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Step-by-step guide to Junior ISAs

With house prices and university fees increasing, it is important children have a savings pot for the future. Recently introduced, the Junior ISA represents a straightforward way to save towards your child's education costs, first car or house deposit. The JISA has overcome many of the tax and legal problems hitherto investing for children.

What is a JISA?

The JISA offers parents a tax-free way of saving for their child. You can only hold one cash and one investment JISA at a time, but it's possible to invest in a range of assets from cash to bonds and shares within these accounts. The tax benefits work exactly the same way as for adult ISAs.

So interest on cash JISAs is tax-free; similarly, you won't pay tax on income paid out by investments in your JISA (although dividends on shares are stilltaxed within investment funds held in it), nor capital gains tax on the sale of investments within it.

How much can I invest?

You can deposit up to £3,600 each year into a JISA. Unlike adult ISAs, there are no rules on how the allowance can be split between cash and investments. The allowance will increase with inflation each year from 5 April 2013.

To give you some idea of the growth potential of JISAs, investing the full allowance (£3,600) every year for 18 years with 5% return would accumulate to a tax free payout of £105,000.

A more modest contribution of £30 a month, assuming the same return, would grow to £10,600 over 18 years.

The JISA is a long-term savings plan and therefore investing in stocks and shares is likely to provide a better return that cash over 18 years. But as with all investments, you have to be aware that it can as well as fall.

Is my child eligible?

JISAs are only available to those who did not qualify for a Child Trust Fund. Specifically children born on or after the 3rd January 2011 and children born before 1st September 2002 are eligible for a Junior Isa. For those born between January and the launch of the JISA there will be an additional backdated balance.

Applications can only be made by a person who has parental responsibility for the child. Management of the account will pass to the child when they turn 16, but they can't access the funds until their 18th birthday when the Junior ISA will roll over into an adult ISA by default. This allows them to take a large 'tax-exempt' pot into adulthood – a valuable benefit.

Where a child is aged over 16 or over the child can open the account themselves if they so choose.

What are the tax benefits

All returns within a Junior ISA are tax efficient for the child/parent/donor.

Income tax – no addicitonal tax to pay other than the standard 10% deducted at source on all dividends.

Capital gains tax – none.

Inheritance tax – none, provided investments are made from disposable income of the donor and are therefore the child's for tax purposes.

Having said this not every child will benefit from tax breaks, because most children's investments don't make enough to be taxed at all. Children have the same tax-free personal allowance as adults (£7,475 in 2011/12), which very few exceed.

What are the disadvantages?

At present, any child with a CTF cannot hold a JISA and it's impossible to transfer funds from a CTF into a JISA.

The fact that the child has automatic access to the money at age 18 may make some people anxious, as there is nothing to stop the child withdrawing and squandering the lot. One alternative is to use your own ISA allowance to save for your child. That way the money remains under your control until you decide to hand it over. But this means you have to eat into your own ISA allowance for the year.