How a custodial IRA can help your child with future retirement savings

Give your child a leg up on their future by opening a Roth IRA for them as soon as they start earning income.

KEY INSIGHTS

- An adult can open a custodial Roth IRA for minors who have earned income (without any age requirement), and that adult can contribute the amount of money the child earned for that year up to the IRA contribution limit ($7,000 for 2024).
- Opening a Roth IRA for a child can allow for decades of compounded growth, enabling the account to grow substantially until retirement.
- Once the IRA is open, all assets are managed by a parent/guardian until the child reaches age 18 (or 21 in some states).
- Unlike Traditional IRAs, Roth IRAs can also be used for college expenses or for the purchase of a first home.

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A friend recently recounted to me that as a teenager she cashed the checks from her first job and kept half of the earnings while giving the other half to her mother for her "savings account," which was the bottom of a dresser drawer. I tried not to show my disappointment, as she could have greatly benefited from the power of compound growth by investing that money into a Roth individual retirement account (IRA).

When it comes to saving for retirement, there's a common saying: The earlier you start, the better—and the earliest your children can start is with a custodial IRA.

The benefit of a Roth IRA

A custodial Roth IRA can be a great way to instill the value of investing for a child with earned income. This income could be from a job that provides a Form W-2 or a side gig, such as dog walking or babysitting.* The custodial Roth IRA is managed by a parent or another adult, such as a grandparent or uncle, on behalf of the child. The contribution limit for a Roth IRA in 2024 is the lesser of $7,000 or your child's total compensation for the year. Once your child has earned income, it doesn't matter who contributes to the IRA. You may be able to entice your child to open an account by offering matching contributions from you or a grandparent

* Note that the child's income may need to be declared as taxable self-employment income in the year it is earned. We suggest consulting with a tax professional.

or by funding the account up to the allowable amount. That way they will still have money left from their paycheck to spend however they choose.

Once the custodial Roth IRA is open for a minor, all assets are managed by the custodian until the child reaches age 18 (or 21 in some states). Given the tax bracket most teens are in, and the length of time they have to invest, a Roth IRA may provide the most long-term financial gain. An additional benefit of a Roth IRA is its flexibility. Contributions are available anytime, and withdrawals of earnings can be made penalty-free in some circumstances prior to age 59½.* * But as the IRA custodian, it is important to make clear to your child that it would be most advantageous to hold on to the account for the use of funding their retirement. Also, be sure to discuss the adoption of a custodial Roth IRA with your financial advisor to make sure it fits with your existing financial plan and goals.

Can a custodial Roth IRA impact a child's financial aid eligibility?

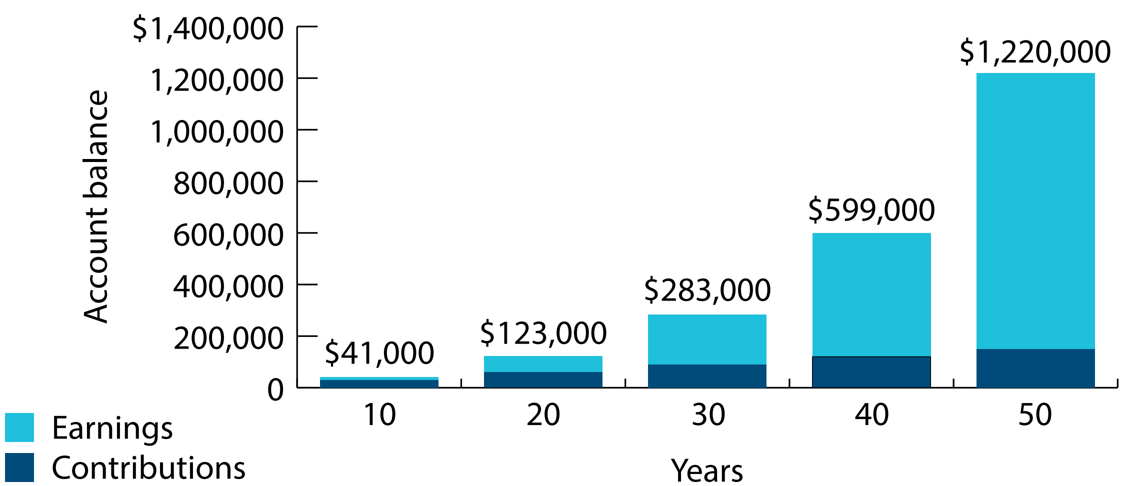
The value of Roth IRAs is not currently a factor in the federal financial aid formula. While universities offering nonfederal financial aid can apply their own requirements regarding Roth IRAs, only some universities consider these assets in relation to tuition assistance. However, if withdrawals from the Roth IRA are used to pay for college, that income amount will be considered in a future year's eligibility process and could have an impact.

