Can a Child have a pension?

Many people are unaware that children can have a pension. Long-term investments, such as pensions, can help to create a healthy income stream for a child later in life. Here we investigate some of the things you might not know about children's pensions.

1. Children are eligible for pensions

To most people, pensions are a bit of a mystery and when it comes to children many don't appreciate the rules, that as soon as a child is born in the UK they are eligible for a pension. It's probably not the first consideration when you first have a baby, but if you can step back for a few moments at this time to think of their long term future, then any money, however little, invested will have decades to grow, as currently it cannot usually be withdrawn until age 55 (57 from 2028, and likely to rise further in the future).

The great advantage of even small amounts invested in a pension is the tax relief on contributions. Most children will receive 20% tax relief on payments into their pension up to £3,600 gross. In other words, if you pay in £2,880 (net) the taxman will automatically top it up by £720 to make £3,600, and even better, investments in a pension are free from UK income and capital gains tax, which means any growth or income (in the form of dividends, for instance) is free of UK tax. This is of course based upon how the current rules stand now and they may change and the benefits will depend on personal circumstances.

2. Anyone can contribute and these payments will not count towards your own pension allowances

Any relative, grandparent and family friend may want to gift money to a child. But at the same time, they may also want to make sure the money is put to good use. Only a parent or legal guardian can open a child's pension, but once that's done anybody can pay money into it.

There's also no impact on the donors own pension allowances as 'technically' the money belongs to the child, allowing you to continue paying into your own personal pension(s) up to your own limits.

3. Pension donations could reduce future inheritance tax

Donations paid into a child's pension is often covered by one of the Inheritance Tax (IHT) exemptions, such as the annual exemption or 'gifts out of income'. This means it might be exempt immediately should the donor pass away. If, for whatever reason, the money isn't covered by one of these exemptions, it might still be exempt from IHT, as a Potentially Exempt Transfer (PET), provided the donor survives seven years from making the gift.

With this in mind, children's pensions might be very attractive to parents and, particularly, grandparents who are keen to pass on their wealth but don't want the benefactor to be landed with a large IHT bill.

4. What type of child pensions are available?

There are many options available and the choice generally comes down to how much input you want to have into how your child's money is invested, you might opt for a stakeholder account. Stakeholder pensions, whether held by an adult or a child, are subject to Government minimum requirements on charges and investment amounts. However, they can be more limited in terms of the investments available.

If you think you would like more control and flexibility, then a child can also have a Self Invested Personal Pension (SIPP). The parent or legal guardian who opens the account is free to choose the investments, they could opt for a ready-made investment portfolio if, for instance, they need a bit of help getting started, or they could start their own portfolio of investments. The important thing about these accounts is that if you're not happy with the performance of your child's investments, then you have a wide choice of alternatives, which may not be the case in a stakeholder account.

5. The compounding effect of pensions

Compound growth is at the core of investing and is possibly one of the most powerful geometric progression ratios known to man, providing a constant rate of growth over the 'period'.

With the investment horizon many decades away, children's pensions are well-placed to make the most of this phenomenon. In fact, the earlier you start the more powerful compounding can be. By paying in just £300 (gross) each month up to a child's 18th birthday, their pension pot could be worth over £500,000 as they approach retirement. But remember, there are no guarantees, and there is a risk your child will get back less than was invested. Inflation will also erode values over time. Remember this is just an illustration rather than a projection of what a pension could be worth.

You can transfer a child's pension

If you have invested in a pension for your child already, you don't have to stick to that provider. It's important to regularly check they are meeting your needs as a client and the investments are on track to achieve your objectives.

It is worth knowing that some pensions can come with exit fees should you decide to transfer, so it's vital you check the terms of your child's account before you go ahead. You should also check they won't lose valuable benefits or guarantees. Pensions are also usually transferred as cash, meaning your child's investments will be sold prior to the transfer. This means they will be outside of the market while the transfer takes place and they could miss out on any market place growth while cash is held.

Another good point regarding transfers is that on transferring a pension it doesn't count as a contribution and so won't affect your child's remaining annual allowance for this tax year.

The sooner you start the better

Once you've decided which sort of pension (e.g. a stakeholder pension or a more flexible personal pension) you'd prefer, it's pretty easy to open an account for a child.

A child's contribution allowance 'resets' every tax year. So if you're planning to use this year's allowance, it must be received by 5 April 2017, leave it any later and they will lose this year's allowance.

Investing just £25 per month is only £300 per year and it could very well be the greatest gift you can give a child in their entire lifetime. The sooner you start a child pension the bigger the final pot will be when they reach retirement.