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How To Give a Child Retirement Security

By Carla Fried

Look at your kids and you'll likely think of education, marriage or career, not retirement. Now, though, when kids are relatively young, is the smart time to set them up with a Roth IRA for their retirement.

T. Rowe Price estimates that parents and grandparents who bankroll or subsidize an annual $2,000 Roth IRA contribution for five years, starting when the recipient is at age 13, are putting a teen in line to receive $10,000 of annual retirement income from that original seed money. "You're gifting 50 years of compound growth," says Christine Fahlund, a senior financial planner at the fund firm. Remember, that's potentially tax-free retirement income. All contributions to Roth IRAs can be taken out, free of tax, at any time, and earnings can also circumvent the IRS toll as long as your kid waits until age 59 1/2 to begin taking out profits. All withdrawals from Traditional IRAs will be hit with income tax.

The one catch: Teens must have their own earned income equal to the amount of a Roth contribution. Investment income doesn't count, nor does trust income -- it's strictly earnings. To qualify, they need wages from any job -- babysitting, mowing lawns, waiting tables. The child doesn't need to fork over his or her own earnings to fund the Roth, however. If your child or grandchild earned $2,000 this year, you can bankroll a $2,000 Roth contribution.

Offer a Match

Fahlund recommends an incentive program by which adults don't bankroll 100% of the retirement contribution, but instead offer a generous matching contribution. Say, for every dollar they contribute, you pitch in $10. Or $20. That's unimpeachable advice, if you can make it fly with your teen.

Jean Dorrell, an estate-planning specialist at Senior Financial Security in Summerfield, Florida, says this is an increasingly popular move with grandparents. "They enjoy knowing they are helping build something, not just giving away money without a goal." Giving Roth IRA contributions is indeed a smart way to transfer assets from one generation to another. The $5,000 maximum IRA contribution is well within the 2012 $13,000 annual limit on money gifts (per individual recipient), so you'll steer clear of having to file a gift tax return with the IRS.

Most brokerages and fund companies allow accounts to be set up for minors, as long as an adult signs on as custodian. You'll need to check with your current financial institution. T. Rowe Price Vanguard and Schwab offer Roths for minors. Fidelity doesn't. "It's something we're working on and hope to offer in the future," says Fidelity spokesman Michael Shamrell.

A Minor Consideration

Keep in mind that somewhere from the age of 18 to 21 (depending on your state), the recipient can take can take complete control of the account. So you might want to start talking now about what your hopes and wishes are for this money, and how that doesn't, um, include early withdrawals for a Spring Break jaunt or car.

That said, a Roth IRA can be strategically tapped well before your child hits retirement age. Again, all contributions can be withdrawn, fully tax-free, at any time. It's just the earnings on the account that can run up a tax bill. Typically, withdrawing Roth earnings before age 59 1/2 will trigger a 10% early withdrawal penalty and income tax on the amount withdrawn. Up to $10,000 of earnings can be tapped tax-free at any age, though, when used for a down payment on a first home. If earnings are tapped to pay college expenses, there's no 10 percent early withdrawal penalty, but income tax will be due.

Giving the gift of a Roth IRA contribution isn't only for young ones. Dorrell says she has many clients who are funding Roth IRAs for grown children. "Their [grown] kids have their hands full, figuring out how to put their own kids through college." Dorrell says one 83-year-old client just funded a Roth for her 55-year-old son; another set up Roths for 16 grandchildren. A parent's job is never done.

Senior Financial Security, Inc.