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Investing for children

Investing for children can be complex and a range of issues, such as access and taxation, need to be considered.

Background

Parents and grandparents may wish to set aside savings for their children or grandchildren for various reasons, such as education or a deposit for a home.

When putting away money for a child, people can invest directly in the child’s name (where possible) or on behalf of the child using managed funds or other options where the investment is held in the adult’s name ‘as trustee for’ the child. This usually results in the creation of an informal trust arrangement.

When deciding on appropriate ways to invest for a minor, consider:

- the purpose of the investment and the investment time horizon
- the acceptable level of investment risk
- ongoing taxation of any income derived, including any future capital gains tax
- when access to the money is intended
- the desired level of ongoing control over the money and the need to ‘protect’ the funds, and
- the client’s investment knowledge and experience.

Many of the above issues also determine who actually owns the money or investment.

This article outlines the taxation and other factors to consider when reviewing or making investments for a minor (ie an individual under age 18). We also consider the pros and cons of a range of investment options. This article only considers the potential tax implications for minors who receive unearned income and no other income sources.

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Taxation of income of minors

When investing for a child, there are several factors which determine whether the income is taxed in the hands of the minor, the adult investing on the child’s behalf or the trustee of a trust of which the minor is a beneficiary. Where the income is assessed as being derived by the child, the rate of tax payable by a minor depends on:

- the source of the income, and
- personal circumstances of the minor, including employment status and whether the person has a specified disability.

Generally, income earned by a minor is taxed at special minor rates which are higher than adult rates, except in special circumstances where income earned is ‘excepted income’ or the minor is an ‘excepted person’. These exceptions are explained below.

Unearned income

The higher tax rates apply to unearned income, which is passively derived income (ie not derived from the individual's personal exertion), such as:

- interest
- dividends
- rent
- distributions from managed funds, and
- distributions from discretionary trusts.

Minors are not eligible to claim the low income tax offset (LITO) on unearned income. This means the maximum amount of unearned income a child can receive tax-free is \$416 pa.

The table below summarises the tax treatment of unearned income received by minors.

Income	Tax on unearned income received by minors ¹
\$0 – \$416	Nil
\$417 – \$1,307	66% on income exceeding \$416
Over \$1,307	45% on entire 'eligible taxable income'

Different tax rates apply to the unearned income of a **minor who is a foreign tax resident**, refer to the ATO. The higher tax rates are intended to discourage adults from diverting income to a minor's account to avoid paying tax on earnings.

Excepted income

Excepted income is exempt from the higher minor rate of tax and is taxed at ordinary adult rates. This income is also eligible to receive the LITO. Excepted income may include:

- employment income or income from their own business
- compensation, superannuation lump sums or income streams
- income from a testamentary trust (or from a trust resulting from an intestacy). Since 1 July 2019, income from a testamentary trust is not excepted income if it is generated from assets acquired by or transferred to the trustee of the trust on or after that date, and the assets were unrelated to property (eg assets and money) of the deceased estate
- income from a deceased estate to which the minor is presently entitled or from the investment of property that is inherited from a deceased estate
- income from the investment of property transferred to a minor (or from the investment of property transferred to a trust² for the benefit of a minor):
 - arising from damages for personal injury or loss or parental support
 - arising from worker's compensation or compensation for personal injuries
 - directly under the terms of a life insurance policy
 - directly because of death of another person from a superannuation fund
 - directly from an employer because of the death of a person
 - as a result of family breakdown (see 'Child maintenance trusts')
 - from another person out of property inherited by that person from a deceased estate, within 3 years after the date of death (to the extent that the minor would have inherited that property if the person died intestate)
- taxable pensions or payments from Centrelink or the Department of Veterans' Affairs
- income or capital gains resulting from investments originating from any of the amounts above.

¹ Tax rates exclude Medicare Levy. Medicare levy applies when income is above standard income threshold applicable to all individuals.

² Income from the trust is excepted income (i.e. taxed at adult rates) only if the minor acquires the trust property when the trust ends.

Excepted person

Where a minor is an excepted person, all their income is taxed at adult rates, regardless of the source³. This may occur if the minor:

- works full-time, or
- has a disability and certain requirements are satisfied.

