The ABC of setting money aside for the kids

Saving for their children's schooling or a house deposit is important for many parents. The key is to start saving early and regularly, says Suncorp Life's Sarina Raffo.

Saving for the kids is a priority for many parents, whether it is for schooling, a home deposit or a financial head start, the earlier parents start saving the easier this will be.

The challenge is striking a balance between providing a helping hand and saving for their own retirement. Older parents may be approaching retirement just when their kids need financial help the most, and often while also supporting their own elderly parents. Here's a sobering fact – more than half a million Australians aged over 55 have adult children still living with them.

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The increasing costs of education, housing and funding a comfortable retirement exacerbate the problem. A university degree can cost $25,000 or more (in fees alone), a house deposit about $50,000 – substantial amounts of money to save, and this is only for one child. One of the best strategies for parents may be to get their own financial affairs in order. The dual cost of funding their own financial goals and saving for their children can be made easier by paying off the mortgage and building up their superannuation and other assets. While it can seem daunting, giving a child a financial head start is achievable. Parents have around 12 years (until high school) or 18 years (until university) on their side to start putting money aside for their kids for these life stages. This is an opportune time frame for parents to take advantage of investment in high-growth assets such as shares, managed funds or investment bonds. With the power of compounding, investing even a small amount for the children each month can add up to a significant sum. Some factors to consider when investing for children include taxation, investment ownership, legal considerations, Centrelink, estate planning, legal consideration, and savings options.

TAXATION

A critical consideration in any investment is taxation. A minor doesn't benefit from the $6000 tax-free threshold on 'unearned income' but faces tax rates of 66 per cent and 45 per cent on such income. The 'true' owner of an investment will determine the tax treatment. Where the investment earnings are derived by a minor (child under age 18), tax will generally be levied at penalty rates. After application of the low-income tax offset, minors can effectively earn $3333 in 2010/11 in unearned income before they are liable for tax. If the investment earnings are deemed to be derived by the parent/grandparent (regardless of the name on the account documentation), tax will be levied as if the investment is held directly by the parent/grandparent and taxed at their marginal tax rate (MTR).

Capital gains tax

Where an investment is held for the sole benefit of a minor for the duration of the investment and is transferred to the minor on reaching age 18, there is usually no change in beneficial ownership, and therefore no capital gains tax (CGT) implications.

By contrast, where the investment is deemed to belong to the parent/grandparent and ownership is transferred to the child after turning 18, CGT may be payable as this is considered a deemed disposal by the adult.

Taxation of shares

Purchase in a minor's name – the legal and beneficial owner of the shares is the minor:

- Up to $3333 of unearned income is tax free to the minor. No tax return is required

	Online savings accounts/term deposits	Managed funds	Insurance bonds	Education savings plans	Mortgage reduction	Direct shares	Superannuation
Suitability	Individuals with low risk tolerance	Individuals on low MTRs	MTR over 30%	MTR over 30%	Individuals with a mortgage that has an offset account attached	Individuals seeking high growth as trade-off for higher risk	Individuals that want to save for retirement
Investment time frame	Short to medium	Medium to long	Medium to long	Medium to long	Long	Medium to long	Medium to long
Allowable ownership options	Child's name, parent as trustee, or parent's name	Parent as trustee or parent's name	Parent as trustee or parent's name	Parent as trustee or parent's name	Parent's name	Parent as trustee, or parent's name	Parent's name
Tax implications	Earnings taxed at MTR	Dividends taxed at MTR with allowance for imputation credits (if any)	Earnings tax paid at 30% Tax free to investor if held for at least 10 years	Earnings tax paid at 30%. Tax free if used for educational purposes	Tax free (as no earnings)	Dividends taxed at MTR with allowance for imputation credits (if any)	Up to 15% on earnings within super fund taxed as super lump sum or pension upon withdrawal
Fees and charges	Low or nil	Management, contribution and ongoing fees	Management, contribution and ongoing fees	Management fee	May be offset account and redraw fees	Brokerage costs	Entry and management fees
Risk/return	Low	Medium to high (depending on investment selection)	Medium to high (depending on investment selection)	Low to medium depending on investment selection	None	Medium to high (depending on investment selection)	Low to medium (depending on investment selection)
Flexibility	Readily accessible	Reasonably accessible, however, benefits may only be seen over the medium tolong term	Reasonably accessible, however, earnings are taxable if withdrawals occur before 10 years	Some plans only pay out the original contributions (no earnings) if the child does not attend university or TAFE	Readily accessible	Reasonably accessible, however, benefits may only be seen over the medium to long term	Poor – access restricted until satisfaction of condition of release

(unless claiming a refund of franking credits).

