Unit Trust and OEIC Investments for Minor Children

We are frequently asked as to how parents and grandparents should set up an oeic or unit trust investments on behalf of their minor children or grandchildren and what are the tax implications? We consider the two normal alternatives – a designated account or a trust.

Can a minor invest in an oeic?

This is dependent on the practice of the particular provider. Many providers will not accept applications from minors (persons under the age of 18 in English law). The reason is that such contracts would be voidable by the child during minority or within a reasonable time of attaining majority. However, some providers are prepared to take this risk and will contract with minors, in some cases as young as 14. If the provider will not accept applications from minors, or if the child is below an age acceptable to the provider, then the alternative is to use either a designated account or a trust form.

What is a designated account?

A designated account is an informal arrangement for transferring a beneficial interest to someone (normally a minor) other than the registered holder of the shares. Thus, the adult (normally, but necessarily, a parent or grandparent) is the registered holder of the oeic shares and acts as nominee for the minor whole beneficial entitlement is conveyed by the designation. Once the child reaches the age of 18 a stock transfer form can be completed to register the child as the shareholder. Thus, the child becomes the legal as well as the beneficial owner of the shares.

How is a designated account created?

The application form will normally include a box for designations. It is common practice simply to enter the child's initials in this box.

What happens when the child attains the age of majority?

The shares should be re-registered in the name of the child. This will not happen automatically but once it is done the child will have the legal as well as the beneficial interest and will be able to deal directly with the provider.

What is the income tax treatment of a designated account for a minor child?

This depends on whether the source of the money is a parent or someone else such as a grandparent. If the money has come from a parent then the normal anti-avoidance rule applies. The rule is that if the income exceeds £100 per annum (gross) then it is all taxed as the parent's.

The £100 threshold is per parent per child. In practice, parents can largely avoid the risk of a tax liability by choosing low yield, growth oriented funds.

If the source of the money is a grandparent or anyone else then the £100 rule does not apply and all the income should be taxed as the child's. This is dependent on the Inland Revenue being satisfied that the beneficial interest has genuinely passed to the child. Therefore, it is vital that income is paid to or used for the benefit of the child. If income is used by the adult for his/her own benefit then it will be taxed accordingly. Children have their own personal allowance for income tax (£5,035 for 2006/2007). Of course, the 10% tax credit accompanying dividend income from oeics can no longer be reclaimed by non-taxpayers. Funds that are at least 60% invested in fixed interest securities such as gilts and corporate bonds are deemed to distribute interest rather than dividends. This means that they come with a 20% tax credit that is reclaimable by non-taxpayers.

What is the capital gains tax treatment of a designated account for a minor child?

Any capital gains will be assessed on the child irrespective of the source of the money. The only caveat is, as above, the beneficial interest must have genuinely passed to the child. Children have their own annual capital gains tax exemption (£8,800 for 2006/2007).

What is the inheritance tax treatment of a designated account for a minor child?

We understand that the Capital Taxes Office may take the view that, as a designation is not irrevocable, it does not constitute a lifetime transfer for inheritance tax purposes and so would remain in the donor's estate. If this is the case, and assuming the donor is still alive, then once the shares are transferred to the child on attaining majority a lifetime transfer for IHT occurs. This will be a potentially exempt transfer to the extent that the annual exemption is not available. If inheritance tax is an issue then the donor should consider declaring a trust rather than using a designation.

How does a declaration of trust differ from a designated account?

Many people suggest that a designated account is a form of bare trust. This is not strictly true. Both are designed to transfer the beneficial ownership of the asset but a trust form also transfers the legal ownership (to the trustees) and is a formal arrangement backed up by trust law.

What types of trust are available for use with oeics?

Any type of trust can be used i.e., bare, interest in possession, accumulation and maintenance (A&M) or discretionary. However, it is the bare trust that is most commonly considered in conjunction with oeic investments for minors and it is the bare trust that is most comparable to a designated account. Of course, there may be circumstances when a different type of trust, such as a A&M, is more appropriate.

What is the income tax treatment of a bare trust for a minor child?

It is the same as outlined above for a designated account. It is actually more clear-cut in that a trust is a more formal arrangement than a designated account and there is no doubt that the beneficial interest has been transferred.

It used to be the case that the £100 rule for parental gifts could be avoided if the income of a bare trust was accumulated until the child attains age 18. Income that was accumulated rather than being paid to or for the benefit of the child was taxed on the child and not the parent, regardless of the amount. However, this simple ploy was made ineffective by the 1999 Chancellor's Budget. For trusts created by parents on or after 9 March 1999 all income, even if accumulated, will be subject to the £100 rule. This change will also apply if the income arises from new funds added on or after 9 March 1999 to trusts in existence before this date. Income arising from bare trusts created by parents before 9 March 1999 can still be accumulated without creating a tax liability for the parents even if it is in excess of £100 per annum as long as the funds to which the income relates were not added on or after this date.

What is the capital gains tax treatment of a bare trust for a minor child?

Again the position is the same as stared for a designated account but with the lack of any doubt as to beneficial entitlement.

What is the inheritance tax treatment of a trust for a minor child?

The inheritance tax treatment is clear-cut if an oeic investment is written subject to trust. For this reason a trust is preferable to a designation if the investment is art of an inheritance tax planning exercise. To the extent that exemptions are not available, and assuming there is no gift with reservation, the fit will either be a chargeable transfer (discretionary trust only) or potentially exempt transfer (all other types of trust).

Are oeics suitable investments for trustees?

Most modern trusts give express investment powers to the trustees, but even if they d not the Trustee Act 2000 will normally enable trustees to make any investment of their choice, subject to taking investment advice. (However if the trust specifically excludes any type of investment, that exclusion must be respected.)

There is some confusion because registrars will not normally enter trust details on the register. The shares will normally be registered in the individual name(s) of the trustee(s) but not noted as "trustee(s) of the XYZ settlement". The oeic provider does not need to concern itself with details of the trust and can simply act on the instructions of the registered holder(s) of the shares.

This Briefing Note represents Williams Farrall Woodward's understanding of the law of England and Wales (unless provisions relating to other countries are expressly stated) and Inland Revenue practice in April 2006. Whilst every effort has been made to ensure that the content of this bulletin is correct, it does not constitute legal advice and Williams Farrall Woodward cannot accept any legal responsibility for it.

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E & O excepted.