The ATO provide further guidance about [excepted persons](#). A person is considered a minor if under age 18 at 30 June of the financial year.

If the minor is not an excepted person, only excepted income is taxed at adult rates. If the minor is neither an excepted person nor has excepted income, all income derived and assessed to the minor is taxed at minor rates.

Considerations when deciding which taxpayer should incur the tax liability

Advisers frequently ask whether investment should be held in an adult's name or the name of the child.

- If a child earns more than \$416 in unearned income, they may pay penalty rates of tax. Furthermore, the ATO may consider that the assessable income belongs to the parent (see next section "Cash-based accounts")
- If a low income spouse owns the income, it is assessed at their marginal tax rates. The tax-free threshold may allow some or all investment income (including a refund of franking credits) to be received without paying tax.

Investment alternatives

Cash-based accounts

Cash-based accounts include child savings accounts, regular bank accounts, internet savings accounts and term deposits. An account can be opened in the name of an adult (ie parent), where interest earned is included in assessable income of the adult and taxed at the adult's marginal rate.

Alternatively, with most financial institutions, the account can be opened by an adult 'as trustee for' a child (where an informal trust arrangement would arise), or in the child's name only. Child tax rates may apply in these cases.

The advantages of cash-based accounts are:

- secure capital with low investment risk
- low minimum investment requirements, and
- low or nil fees (except when term deposits are cashed out before the end of the term).

The main disadvantage of cash accounts is they provide no long-term capital growth or hedge against inflation.

Taxation of bank account interest

Taxation Determination [TD 2017/11](#) explains the ATO's view on the assessment of certain investment income earned on bank accounts for tax purposes. Based on this determination, income generated from investments is assessable income to the person/s who has beneficial ownership of the funds invested and interest earned.

What is beneficial ownership?

TD 2017/11 states that beneficial ownership is determined by considering who:

- contributed to the account
- drew upon the funds in the account, and
- uses the funds as their own property.

In situations where the child is the beneficial owner of the account, any income is taxed in the hands of the child. This may result in the child needing to lodge a tax return even for small amounts of income.

³ ITAA 1936 s102AC

Example 1: child does not have beneficial ownership of bank account

Malcolm (aged 8) has a bank account in his name. This account was opened by Malcolm's mother who deposited \$10,000 of her own money and she is the signatory to the account. She makes regular deposits and withdrawals to pay for Malcolm's school fees.

As Malcolm's mother use this account as if it belongs to her, she is deemed to be the beneficial owner. According to TD 2017/11, assessable income from this bank account forms part of the mother's income and taxed at her marginal tax rate.

Example 2: child has beneficial ownership of bank account while a parent operates as trustee

Oliver is aged 10 and his mother puts aside money gifted to him for birthdays over the past few years. This now totals \$5,000. Oliver's mother deposits the money into a bank account in his name and operates this account on his behalf as a trustee. She does not make withdrawals from this account.

In the ATO's view, Oliver has beneficial ownership of the money because his mother operates only as trustee and maintains the funds as Oliver's. Therefore, income generated from this bank account is unearned income for Oliver. As Oliver is under age 18 years, the interest earned on this account is taxed in his name, at the higher rates of tax payable by minors.

Direct Australian shares

Another option is to invest directly in Australian shares, which can be in the name of an:

- adult, where the dividends are taxed at the adult's marginal rate, or
- adult 'as trustee for' the child, where an informal trust arrangement would normally arise and child tax rates may apply.

The advantages of investing in Australian shares directly include:

- higher long-term growth potential than cash-based accounts
- potentially tax-effective income if the company pays franked dividends as excess franking credits are refundable. If the tax liability is levied on the child, the child can utilise franking credits to offset any tax liability or receive a refund, and
- more control over taxation events than managed funds and other professionally run investments.

The disadvantages include:

- limited diversification if the investment amount is small
- a higher level of investment risk than cash-based accounts, and
- a higher level of investment monitoring may be required than managed funds and other professionally managed investment options.