- Income in excess of $3333 is taxed at the top marginal tax rate.

Purchase in a minor's name – the parent/grandparent as legal owner:

- The beneficial owner is considered to be the person who makes the investment decisions and benefits from income and capital gains. The beneficial owner includes any income in their tax return. If the benefits are genuinely held on behalf of the minor, the minor may be deemed the beneficial owner and penalty tax rates may apply on unearned income in excess of $3333.

Purchase as trustee of discretionary family trust:

- The legal owner of assets held in a trust is the trustee. Beneficial ownership of a trust depends on whether the trust is discretionary or fixed. The beneficial owner of a discretionary trust is the trustee.
- However, tax is payable by the beneficiary if income is distributed by the trustee.

Tax file number

A child can get a tax file number (TFN) at any age (there is no minimum age).

Children are not exempt from quoting a TFN. A TFN must be quoted when a savings account is opened or when shares are purchased. Where no TFN is quoted, the top marginal rate of tax is applied to any earnings.

WHOSE NAME?

Due to the high rates of tax on unearned income of a minor, it is not advisable to place large sums of money in children's names. The simpler and more clear-cut option is to invest in the parent's name. Any investment income will be taxed at their personal tax rate. Even better, invest in the name of the parent with the lowest marginal tax rate. After application of the low-income tax offset, a non-working parent can earn up to $16,000 a year in 2010/11 before paying income tax. Investing in a grandparent's name could also be a good option, particularly if they're retired. A family trust can be used to save or invest for children as the income can be distributed tax-effectively. This may only be suitable for wealthier families due to the set-up and ongoing costs.

Rule of thumb

A good rule of thumb for deciding whose name to use when saving and investing for children follows:

- Where the expected income from an investment is less than $3333, it may be preferable to hold the investment in the child's name.
- Where income and/or capital gains are expected to be significant, it may be preferable to invest in the name of a parent/grandparent.

LEGAL CONSIDERATIONS

Many investments cannot be held in a child's name for legal reasons. The general rule at common law is that minors do not have the capacity to make a contract except for the necessities of life or beneficial contracts of service such as contracts of employment.

CENTRELINK

The impact of an investment for a child on the Centrelink entitlements of the parent/grandparent is an important consideration for asset and income test-sensitive individuals. For Centrelink purposes, the investment asset may be attributed to the parent/grandparent, regardless of who pays tax on an investment. The Centrelink gifting rules may also be applied.

ESTATE PLANNING

An investment intended for a child or grandchild may end up in the hands of an unintended beneficiary under a will. Upon death of the parent/grandparent, assets held on trust for children may form part of the deceased's estate and be distributed according to the will. A solution may be the use of a discretionary family or testamentary trust with the children or grandchildren as beneficiaries. A discretionary trust has the dual benefit of asset protection and discretionary distribution of assets and income.

- Asset protection – the assets are owned by the trust and beneficiaries do not have a right to the assets or income of the trust. This means that if a beneficiary becomes bankrupt or is sued, creditors cannot access the assets or income of the trust.
- Trustee discretion – the trustee has full discretion to distribute the income and assets of the trust to the beneficiaries as it sees fit; this allows the trustee to take advantage of differing MTRs and other factors that may benefit a beneficiary.

SAVINGS OPTIONS

Let's compare some of the main savings options available. Options include:

- online savings accounts and term deposits,
- investment bonds provided by life insurance companies – the underlying investments are similar to managed funds but receive concessional tax treatment. They provide a range of investment options such as fixed interest, property and shares,
- managed funds,
- education saving plans – a single-purpose product designed to meet a child's future education costs, offered by friendly societies,
- mortgage reduction – excess savings are directed to the home loan and redrawn to pay for school fees, for example,
- direct shares, and
- superannuation.

The best option will depend on the parents' combined income, investment time frame, age of child(ren), taxation, purpose of savings and flexibility/liquidity required.

CONCLUSION

There is no right or wrong investment when it comes to saving or investing for children. Whatever option is chosen, the key is to start saving early and regularly. It's worth noting a comment once made by investment guru Warren Buffett: "I want to give my kids just enough so that they would feel that they could do anything, but not so much that they would feel like doing nothing." «

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