

Q & A: IRAs for your children

Establishing a retirement plan for a child might, initially, sound a bit strange—or at least premature. Truly, it is not. Establishing an IRA for your children or grandchildren can help them achieve financial independence in retirement and, possibly, for the rest of their lives. That claim may raise some questions in your mind.

How is it possible?

Simply stated, given enough years of tax-deferred compounding of investment earnings, an IRA can yield some amazing numbers. (See the examples below.)

How can my child set up an IRA?

Actually, although the IRA will be your child's, *you* set it up and serve as custodian until the child reaches majority. But your child rather than you is the “owner” of the IRA and is subject to all the income requirements and rules.

How much can my child contribute?

The contribution rule is the same for your child as it is for you. For 2006 the maximum allowable contribution to a traditional IRA or Roth IRA is \$4,000. (If you are age 50 or older, you can contribute up to \$1,000 more.) But there is a catch, one that is especially relevant when we're talking about children. If the IRA owner's earned income (income from wages, not from investments) is less than the maximum contribution amount, the contribution is limited to the income that he or she earns.

How can I convince my child to give up his or her earnings and put them in an IRA?

You don't have to. *You* can make the contribution, by making a gift to your child of the contribution amount (up to his or her earned income). The annual gift tax exclusion (\$11,000 in 2005 and \$12,000 in 2006) shelters your gift from tax.

Which is better, a traditional or a Roth IRA?

A Roth IRA generally is considered to work best for children. First, withdrawals from a Roth IRA are tax free, provided that all the conditions are met. And there are no required distributions when the owner reaches age 70 1/2. But though contributions can be withdrawn tax free at any time, for the earnings to get the preferential treatment, a Roth IRA must be owned for at least five years and the owner be at least age 59 1/2. A traditional IRA allows pretax contributions, but tax is owed on withdrawals. That may not be a big benefit when your child is relatively young and owes little or no tax on that income. Both IRAs permit penalty-free withdrawals for education expenses and \$10,000 in home-buying expenses for the first residence purchased.

What kind of wage income are we talking about?

Paying your child an allowance for helping out at home isn't likely to be "earned income" and survive IRS scrutiny. On the other end of the spectrum, a regular paycheck from a business or the like clearly qualifies. Whether money from in-between situations—baby-sitting, lawn mowing, snow shoveling—is earned income is less certain. The best approach is for your child to keep accurate and detailed records (dates, names of employers, amounts paid for each job) of his or her earnings. If you are employing your child at your business, be sure to treat him or her as you would any other employee.

Is there a downside to setting up an IRA for my child?

Potentially, there's a major one: Once your child reaches majority, he or she is free to take funds from the IRA as he or she pleases, even close it out. If all the Roth IRA conditions aren't met, in addition to tax on the investment earnings, penalties could apply as well. And who knows how the money will be spent?

Examples: Big things can happen to small contributions

Just how big can a Roth IRA grow? Here are two examples (all names and circumstances fictitious):

- The Smiths set up a Roth IRA for their 16-year-old daughter, Sarah, who works after high school and during summers and also will work throughout college, earning at least \$3,000 a year. Each year, for six years, the Smiths contribute \$3,000 a year to the IRA for Sarah. There are no subsequent contributions. Assuming an investment rate of return of 6% a year, here's what will accumulate in Sarah's IRA:*

After the six years of contributions end (at age 22): \$20,926

After ten more years: \$36,526

When Sarah reaches age 65: \$249,860

- The Petersons set up a Roth IRA for their 16-year-old son Al, who also works after high school, during summers and throughout college, earning enough to allow the Petersons to make \$3,000 a year in contributions for him. At age 22 Al takes on the responsibility for making contributions from then on, putting \$5,000 a year into his IRA.** Assuming retirement at age 65 and an investment return of 6% a year, here's what will accumulate in Al's IRA:*

After six years of \$3,000 contributions: \$20,926

After ten additional years of \$5,000 contributions: \$102,430

When Al reaches age 65: \$1,187,398

*This rate is hypothetical, chosen for illustrative purposes only. It does not represent the past or future performance of any specific investment or mutual fund.

**\$5,000 per year is the maximum allowable contribution for 2008 and after, assuming that the increases that became law in 2001 become permanent instead of expiring after 2010. Contributions to a Roth IRA may be limited or unavailable above certain adjusted gross income limits.

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Any developments occurring after January 31, 2006, are not reflected in this article.