Children usually cannot buy shares in their own name. The ATO has provided guidance and the [view of tax implications](#) when buying direct Australian shares on behalf of a minor. The three examples below are sourced from the ATO website which explains the different tax assessment based on individual circumstances.

Example 3: taxed in adult's hands

Peter withdraws \$3,000 from his own bank account to buy shares in the name of his daughter Georgia. He deposits the dividend of \$200 into his own bank account and uses it for his own personal expenses. Peter declares the \$200 on his tax return. When he sells the shares, he will also declare any capital gain or loss.

Example 4: taxed in child's hands

Simon withdraws \$5,000 from his bank account to buy shares in the name of his son Jordan. He quotes Jordan's TFN when he buys the shares. Simon makes all the decisions about those shares as Jordan is only three years old. All dividend income and any profit from the sale of those shares are deposited into a bank account in Jordan's name with Simon as trustee. The dividends and capital gains are declared on Jordan's tax return.

Example 5: taxed in child's hands

Jenny buys shares on behalf of her daughter, Talia, with money saved from Talia's part-time job, plus money received for Talia's birthday. Talia and Jenny decide not to quote Talia's TFN. Dividends of 300 are deposited in Talia's bank account. Talia declares the \$300 on her tax return. When those shares are sold, any capital gain or loss from the sale will belong to Talia.

In the above ATO examples, the tax implications appear similar to the guidance provided in TD 2017/11 where the beneficial owner needs to be identified.

Managed funds

Managed funds are an alternative to directly held investments, such as cash-based accounts and listed shares. However, for contractual reasons, a minor cannot invest in a managed fund in their own name. An adult must open the account, which can be done by owning the investment:

- in their own name outright, where earnings are taxable at their marginal rate (and CGT payable upon transfer to the child), or
- 'as trustee for' the child, where an informal trust arrangement would normally arise and child tax rates may apply.

Key advantages of managed funds include:

- higher long-term growth potential than cash-based investments
- professional investment management
- diversification across and within asset classes and across investment managers
- tax-effective dividend income if invested in Australian shares, and
- relatively low minimum investments required.

The main disadvantages of managed funds are generally:

- higher level of investment risk than cash-based accounts, depending on investment option chosen, and
- less investment control and control of taxation events, when compared to directly held investments.

Investment bonds

Investment bonds have similar advantages and disadvantages to managed funds. The key differences are that:

- the bond is purchased in the adult's name
- there is no access to the 50% discount on capital gains, as taxed in hands of life company
- earnings are taxed in the bond up to a maximum of 30%
- additional tax may be payable if withdrawals are made from the bond prior to the 10-year anniversary⁴, and
- no additional tax is payable if the bond is held for 10 years or more⁵.

Some policies allow the ownership to pass over to the child (as the life insured) at a given age, generally between 10 and 25. These are sometimes called 'Child Advancement Policies'. Once ownership has been transferred, the child has complete control (ie can retain or redeem the bond). Until the nominated age is reached, the trustee retains control.

From a social security perspective, if the insurance bond is own directly (ie not via a company or trust), the amount is a financial investment. The account balance is an assessable asset and deemed under the income test. However, deprivation (ie gifting) may be triggered when the policy transfers at vesting age. The amount gifted is based on the value at the vesting age.

If the life insured dies, in this case the child, the proceeds from the investment bond are received by the policy owner without any additional tax. See ['Investment bonds – a super alternative'](#) for more information on the taxation of Investment bonds.

⁴ This would be regardless of whether a partial or full withdrawal is made and it would not matter if the '125% rule' had not been breached since commencement.

⁵ Where the '125% rule' is breached, the 10-year period resets to start of the year in which the excess contributions are made.

Scholarship (education) bonds

A scholarship bond is a life insurance policy provided by a friendly society for the sole purpose of providing benefits to help the education of nominated students. These bonds vary greatly for each product provider, so it is important to understand the features of each bond and identify the tax, social security and estate planning implications. Like investment bonds, income is taxed to the provider up to a maximum of 30%.

Where a withdrawal is used to reimburse the child's education expenses, the 30% tax paid by the friendly society on the income component is 'reversed.' The income component of the withdrawal is grossed up representing the reversion of this tax. Therefore, for every \$70 of income withdrawn, \$30 is added representing the tax paid by the friendly society and the total income received is \$100.

