IRAs for Teens

Few teenagers think much about retirement, but funding an Individual Retirement Account may be one of the best financial steps they will ever take. The reasons are simple – taxes and time.

IRAs can be established by individuals of any age. The only requirement is that they have earned income equal to or exceeding the amount they contribute to an IRA. Contributions to regular IRAs can be tax deductible, but most teens have low enough incomes that much of their income is not subject to tax; or if it is, the tax rates are low. Roth IRAs are especially attractive for younger individuals because they offer the potential to accumulate funds that, if handled properly, will never be subject to income taxation.

The Basic Rules for Roth IRAs

- *Contribution Limits* – For the taxable year of 2010, you can contribute up to $5000 to a Roth IRA. You must have wages (or other earned income) equal to or greater than your contribution. The annual contribution limit is scheduled to increase beginning in 2011.
- *Deductibility* – Contributions to a Roth IRA are not deductible.
- *Earnings within the Roth IRA* – Earnings on the funds within the Roth IRA are not subject to income tax. This enables your funds to grow faster than they would in a taxable account.
- *Distributions from a Roth IRA* – The significant advantage of a Roth IRA compared to a regular IRA is that distributions from the Roth IRA are not subject to tax provided you meet certain rules. Generally, if you take distributions after reaching age 59 ½, they are tax free. In addition, there are some rules that allow for distributions earlier if the funds are used for first home purchases or qualified education expenses.

As with most income tax issues, the actual rules can be complex. You may want to consult with your tax advisor for more details.

Putting Time on Your Side

The longer the funds remain in a Roth IRA, the larger the balance can become. For younger individuals, this can be very significant.

Consider these scenarios:

Let us assume that Sue has a part-time job for her last two high school years and contributes $3000 in those two years. If she earns 8%, when she reaches age 60, her Roth IRA would have grown to over $180,000.

Now let us assume that she continues to work part time while going to college for four years. In this case, Sue would have accumulated almost $465,000 at age 60.

These large accumulations are possible because the money compounds for such a long period of time.

Putting This to Work

It is easy to establish a Roth IRA. Just visit your financial institution. You may even want to consider giving the child money for their contribution. Just remember that the individual must have wages at least equal to the contribution.

What a wonderful way for a young person to start on the road to financial security and to start a saving pattern that will provide returns for the rest of his or her life.