Key Questions

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Should my Teenager Start a Roth IRA Account?

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If you have teenage kids who received their W-2s and 1099s for nonemployee compensation in the last few weeks, you may be missing an opportunity that could potentially leave them with a nice bucket of tax-free money in the future. Several years ago, my teenage sons started their first paying summer jobs. There's something gratifying about having my kids learn the value of a work ethic at an early age. There's also great value in teaching my kids that if they begin to save early, with compounding, their money will work for them, and they will be rewarded in the long-term.

I started custodial Roth accounts for them the year after they started their first summer jobs. A parent or guardian of a minor child may establish a Roth IRA on behalf of the minor child. Children are way below the Roth IRA income phaseout level. And they probably will be for a few years even when they graduate from college and start their first real-world jobs. For 2023, those limits were $138,000 – $153,000 for single filers. A person must have earned income, whether in the form of formal employment income or self-employment income, in order to make a Roth IRA contribution. The maximum Roth IRA contribution for 2023 was $6,500 ($7,500 for anyone age 50 and older), and a person cannot contribute more than what they earned in compensation. Tips are included as compensation if they are reported as gross income and reflected on a W-2 or 1099. Unreported tips don't count as compensation. If children are paid "under the table" like many kids who babysit, walk dogs, mow lawns, etc., that would not qualify for a Roth IRA contribution. If they perform services for a trade or business, but not as an employee, and are paid at least $600, they should receive a 1099-NEC (nonemployee compensation), which also counts as compensation for the Roth contribution limit purposes.

My teenage sons don't even have to actually use their own money to make the Roth IRA contribution into their account. They could spend their earnings on whatever they want, like going out with friends or buying the latest tech gadget. It doesn't matter where the money to fund the Roth IRA comes from. It could come from parents, grandparents, or a generous family friend. The IRS is only concerned that the contribution amount doesn't exceed the amount of earned compensation. Remember that a donor who makes a cash gift can gift annually up to $18,000 in 2024 without triggering any gift tax or use of lifetime gift exemption. You could partially fund the contribution with some of the child's own earnings and match a portion of it as a way to reward them for working and saving. I think that's a nice way to meet halfway for both the parent and child. The contribution to the Roth IRA account needs to be made by April 15 (the return due date). If you make an excess contribution (due to the compensation limit), for instance because you made your contribution before you received the actual W-2, you can still distribute the excess amount, accompanied with any "net income" attributable to the contribution, on or before the due date for filing the individual return (including extensions) and not be subject to an excise tax for excess contributions. Any excess contribution not distributed before a tax return's filing due date would be subject to a 6% excise tax.

Since I don't intend for my kids to touch their Roth IRA money for a long-time, I have them invested in mutual funds with a growth orientation (not an investment recommendation). With the power of compounding, if a teenager were able to contribute $5,000 to a Roth IRA account each year for the next decade, earning 6%, and then stopped contributing after that, after 40 years, they would have $378,519. If the account earned 8%, they would have $728,868. Even a mere $2,000 contribution per year for the next 10 years, without contributing after that, would grow to $151,410 at 6% and $291,545 at 8% after 40 years. This is another reminder that time in the market should be more of the focus for long-term growth. The lesson learned is that starting to save in a Roth account now, with years of tax-free growth potential, can lead to a quite sizeable long-term benefit. I can't think of a better way to teach my teenagers about the power of saving and starting early.

For more information, please contact your advisor.

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