The income component of the withdrawal and the tax benefit are included in the nominated student's assessable income in the year it is paid. Tax rates that apply to the income depend on:

- whether the student is an adult, or
- if the student is a minor, whether the income is excepted income, or the minor is an excepted person.

Education expenses may include uniforms, travel costs, fees, materials, living away from home allowances and certain residential boarding expenses.

Where the withdrawal does not reimburse educational expenses, the withdrawal is taxed like an investment bond – there is no reversion of the tax paid by the friendly society.

For social security purposes, where the investment is personally owned, it is assessed for the asset test and deemed under the income test. Unless the owner is the custodial parent of the student, any amounts paid for the student is regarded as a gift and may trigger deprivation.

Alternative strategies

Superannuation

In some circumstances, superannuation may be a valid savings option for children depending on their needs and objectives. The main advantage associated with this strategy is earnings are taxed at a maximum rate of 15%.

Contributions made by parents or the child are generally non-concessional contributions (NCCs) and limited by the NCC cap. If the child wishes to claim tax deductions on contributions made, they must have derived income from employment or carrying on a business. In relation to a self-managed superannuation fund, a minor cannot act as a trustee (or director of a corporate trustee), however a parent or guardian can fulfil this role.

There is no minimum age for a person to be eligible for the government co-contribution. However, to qualify for the co-contribution, individuals must derive at least 10% of their total income from employment, self-employment or a combination of both. The child must contribute the amount themselves as contributions from third parties (including parents) do not qualify for co-contribution.

The first home super saver scheme (FHSSS) allows eligible individuals to save for their first home using voluntary contributions to super. Eligible contributions must be made by the child themselves as amounts contributed from third parties (including parents) are not eligible. Although the child must be aged at least 18 to release amounts under the scheme, eligible contributions can be made before age 18.

The main disadvantage of super is the risk of legislative changes and that capital cannot be accessed until a condition of release is met. This means that for other purposes (such as funding education) super is not an appropriate investment vehicle.

Additional mortgage repayments

Rather than using a standalone cash account to invest for a child, a client can make additional mortgage repayments and redraw the money when required, if the facility is available. Alternatively, they could deposit the money in an offset account attached to their mortgage.

Both these methods generate interest savings and may enable the home loan to be paid off earlier while still providing access to those funds for the child or other expenses. When compared to other investment options available, the advantages include:

- a risk-free and tax-free investment return equivalent to the home loan interest rate, and
- low or nil fees are payable, although some lenders do charge a fee for redraws.

The disadvantages include:

- there is no account balance to keep track of, unless a separate offset account is established for this purpose
- unlike other options, the return is not credited to the account but is in the form of interest savings
- a redraw facility or offset account needs to be established if one does not already exist, and
- more discipline is usually required to ensure the money is not accessed for other purposes.

Other taxation issues

Common issues raised when an asset is held in trust relate to tax implications including:

- Is the child or adult's TFN quoted?
- Are there any CGT implications?
- When may a tax return need to be lodged for the child?

Tax File Numbers

No TFN withholding tax is withheld if a tax file number (TFN) is quoted on an investment. Depending on the ownership structure, the table below shows whose TFN should be quoted:

Owner is:	TFN to quote
Child	Child
Person as trustee (informal trust)	Child or trustee
Formal trust structure ⁶	Trust

There is no age restriction to obtain a TFN.

Where there is an informal trust arrangement and the trustee's TFN is quoted, this can create a data mismatch for information received by the ATO. The TFN is the trustee's, however, the income is declared in the child's tax return.

If the ATO questions the trustee of an informal trust arrangement, it is usually a matter of explaining the situation. This is easily supported where the income has been declared in the child's tax return and ensuring the ownership title is correctly established (ie 'as trustee for').

Under formal trust arrangements, the trustee of the trust must withhold tax for any beneficiary who is under a legal disability (which includes a minor). The trustee is taxed as if the income is taxed in the hands of the child. Any tax withheld is remitted to the ATO.

Capital Gains Tax

Generally, a CGT event occurs when there is a change in beneficial ownership.

