



FINANCIAL PLANNING

Individual Retirement Account Options for Your Children

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Most of us are well aware of the benefits of Individual Retirement Accounts (IRAs) both while we are working and when we retire. However, few people consider the advantages of opening these accounts for their children—and the sooner, the better.

As discussed in a previous article (Income-shifting strategies involving your children. *The Female Patient*. 2007;32[5]35-37), the physician's children are often employed in the practice. One option for any income earned as a result of such employment is to open an IRA for the child. This strategy has many benefits (Table), allowing for gains to help provide for retirement. In the case of teenaged and young adult children, an IRA may have 50 years to accumulate.

Consider this scenario: By age 18 years, your child saves \$10,000 in an IRA. Without contributing another cent, if the IRA grows at an 8% average rate of return (net of expenses such as management fees and account service charges), he or she could have \$372,320 in the account by age 65 years. However, if your child waits until age 28 years to fund the

account with the same \$10,000, the account would hold only \$172,456 by age 65 years. You can help your children or grandchildren to take advantage of this compounding by opening an IRA, and there are several options to contemplate.

TAX LAW BASICS

Although an IRA represents a great savings opportunity for children, there is a catch; the account holder must have earned income to qualify for one. Unearned income from a savings account, allowance, or investments does not count, so how can your child fund the IRA? Options include:

- Neighborhood jobs such as baby-sitting and mowing lawns earn income, but such activities do not merit a W-2. Therefore, it is important to keep good records for each job (including job description, date, payment, and employer), and to file an income tax return. Your certified public accountant (CPA) can provide further advice about self-employment tax issues.
- Teenagers can earn income from summer jobs and part-time work at stores, restaurants, amusement parks, or swimming pools.
- Your children can be employed in your practice, and you can deduct taxes for any reasonable wages that you pay your children (aged 7 years or older) to perform duties related to your work.

Any child who earns wages can establish an IRA, and there is no minimum age for opening one. The maximum contribution to an IRA is \$4,000 for 2007, so your children can contribute up to \$4,000 or the amount

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of their annual earnings, whichever is less. For example, if your child earns \$3,000, he or she can contribute up to \$3,000 to the account.

OWNERSHIP VERSUS CUSTODIAL ACCOUNT

An IRA for your child is similar to a custodial account, with several differences. You control the account until your child reaches the age of majority, as you would with a custodial account. However, an IRA account is not actually considered to be a custodial account under the law.

ACCOUNT TYPES

There are three main types of IRA options for employed children—traditional, Roth, and education. Each type has its pros and cons.

Traditional Accounts

Traditional IRAs are personal accounts that working people and their spouses can establish on a pretax, tax-deferred basis for the purpose of saving and investing for retirement. This is the IRA that allows you to contribute pretax dollars if your income limits qualify. Contributions to a traditional IRA are made pretax and earnings are tax free, but withdrawals are subject to tax. These contributions are fully deductible for all individuals who are not active participants

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in employer-sponsored retirement plans or for plan participants within certain income ranges. Earnings accumulate tax-free until you begin withdrawing the funds. Distributions from a traditional IRA are taxable, except to the extent they represent nondeductible contributions. If your child withdraws funds before age 59.5 years, in most cases he or she would be required to pay both income tax and a 10% penalty on the distributions. However, if the funds are used to pay for “qualified higher education expenses,” then the penalty is waived. As with all IRAs, there are specific eligibility and filing status requirements mandated by the Internal Revenue Service.

TABLE. Individual Retirement Account Benefits

- **Compounding interest:** The original investment, as well as the income derived from that investment, is reinvested.
- **Current and future savings:** Compounding interest can be especially dramatic when the effect of taxes is removed from the equation.
- **Future inflation protection:** It is essential to prepare for future inflation. In general, prices for goods and services at retirement will likely be higher due to inflation, which in turn could affect the buying power of retirees and their families.
- **Supplement to Social Security income:** Social Security was not designed to be—and never should be—the lone source of retirement income. Although about 20% of retirees depend solely on Social Security for their income, it is essential to teach children to make supplemental provisions.
- **Supplement to employer-sponsored retirement benefits:** Employer-sponsored retirement benefits are shrinking, and may not provide the level of income desired in retirement.

There are also nondeductible IRAs for account holders whose income is over a certain limit and who participate in a qualified pension/profit sharing/retirement plan. These most likely would not apply to a minor child.

Although traditional IRA contributions are tax-deductible, many children do not earn enough to maximize the tax benefit. Plus, the child will have to pay income tax when he or she receives distributions from a traditional IRA. Traditional IRA holders must pay taxes on all withdrawals of both contributions *and* earnings. These factors may tend to favor the establishment of a Roth IRA.

Roth Accounts

For children with earned income, a Roth IRA is typically a better choice than a traditional IRA, primarily because a minor child's income is generally too small to benefit much from tax deductions for contributions to a traditional IRA. Roth IRA contributions are not tax-deductible, which generally is not an issue for minor children. However, your child can withdraw contributions tax-free any time and for any reason. Further, earnings can also be withdrawn tax-free at age 59.5 years if the Roth IRA has been open for at least 5 years. However, as with traditional IRAs, there is a 10% penalty for withdrawals of Roth IRA earnings before age 59.5 years. When purchasing a first home, though, it is possible to make early withdrawals penalty-free from a traditional or Roth IRA for these qualified expenses.

Education Accounts

A Coverdell Education Savings Account (ESA)—formerly called an “education IRA”—is an account created as an incentive to help parents and students save for education expenses. All earnings in the account accumulate on a tax-deferred basis, and can be withdrawn from the account tax-free if used to pay for qualified education costs.

The total contributions for the beneficiary of this account cannot exceed \$2,000 in any year, no matter how many such accounts are established. The beneficiary must be under age 18 years, or be a special-needs benefi-

ciary. Contributions to a Coverdell ESA are not tax-deductible, but amounts deposited in the account grow tax-free until distributed. The beneficiary will not owe tax on the distributions if they are less than the qualified education expenses at an eligible institution. This benefit applies to expenses for elementary, secondary, and higher education. Qualified education expenses include tuition, books, and fees.

INVESTMENT OPTIONS

Many people wrongly believe that an IRA must be opened with a bank or savings and loan institution, usually in the form of a certificate of deposit (CD). On the contrary, there is a multitude of IRA investment opportunities, including:

- Interest-bearing checking accounts
- Interest-bearing savings accounts
- CDs
- Mutual funds
- Stocks
- Bonds
- Annuities.

CONCLUSION

Establishing an IRA is an excellent method for helping your children and grandchildren to get a head start on saving for their retirement. However, many of the methods mentioned here have tax implications for you and your children, so consult a CPA for more detailed explanation and advice.