Aldrich Wealth LP
888-299-3102

Custodial ROTH IRAs

Children often work in some fashion before they reach age 18. However, most children probably are not thinking about saving for retirement, purchasing a home or even paying for college yet. Although funding a custodial Roth IRA might not spark much excitement, it can be an excellent way to teach a child about financial responsibility while demonstrating the benefits of long-term investing as soon as they begin earning income.

WHAT IS A CUSTODIAL ROTH IRA?

A custodial Roth IRA operates in the same way as a regular Roth IRA with a few exceptions. An adult, usually a parent or relative, must open the custodial Roth IRA on behalf of the minor. As the custodian, the adult is responsible for managing all of the assets until the minor reaches the age of majority. This can be age 18, but also age 21 or 25, depending on the child's state of residence. Once the child reaches the age of majority, the custodian has a duty to turn the account over to the child, at which time the child will become the account owner with complete authority over the account.

With a custodial Roth IRA, contributions are made with after-tax dollars and can grow tax-free which can have a powerful compounding effect over the long-term. Distributions can also generally be made tax and penalty free as long as certain rules are met.

RULES FOR A CUSTODIAL ROTH IRA

- **Eligibility.** There is no minimum age limit to open a custodial Roth IRA. However, the child must have earned income for the year. Earned income can come from salaries, wages, tips, bonuses, commissions and self-employment. Although the income limits are seldom relevant for custodial Roth IRAs, the child's modified adjusted gross income also must fall within certain limits. For single filers, eligibility to contribute starts to phase out at $146,000 and completely phases out at $161,000.
- **Contribution Limit.** For 2024, the maximum contribution is $7,000 or the child's total earned income for the year, whichever is less. Anyone can also make the contribution on the child's behalf. For example, if a teenager earned $3,000 working over the summer, a parent could allow the teenager to keep that money and contribute up to $3,000 in the child's Roth IRA themselves.
- **Contribution Deadline.** The deadline for making custodial Roth IRA contributions for a given tax year is the tax filing deadline for that year, not including extensions (typically April 15 of the following year). For 2024, the custodial Roth IRA contribution deadline is April 15, 2025.
- **Distributions.** Contributions to a custodial Roth IRA can be withdrawn any time, with no taxes or penalties. Generally, any withdrawals are considered to come from contributions first. Distributions from earnings begin only when all contributions have been withdrawn. Earnings can be taken out tax and penalty free after the account owner reaches age 59 ½ and the account has been established for at least 5 years. If the account owner takes withdrawals of earnings prior to age 59 ½ and/or satisfying the 5-year rule, they may be subject to ordinary income taxes and a 10% early withdrawal penalty. However, the rules allow for tax-free and penalty-free withdrawals under certain situations such as to make a first-time home purchase (up to a $10,000 lifetime maximum), to pay for qualified higher education expenses or to pay for unreimbursed medical bills or health insurance while unemployed.

WHEN DOES A CHILD NEED TO FILE A TAX RETURN?

A child generally must file a separate tax return when they are a dependent and exceed the thresholds for earned and/or unearned income during the year. To be considered a dependent, a child must be under age 19, under age 24 and a full-time student, or permanently disabled at any age. The child also must live with the parent or guardian more than 50% of the year (if they are not a full-time student) and cannot provide more than half of their own financial support.

- **Earned Income.** Earned income is any income received from a job or self-employment. A child who has only earned income typically needs to file a tax return if their income exceeds the standard deduction for the year. For 2024, the standard deduction is $14,600. However, if the child's net earnings from self-employment are $400 or more, they may be required to file a tax return to report self-employment taxes.
- **Unearned Income.** Unearned income includes taxable interest, dividends, and capital gains. A child who has only unearned income usually will need to file a tax return if their unearned income is more than $1,300 for 2024. However, if the child's unearned income consists only of interest, dividends and capital gain distributions, the parent or guardian may be able to elect to include the child's investment income on their tax return to avoid the child having to file a tax return. Keep in mind this could result in higher income and/or push the parent or guardian into a higher tax bracket.
- **Earned and Unearned Income.** If the child has both earned and unearned income, the child typically needs to file a tax return if their unearned income is more than $1,300, their earned income is more than $14,600, or their combined income (unearned and earned) exceeds the larger of $1,300 or their earned income (up to $14,200) plus $400.

If a child's income falls below these thresholds, there may be instances where the child should still file a tax return. For example, if a child had income taxes withheld from their wages or qualifies for tax credits, it may make sense for them to file a tax return since they could be eligible for a refund. If the child receives any income, we recommend working with a tax professional to determine whether they have a filing requirement.

DOES A CUSTODIAL ROTH IRA AFFECT FINANCIAL AID?

The Free Application for Federal Student Aid (FAFSA) is generally used by most colleges to assess a student's eligibility for financial aid. Custodial Roth IRAs, like other qualified retirement plans, are not reported as assets regardless of whether they are owned by the parent or student on the FAFSA. Therefore, the mere existence of a custodial Roth IRA will not typically affect a student's eligibility for financial aid. However, distributions from a custodial Roth IRA, even a tax-free return of contributions, might count as income on the FAFSA regardless of whether the distribution is included in Adjusted Gross Income (AGI) or counted as untaxed income. Since the FAFSA for a given academic year uses financial information from two years earlier, it is generally best to wait until at least the spring semester of the student's sophomore year to tap Roth IRA funds for education expenses, assuming the student graduates in four years.