Whoever rightfully owns and controls the investment declares the investment returns (income, net capital gain or loss). For example, if the money used to purchase the investment was provided by another person, and that person makes all investment decisions and uses the investment's income like it was their own, that person (not the child) is the beneficial owner. All income including capital gains from the investment is assessed to that person.

⁶ A formal trust is a trust which has a written trust deed. For example, a testamentary trust is a formal trust. The Will is the trust deed. The trustee generally pays tax on behalf of the minor.

Under this arrangement, if ownership is transferred to the child and the trustee has been declaring the income received from the investment in their tax return, the transfer of ownership results in a change of beneficial ownership. Any capital gain on the transfer of the investment to the child is assessable to the trustee. Although no consideration is received, it is deemed to be disposed at the market value on the date of transfer.

Where the beneficial owner is the child

If an investment is genuinely held in trust for a child (even if via an informal trust arrangement) then the child is the beneficial owner and any income is taxed in the hands of the child (which may be at minor rates). If the asset is sold prior to being transferred to the child, a capital gain may be realised. The beneficial owner (ie the child) is assessed with the capital gain.

If legal ownership is transferred to the child, the beneficial ownership is unchanged and a capital gains tax (CGT) event is not triggered. The cost base is the original cost base. When the child subsequently sells the investment, a capital gain or loss is realised and the normal CGT rules apply.

If the trustee dies, their legal personal representative (generally the executor of their estate) becomes trustee unless someone else is specified in the deceased trustee's Will. There is no CGT consequence when the investment passes to a new trustee as the beneficial ownership is unchanged.

Lodging tax returns

A tax return must be lodged for a minor once income (excluding salary and wages) exceeds \$416 for the financial year. This is a requirement where the person is under 18 on 30 June of the financial year.

A tax return may also be lodged if:

- too much Pay-As-You-Go (PAYG) tax was withheld
- a refund of franking credits is claimed (alternatively an 'Application for refund of franking credit' may be lodged if no tax return is required to be lodged).

Liability for PAYG instalments

Minors may also be liable to pay PAYG instalments. Tax instalments under the PAYG system are generally paid quarterly however some taxpayers may have a different payment frequency. The ATO determines when PAYG instalments are required to be paid and the amount based on past tax returns.

Child maintenance trusts

Clients who separate and have a legal obligation to maintain a minor (eg because of a court order or child support assessment) may transfer assets to a trust for the benefit of a minor. This is known as a 'child maintenance trust'. Income distributions received by the minor are excepted income and taxed to the minor at adult marginal tax rates. However, specific tax advice should be obtained by a client considering a child maintenance trust, to ensure the trust income is taxed at ordinary (adult) personal income tax rates.

Social security implications

If a parent or grandparent receives social security support, they should consider the impact of being trustee for a child's investment on their own benefits. This includes bank accounts or other investments created by a parent/grandparent for children under age 18.

If a trust is administered for the exclusive benefit of a child, the assessment of trust income and assets largely depends on the source of the funds. If the parent/grandparent (or their associate):

- controls the trust, the assets and/or income, and
- is the source of the majority of the assets and/or income of the trust

then the income and assets of the trust would generally be attributed to the parent/grandparent.

In the absence of a source, where assets were transferred to a fixed or discretionary trust for the exclusive benefit of a person unable to manage their own financial affairs, the trust income and assets are generally attributed to the primary beneficiary of the trust.

Clients should contact their local Centrelink office before becoming trustee in case the ownership of the investment affects their entitlements.

Implications for child

If a financial investment is held in the child's name, the assessable asset is deemed for recipients of Youth Allowance. For Youth Allowance and Family Tax Benefits, the income derived by a child is used to determine if the child is a dependant.

If the investment is held in trust for the child and the child is attributed with the trust's income and assets the trust income is generally assessed on an annual basis from the income tax return. If the income and assets of a trust are not attributed to the child, only the trust income received by the child is assessed by Centrelink. Income amounts are attributed for 12 months from the date of resolution.

In all cases, social security recipients should ensure notification of changes in circumstances, including receipt of trust income is reported to Centrelink within 14 days.

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