LCR WEALTH

HOW TO SET UP THE NEXT GENERATION FOR SUCCESS

PART 2: THE ROTH IRA

AN LCR WEALTH WHITE PAPER

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In the first paper of this LCR Wealth Knowledge Series we showed how parents can subsidize their children's living expenses, allowing them to maximize their IRA contributions during the first three years of their careers. For parents of children who are not yet old enough to start a full-time job, **a Roth IRA is an excellent option to start saving and investing early**.

Roth IRAs can be opened for children of all ages. If the child is over the age of 18, they can open the account themselves. For parents of minors, a custodial account can be opened in the name of the child.

A Roth IRA is similar to a traditional IRA in that each is a tax-advantaged individual retirement account. Among the similarities:

- Investments grow tax-free.
- There are annual limits on contributions.
- Early withdrawal results in a 10% penalty.
- Penalty-free withdrawal requirements:
  - Account must be open for >5 years and the account holder must be >59½ years old.

There are some distinct differences that make the Roth IRA a better choice for parents of teens and young adults. The main difference between a traditional IRA and a Roth IRA is in the contributions, or funding of the account.

A traditional IRA is funded with pretax dollars meaning that the tax benefits are realized in the year that the funds are contributed. In short, you don't pay taxes on income that are contributed to a traditional IRA. In contrast, **a Roth IRA** is funded with after-tax dollars. This means you do have to pay tax on income that is contributed to a Roth IRA.

The requirement to use after-tax dollars to fund the Roth IRA may seem like a negative characteristic, but it allows for a tax benefit when making withdrawals from the account. **In a traditional IRA, withdrawals are fully taxed as ordinary income. In a Roth IRA, withdrawals are 100% tax-free**.

There is no early withdrawal penalty if the account holder withdraws only principal contributions or if the withdrawal is used for approved purposes, such as purchasing a home. Funds from investment growth cannot be withdrawn penalty-free before the requirements outlined above are met.

The best way to remember the difference in tax treatment between distributions from a traditional IRA versus from a Roth IRA is to refer to the tax status of the funds—pretax or after tax—used to contribute to the account.

There are no taxes or fees on withdrawals from a Roth IRA, as long as the qualifications are met to avoid the early withdrawal penalty.

As of 2022, the annual contribution limit for a Roth IRA is the lower of $6,000 or one's earned taxable income. Earned income is generally considered to be one's wages that are reported to the Internal Revenue Service. The definition of earned income excludes investment gains, cash gifts, and other funds that are either not considered "earned" or not reported to and taxed by the IRS. Children who do not have a job can earn and report income from their parents or other employers for activities like chores and housework, as long as the wages are earned at a reasonable market rate and reported to the IRS.

Anyone can contribute to the Roth IRA of someone else, as long as the contributions do not exceed the limit of the lesser of $6,000 or the account holder's taxable earned income. If the child has taxes payable on earned income or spends the wages entirely, the parents can still contribute for them up to the account holder's individual annual limit.

	Taxable Account	Traditional IRA	Roth IRA
Contributions	After-Tax	Pretax	After-Tax
Contribution Limits	No limits	$6,000	$6,000
Growth	Taxable on realized gains	Tax-free	Tax-free
Early Withdrawal Penalty Fee	None	10% before age 59½	10% before age 59½
Withdrawals	Capital gains tax on realized gains	Ordinary income rates on all withdrawals	Tax-free on all withdrawals

To highlight the benefits that a Roth IRA provides teens and young adults over a traditional IRA, take the example of an 18-year-old living in New York who earns $5,000 from a summer job. This hypothetical teen can invest their $5,000 through a regular taxable account (like a bank account), a traditional IRA, or a Roth IRA. The effective gross income tax rate on the $5,000 earned is roughly 9%, or approximately $450.

	Taxable Account	Traditional IRA	Roth IRA	Roth IRA Subsidized by Parents
Earned Income	$5,000	$5,000	$5,000	$5,000
Tax Burden in Year 1	$450	$0	$450	$450
Year 1 Contribution	$4,550	$5,000	$4,550	$5,000
7% Growth for 40 Years (No Realized Gains)	$68,134	$74,872	$68,134	$74,872
Withdrawal Tax Burden on Full Balance	–$12,717	–$23,959	–$0	–$0
After-Tax Withdrawal	$55,417	$50,913	$68,134	$74,872

By investing in a Roth IRA, children get a head start on investing for retirement, just as with a traditional IRA or regular investment account. However, unlike almost any other investment asset, the Roth IRA will be completely tax-free to withdraw from or to liquidate once the account holder reaches retirement age.