Children's taxes

The politicians say "we" can't afford a tax cut. Maybe we can't afford the politicians.

— Steve Forbes

The best investment of all is teaching your children how to save, but difficulties arise when you try to put a strategy in place. This is because children's "unearned income" is taxed at special rates.

The rules apply to unmarried people under 18 years of age and provide for "children's tax" of up to 45% on the "unearned income" of a person under 18. The first $416 is exempt and then a rate of 66% applies on the next $891. This takes us to a level of $1,307 where the 45% rate cuts in. Above $1,307, this 45% rate is levied on the total income — even the first $416. If you calculate the tax on $891 at 66% you will see that it comes to $588, which is precisely 45% of $1,307. Thus, the aim of the shading-in provisions between $416 and $1,307 is to achieve a maximum overall rate of 45% — the same as the top marginal rate paid by adult taxpayers.

The rules apply only to ***unearned*** income (which includes interest on gifts given to the child). Any income earned by a child from personal exertion, such as work-

ing in a shop or delivering newspapers, is taxed at normal adult rates. Any interest or dividends that are received on money thus earned by the child will also be assessed under the normal rules. As a result, the child could earn money (including interest on "earned savings") of up to $23,226 a year in this way and pay no tax, provided they took advantage of the low tax offset.

There are a few other areas where the income from the earnings is exempt from children's tax. These include legacies, genuine wins in lotteries, or where special funds have been set up under divorce settlements.

The position is further complicated because most fund managers refuse to accept direct applications from minors because of possible legal ramifications.

Given that leaving the money in the bank is a disincentive to a child, and nobody else will take it, this leaves the parent with three choices: invest as trustee for the child, invest in a parent's name, or invest in insurance bonds that need not create an annual taxable income for the parent or the child. Let's look at each one individually.

Investing by the parent as trustee

This does not get you around the punitive children's tax rates because the trustee will be assessed at 66% and there is a major difficulty: the parent must at all times act as a bona fide trustee and not intermingle trust money with their own.

Investing directly by the parent

In some cases a better strategy could be to invest in the name of the lowest earning parent. Provided the parent earns less than $90,000 a year, the maximum tax rate is 32.5% and all income that is derived from franked dividends is nearly tax-free because of the imputation credits. The only disadvantage is that CGT will apply if the parent transfers the asset to the child at a later date. Also, the extra income in the parent's name could affect family tax payments.

Investing in insurance bonds

These are the ideal investment when both parents are higher income earners, as the bond fund itself pays tax at no more than 30%. A further benefit is that the bonds can be cashed in tax-free after 10 years. Once the child reaches the age of 18, the bond may be transferred and there will be no CGT payable. Any tax liability that has accrued within the bond will be borne by the child, who can cash the bond immediately or continue to defer the income indefinitely.

Complicated? A little. But if you have children, take the time to understand how it works. There is no time like the

present to invest on your child's behalf. Also, getting your child involved in the process will bring you both a great deal of pleasure — as well as financial rewards.

$ MONEY CLIPS

- *If you have money to set aside for your children, talk to your accountant and avoid tax penalties.*
- *The use of the right structure is vital. Often the money is best held in the name of the lowest earning parent.*
- *Income on money held for children can be minimised by investing it in shares or managed funds that aim for high growth and low income or by investing in friendly society bonds or insurance bonds. If still in doubt consult your accountant or financial adviser.*