Roth IRAs as a Savings Vehicle for Children

One frequent concern for parents is instilling financial awareness in their children. While many parents are familiar with the concept of saving for education through 529 plans, parents are frequently less aware of the benefits of contributing to a Roth IRA on behalf of their children. This can be one of the most powerful tools for building a strong financial foundation for a child.

Roth IRA Contribution Rules

1. There is no age requirement for contributing to a Roth IRA. If the account is being set up for a minor, the account would simply be opened as a custodial account until the minor reaches the age of majority.
2. The individual for whom the contribution is being made must have earned income to contribute to a Roth IRA. As a result, most Roth IRAs for minors cannot be opened and funded until the minor is at least 14 years old and working.
3. The lesser of earned income or $6,000 can be contributed to a Roth IRA. There is no requirement that the child make the contribution (*i.e.*, a parent can contribute on behalf of a minor as long as the minor has the requisite earned income).
4. Your contribution cap is phased out at the IRS income limits ($129,000-$144,000 for single filers in 2022 and $204,000-$214,000 for married filing joint in 2022). Note that this applies only to contributions – you can still convert an IRA to Roth IRA over these income limits under current law. Note that the income limitations apply to the individual for whom the contribution is being made. A parent would be able to contribute to a child’s Roth IRA as long as the child makes less than the IRS income limits (even if the parent earns more).

Applying these rules, if a child makes $8,000 working a part-time job, his or her parents would be able to contribute $6,000 to a Roth IRA on behalf of the child. If the child makes $4,000 in a given year, his or her parents would be limited to a $4,000 contribution on the child’s behalf.

While there is no income tax deduction for a Roth IRA contribution, if the funds are held in the Roth IRA until a qualified distribution, there will be no tax on the withdrawal (including earnings). Importantly, since contributions to a Roth IRA are made with after-tax funds, they may always be withdrawn income tax and penalty free. Earnings within the account will be income tax free and penalty free as long as they are part of a “qualified distribution.” A qualified distribution is one which was made at least 5 years after your first Roth IRA contribution and: (i) after age 59½, (ii) as a result of your passing or disability; or (iii) up to $10,000 of earnings for a first-time home purchase. There are additional exceptions in which the earnings may be free of tax or 10% penalty. For example, distributions may be taken for unreimbursed medical expenses in excess of 7.5% or for qualified education expenses free of penalties (but subject to tax on the earnings). When administered properly, the tax-free earnings within a Roth IRA can be an extremely effective savings tool.

Parents wishing to employ this strategy should be aware that children will have access to the funds upon reaching the age of majority, and the parents would lose control over the account. If the child withdraws funds in a distribution that is not considered a "qualified distribution," there may be a tax on the earnings of the account, along with a 10% penalty. Last, parents should be aware that making a contribution to a Roth IRA on behalf of a child would be considered a gift to the child. If the total amount of gifts to any individual is in excess of $16,000 (in 2022), a gift tax return would be required to report the gifts. Teaching your child the benefits of Roth IRA contributions and saving for retirement can lead to a greater sense of financial awareness, while building a great financial foundation for your child. More information on Roth IRAs is available in IRS Publications 590-A (Contributions) and 590-B (Distributions).