

Last-Minute Gift (For A Lifetime) Idea: A Child IRA For Your Kids Or Grandkids

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The gift-giving season is upon us, and if you're like many, you'll be looking for a last-minute gift that isn't the same-old, same-old. This year, why not give the gift of a lifetime? Forget those faddish toys that get broken or lost within days. Give your kid or grandkid [a Child IRA](#).

"The primary benefit of opening a Child IRA is the benefit of compounding on the IRA plan assets," says Marcia S. Wagner, founder of The Wagner Law Group in Boston. "If the child is at an age that he or she can understand at

least arithmetic, if not finance, the Child IRA can also be a valuable teaching tool for a child. A third possibility would be providing the child with a head-
towards financial independence.”

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What is A Child IRA?

You may [know the Child IRA](#) by a different name depending on which institution you select to establish it at. It can be called a “Minor IRA,” a “Minor Child IRA,” or a “Custodial IRA.” It may simply be called an “IRA.” That’s because it is fundamentally no different from any other IRA.

A Child IRA is “a tax-advantaged savings account that benefits a child and is managed (and invested) by the parent until the child is legally an adult (usually age 18),” says Pam Krueger, founder and CEO of Wealthramp in Tiburon, California. “Savings can grow tax-deferred using a traditional custodial IRA account or enjoy tax-free withdrawals by investing in a Custodial Roth IRA.”

Can you gift to children and grandchildren?

Normally, you’re trained to think the owner of the IRA has the sole responsibility for contributing to it. In a sense, that’s correct. However, the source of the money can come from anywhere. As long as you’re eligible to contribute, you can use any funds in your possession. You don’t have to actually save the physical dollars you earned and put just those dollars into your IRA. You can spend the money you got from working and use other money that you got from, say, winning the church raffle, finding it on the street, or receiving it as a birthday gift.

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If you're following this line of reasoning, you've now guessed that even if your children spent all their hard-earned earnings and have no money left, they can still set up a Child IRA. How? Well, they can go to the Bank of Mom & Pop (or Grandmom & Grandpop). Yes, parents and grandparents [can gift the money](#) children need to open a Child IRA. Unfortunately, though, they overlook this opportunity.

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“Parents often do not see the Child IRA as important because they do not understand how much saving a little matters in building habits and knowledge for the long term,” says Chicago-based Anna Rappaport, president of Anna Rappaport Consulting.

How do you open a Child IRA?

Here's the best part. [Opening a Child IRA](#) is no harder than opening your own IRA.

“A Child IRA, from a document perspective, is open in the same manner as a traditional or Roth IRA,” says Wagner. “Except that since a child lacks legal capacity to establish an IRA, it must be established by the child's parent or legal guardian.”

Under current rules, minor children must abide by the same rules as adults. They must have earned income in order to contribute to an IRA. Once you

pass that threshold, you'll need to determine which type of IRA to use.

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typical child (excluding child movie stars, etc..) has a zero taxable income,” says Lawrence (Larry) Starr, executive vice president at Cornerstone Retirement/QPC in West Springfield, Massachusetts.

“Therefore, if there is the ability to fund an IRA (the child needs to have some earned income), it should be set up as a Roth, given there is no ‘give up’ of the tax benefits of a regular IRA since there is no tax at the child’s income level. If the child does not have earned income, if there is the ability to put the child on a payroll for some services (usually, I recommend emptying wastepaper baskets!), and the parent is willing to fund the income AND the IRA, this works very well. The typical benefits of an IRA apply (compounding tax-free for 50, 60, or 70 years; plus, no tax on the distribution of a Roth account).”

The good news is you can set up IRAs at almost all large financial institutions. What’s more, if you live in a state that allows it, your infant can serve as a model in an advertisement and get paid for it. That means a baby can have a Child IRA!

“As long as child has earned income, and a social security number there’s no age limit barriers,” says Krueger. “Look for a reputable discount broker — Schwab, Vanguard, ETrade, or Fidelity all offer custodial IRAs. Most offer 24/7 support to help. Just have your banking and other basic financial details on hand, and you can open the account online.”

How can a Child IRA improve financial literacy?

It’s not unusual for parents to be leery of giving money to their young children. They’re OK with the kids getting their own accounts—as long as the parents retain the reins of management. Once the minor comes of age, mom and dad might lack the confidence the child is ready to handle money responsibly.

“Parents may not like the idea that the child is the account holder, which means when your child legally becomes an adult, that account is controlled by the child,” says Krueger. “The child can do whatever the child wants to and incur penalties if the money isn’t spent according to the rules.”

Ironically, if the parent actively engages children in monitoring their Child IRA accounts, it’s more likely the children will gain financial literacy on the road to financial independence.

“Opening a Child Roth IRA, with concurrent education/guidance, ensures the child is aware of three important financial factors, potentially serving them well for the rest of their life,” says Jack Towarnicky, of counsel at Koehler in Powell, Ohio. “These include: the time value of money/compound interest, specifically the Rule of 72; the ‘drag’ of income taxes on investment earnings, comparing Rule of 72 outcomes where monies are invested in a traditional IRA versus a Roth IRA; and a belief in/focus on the future, the near certainty of financial attainment of the American dream for the child, as well as providing legacies for all future generations.”

The Child IRA: How do even small actions add up and begin to make things better?

The power of compounding represents the power of the Child IRA. As Towarnicky says, the Rule of 72 (essentially calculating how fast money doubles based on its average return) reveals the key to financial independence. By the time the child retires (which will be later than you think), the Child IRA can grow to a tidy sum.

“Assuming the small contributions remain in the IRA for decades, the benefits of compounding will increase to a significant sum,” says Wagner. “As of today, a child would not need to begin withdrawals until age 75, and by the time a child is an adult, the required minimum date could well be in the 80s.”

You might not believe the numbers when you see them.

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Roth IRA, contributing \$1,000 at birth and on each of the first four birthdays (\$5,000 over 5 years) growing at 7.5% annually yields \$1 million by age 75,” says Towarnicky. “In a Roth IRA, contributing \$1,000 at birth and on each of the next 18 birthdays (\$19,000 over 18 years) growing at 7.5% annually yields \$1.18 million at age 65 (the current age of Medicare eligibility). You might ask, what will a million dollars be worth in 65 or 75 years? I don’t know, and you don’t either. However, according to a report by United Income, one out of six retirees have \$1 million in cash savings today. So, let’s say that the percentage doubles to 35% over the next 65-75 years. I know which group I want my (grand)children to be in.”

Between the opportunity to learn about managing finances and getting a leap-frog head start on retirement, giving the gift of a Child IRA may be more than the perfect last-minute gift. It just might be the most enduring gift you can give your child or grandchild.

Rappaport, who is also the chair of the Society of Actuaries Committee on Post-Retirement Needs and Risks, says, “Opening a Child IRA will teach them about the importance of saving, the value of savings early and regularly, and will help them learn about financial literacy. The [Society of Actuaries’ survey Aging and Retirement Across the Generations](#) offers perspectives on how people plan and document the challenges families face when trying to help all family members attain security. Many people plan only for the short term and do not see the value of saving early. They also often do not understand investments and how they work.”

Forget giving a subscription to the Jelly of the Month club. Give the gift of a Child IRA.

The Child IRA: It truly is the gift that keeps on giving.

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