STARTING A ROTH IRA FOR A TEEN

This early financial decision could prove helpful over time

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Want to give your child or grandchild a great financial start? A Roth IRA might be a choice to consider. There are many reasons why starting a Roth IRA for a teenager may be a sound financial strategy. Read on to learn more about how doing this may benefit both of you.

WHO IS ELIGIBLE?

Any child aged 17 and younger can contribute to a Roth IRA if they earn income.

Earned income can include money from a W-2 job or self-employment gigs, like babysitting, dog walking, and yard work. While a self-employed child may receive a Form 1099, it's more often that they don't. The lack of this form won't preclude them from investing in a Roth IRA. The minor (or their parent or guardian) will need to keep records or receipts that detail the type of work they did, when it was done and for whom, and the amount received.

TAX-FREE BENEFITS DURING RETIREMENT

Setting up a Roth IRA for the teenager in your life could prime them to have more retirement savings. Plus, a Roth IRA has the potential to accumulate over the years, and the owner may be able to manage their tax burden better if they withdraw the money after age 59½. For example, a 19-year-old who contributes $5,000 a year to a Roth IRA, which earns 8% for 40 years, would be positioned to have about $1.4 million by age 59. Of course, this is a hypothetical example used only for illustrative purposes. It is not representative of any specific investment or combination of investments. Actual results will fluctuate.

GREATER EARNING POTENTIAL, THANKS TO THE MAGIC OF COMPOUND INTEREST

Setting up a Roth IRA for a teenager is a great way to introduce them to basic financial concepts, such as compound interest. Giving your teen a hands-on learning experience may help them understand the value of saving for the future. You might also be facilitating your child or grandchild to develop lifelong financial habits.

LOOKING AHEAD TO THE FUTURE

If money is withdrawn before age 59½, a penalty may be assessed. This is typically a 10% IRS penalty, but in some circumstances, it can be more. There is, however, a notable exception. Up to $10,000 of earnings can be taken out of a Roth IRA at any time if the money is used to buy a first home. In this particular case, the IRS waives the early withdrawal penalty. Should your teenager become a parent someday, a portion of those Roth IRA assets might also be utilized to pay for their child's college tuition costs. There are other exceptions to the withdrawal rules, so it is best to consult with a tax professional or wealth advisor about available options.

TEACHING THE LESSON OF SAVING AND COMPOUND INTEREST

This is a great way to teach the next generations of your family the value of saving early in life and the magic of compound interest on the growth of their accounts. It is easy to illustrate how saving a certain amount of money each year at various rates of interest will grow to a large sum later in life. These basic financial concepts are rarely taught in school and are so valuable for you to teach your kids and grandkids.

RULES FOR GIFTING A ROTH IRA

Setting up a Roth IRA for a teen means you can gift them some of the funds to get it started, provided your teen earns income. So, if your 15-year-old has earned $7,000 at a summer job, you can gift them up to $7,000 (the maximum annual contribution) to invest in a Roth IRA. However, the amount gifted or contributed cannot exceed the teen's income, and the annual contribution limits to a Roth IRA still apply. What's more, you may also realize a tax perk. If you make the initial contribution to the Roth IRA as a parent or grandparent, that money can count as a gift within your $18,000 yearly gift tax exclusion ($36,000 for a married couple).

THERE ARE A FEW THINGS TO CONSIDER WHEN SETTING UP A CUSTODIAL ROTH IRA.

Setting up a Roth IRA for a minor is often referred to as a custodial Roth IRA. Until the child is able to take it over, you act as the custodian of the account. Individual state laws determine when the minor child is able to take over management of the Roth IRA for themselves. It's important to consult with a tax professional to ensure that you and your minor child are following all federal and state regulations.

Setting up a Roth IRA for a teen has many benefits for both the account owner and the beneficiary. As with any complex financial situation, working with a trusted wealth advisor will help determine if this option is a good fit for your long-term financial plan.

Do you have a wealth planning topic you want to learn more about? Email us at wagner@wwmadvisors.com, and you may see your questions answered here.

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