at age 18, a bare trust-based investment will offer maximum tax efficiency. Where more control is required over the investment so that there is, in effect, a 'wait and see' approach before the grandchild benefits at age 18, a discretionary trust may be more appropriate. We will now look at each of these in more detail.

Bare Trust Here, the grandparents could consider an investment into a collective investment (unit trusts or OEICs) held subject to a bare trust for the absolute benefit of the grandchild. The advantages of this structure would be:

- Income will be taxed as the grandchild's (but recovery of the tax credit on dividends will not be possible);
- Capital gains will be taxed on the grandchild so this is an ideal way of using the grandchild's annual £10,600 CGT exemption.

The grandchild could draw down on the investment from age 18 and, provided capital gains fall within the annual CGT exemption, in effect enjoy a tax-free stream of capital payments.

An alternative investment would be an offshore bond. Here, because the investment would be held subject to a bare trust, any chargeable event gains would be taxed on the grandchild. The £100 income tax rule would not apply because the settlor is the grandparent. This would mean that it may well be possible to periodically encash segments and trigger a chargeable event gain that fell within the grandchild's income tax personal allowance and so was tax free.

Discretionary Trust A discretionary trust would give control to the trustees to determine who should benefit in the future and, if the grandchildren do go to university at age 18 and are then responsible, the trustees could consider an appointment of benefits in their favour.

Trustees of discretionary trusts are charged to income tax as if they are additional rate taxpayers with them paying income tax at 42.5% on dividend income and 50% on all other income. Therefore, it would be best for trustees to invest for capital growth, for example in collectives, to use their annual CGT exemption, which is normally £5,300, or at least invest in non-income producing assets such as an offshore single premium bond.

Having made an appropriate absolute appointment of capital, all or part of the investment could be transferred into the name of a grandchild at age 18 to encash and provide for university costs.

In the case of an offshore single premium bond, this could be achieved by assigning segments in the bond from time to time. No tax charge arises on an assignment of segments by the trustees to a beneficiary. In the case of a transfer of collectives, as this would trigger a disposal for CGT purpose, the trustees would need to make a CGT holdover claim (assuming the trust was eligible to make such a claim).

Easing the burden

Children face a daunting financial future in terms of funding for the costs of a university education, house purchase and/or a wedding. Early financial planning by parents and grandparents using financial products and, where relevant, Trusts, can considerably ease the problems. The introduction of the Junior ISA should be regarded as a catalyst for financial advisers to discuss appropriate planning to meet this need with their clients.