Roth IRAs For Children

Would you like to set your child/grandchild up nicely for retirement?
Consider an underutilized tax strategy for children, contributing to a Roth IRA.

Eligibility Rules

Your child/grandchild must have earned income in order to be eligible to open a Roth IRA, so you can encourage them to take on a part-time or summer job. A job will give them some extra spending money or savings for college. You will then have the ability to open a Roth IRA custodial account in their name. Control of the Roth IRA is transferred to them once they become an adult.

Contribution Limits

You may contribute as much as your child/grandchild earned during that tax year, up to the annual Roth IRA limit of $7,000 (tax year 2024). Your contributions toward their Roth IRA are considered a gift and would count against your limit on tax-free gifts you can make to one individual, which is currently $18,000.

Why a Roth IRA?

Setting up a Roth IRA for a 16-year-old gives them many years for their money to grow tax free. Although it is best to take advantage of the compounding and earmark their account for retirement, a Roth IRA also offers some additional flexibility. Since withdrawals are considered to come first from contributions, no tax (or 10% penalty) applies until the total withdrawals exceed the total contributions. Other qualified withdrawals include the first-time homebuyer exception (up to $10,000) and towards postsecondary educational expenses (pay tax on earnings, but no 10% penalty). Distributions after age $59^{1/2}$ are nontaxable.

Importance of contributing to a Roth IRA early

A valuable lesson you can teach your child/grandchild is the importance of saving and investing at a young age. Compounding interest is a necessary mechanism of wealth accumulation. For example, a one-time $7,000 contribution to their Roth IRA when they are 16 will grow to about $200,000 (assuming a 7% annual return) by the time they are 65. Hopefully your generosity will inspire them to max out their Roth IRA contributions every year. If they do, they will have a nice little nest egg to withdraw from tax free.