ROTH IRAS

The Best Way for Kids to Save Isn't in a Boring Bank Account

What's better? A Roth IRA! Here's why.

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Most kids are encouraged by their parents to save their money from their paper route or part-time job by throwing it into a bank savings account. While any kind of saving is better than nothing, there may be a way to do it where your kids can get tax benefits as well as a potentially better rate of return.

A Roth IRA, if properly invested, will likely appreciate in value far more than money sitting in the bank — and could do it with tax-free growth. And the day will come when your child will be very grateful for the parent with the wisdom to have them do this. Later the Roth IRA will be available to help pay for college, and up to $10,000 of it can be put toward your child's first home, all without early withdrawal penalties.

And if the young person can't resist pulling some funds out for that bicycle, the good news is that the original amount invested in a Roth IRA can always be withdrawn tax and penalty free. Also, for the child with the foresight to use some of their Roth IRA for retirement, withdrawals after 59½ will be completely tax free.

Age and income requirements

As long as a child has earned income, they can contribute up to $6,000 per year in a Roth IRA at any age. Someone else can also fund the Roth IRA for the child for up to $6,000 a year as long as the child has earned income equal to the amount contributed on their behalf.

If the child is legally a minor, which means in most states under 18 years of age, they will need to open a custodial Roth IRA where the child is the account owner with an adult, usually a parent, serving as the custodian. Contributions are reported to the IRS under the minor's Social Security number, but the custodian is the individual authorized to act on the account.

Are there any disadvantages or pitfalls to watch out for?

While the original contributions can always be withdrawn tax-free, any growth in the investments in a Roth IRA if withdrawn before age 59½, would be subject to taxes as well as a 10% penalty. But keep in mind the IRS does make an exception if the funds are used for college or up to a $10,000 amount for a first-time home buyer, both which can prove to be a nice benefit for young people. In these cases, the funds can be withdrawn without a 10% penalty, although the growth would still be subject to taxes.

Something else to be aware of is how to document income if the minor is not employed with a company and is not issued a W-2, for example if they mow lawns or shovel snow or babysit. In this case the custodian should document that the child received earned income that was reasonable. For example, a parent should not pay a child $1,000 for shoveling the sidewalk one time.

What about market fluctuation?

For a younger child, don't get overly concerned about putting the Roth IRA money in stocks or stock mutual funds, which historically have made the most money over time compared to putting it in things like bank CDs. The best safety against market fluctuation is time, and for a younger child, statistically speaking, they will have a lot more time to average out the fluctuation in the market and likely end up with some good average returns.

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