What happens to a custodial IRA when the minor turns 18?

If you manage a custodial IRA for your child, they will assume complete control over the account when they turn 18 (or 21 in some states). This means they are

The growth potential of a custodial Roth IRA

Through the use of a custodial Roth IRA, modest contributions starting at age 15 through retirement could help build a substantial nest egg. For example, a 15-year-old contributing $3,000 every year to retirement has the potential to accumulate about $1,220,000 by age 65.



Assumptions: Hypothetical example beginning at age 15 assumes an annual contribution of $3,000 and a 7% annual investment return. Total balances accumulating over 10, 20, 30, 40, and 50 years, respectively. This example is for illustrative purposes only and is not meant to represent the performance of any specific investment option. The assumptions used may not reflect actual market conditions or your specific circumstances. Numbers have been rounded to the nearest thousand.

* * Withdrawals of earnings from Roth IRAs can be made penalty-free if the account has been open for 5 years or more and the money is used for exceptions such as qualified higher education expenses, a first-time home payment up to a lifetime limit of $10,000, certain unreimbursed medical expenses, and other situations.

The sooner your children can start saving for retirement, the better off they'll be in the long run.

What are the advantages and disadvantages of a custodial Roth IRA?

Advantages of a custodial Roth IRA	Disadvantages of a custodial Roth IRA
Your child can take advantage of the power of compounding over several decades, which could allow the account to grow substantially.	There are contribution limitations for IRAs—currently up to $7,000 a year.
A child's earnings may be so low that they are not taxable.	Contributions to custodial Roth IRAs are not tax-deductible.
There are no early withdrawal penalties on contributions to a custodial Roth IRA. Your child can withdraw money for college, to open a business, or for other expenses.	At age 18 or 21, account control will transfer to the child, so it is important that they understand the value of leaving their investments as is and letting the money continue to grow.
Your child can withdraw up to $10,000 worth of earnings from the IRA, without a penalty, for the purchase of their first home.	Your child will not be assessed a penalty on contributions withdrawn but may have to pay a penalty on the earnings if the withdrawals do not fall under qualified distributions.* * *

* * * A qualified distribution is tax-free if taken at least 5 years after the year of your first Roth contribution and you've reached age 59½, become totally disabled, died, or met the requirements for a first-time home purchase.

free to continue contributing, or they can liquidate the account to pay for their first home, college tuition, or any other expense.

All savings accounts are not created equal

The sooner your children can start saving for retirement, the better off they'll be in the long run. It doesn't only matter when you start saving; it matters where you start saving. A Roth IRA has much higher earning potential than a regular savings account. Give your child a leg up on their future and help them learn the immense value of compounding and importance of investing for the long term by opening a Roth IRA for them when they start earning income.

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Important Information

An IRA should be considered a long-term investment. IRAs generally have expenses and account fees, which may impact the value of the account. Nonqualified withdrawals may be subject to taxes and penalties. Maximum contributions are subject to eligibility requirements. For more detailed information about taxes, consult IRS Publication 590 or a tax professional regarding your personal circumstances.

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