Custodial IRAs Explained: Everything You Need to Know

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Tags: Investing | Retirement | Tax Benefits | Children

Introduction to the Custodial IRA

A Custodial IRA is a retirement account established on behalf of a minor, who is the **beneficiary** of the account, by a **custodian**, who is an adult who controls the account until the minor reaches legal adulthood. The custodian is typically the parent/guardian of the minor, but any adult, such as an aunt or uncle, can serve as the custodian of a Custodial IRA. A Custodial IRA is simple to set up, and can meaningfully improve the financial success of the minor's future.

Custodial IRAs allow children and teens to learn about saving and investing in a real way since their own money can be invested. The account can be set up as either a Traditional IRA or a Roth IRA, although the latter is both preferable and practicable in nearly all cases. Custodial IRAs can also be called Minor IRAs, Kid's IRAs, and Youth IRAs.

Why Should I Open a Custodial IRA for My Child?

Opening a Custodial IRA for your child could be one of the most influential financial decisions you make on behalf of your child. Not only will your child receive the significant tax benefits of an IRA, but the added years of compounding can make a monumental impact on the value of the account at retirement. Additionally, teaching and instilling good money habits (such as funding an IRA) in your child at a young age can help set them up for financial success in adulthood.

Tax-Advantaged Growth

Custodial IRAs offer account owners the benefit of **tax-advantaged** growth on assets held within the account. Custodial Traditional IRAs have **tax-deferred** growth, and the more popular Custodial Roth IRAs have **tax-free** growth. Both of these have advantages over standard taxable brokerage accounts, but the tax-free nature of Custodial Roth IRAs is more powerful.

Assets invested in a Custodial Roth IRA can grow tax-free for the lifetime of the account owner. This means your child won't have to pay taxes on the assets withdrawn from this account, no matter how much they grow, as long as he or she follows the withdrawal rules for the account. There are very few investment account types that have this benefit, so opening a Custodial Roth IRA for your child today will give them a leg up on their future.

Longer Investment Horizon

The phrase "time in the market" accurately captures one of the most important factors to the success and long-term growth of an investment portfolio. Adding years onto the growth of a portfolio usually has considerably positive consequences for the value of the portfolio, especially when dealing with retirement accounts for which the time horizon is typically very long. The earlier one starts investing, the larger an investment portfolio can grow.

Take, for example, a 15-year-old who earned $1,000 over the course of a year. If the 15-year-old chooses to make a one-time $1,000 investment in a tax-free investment account—such as a Custodial Roth IRA—her investment could grow to $46,902 by the time she reaches 65 years old (i.e., a 50-year investment horizon). If she waited until age 25 to make this one-time investment, the account value would only be $21,725 at age 65 (i.e., a 40-year investment horizon). In this case, the 10 years of additional "time in the market" would lead to a more than doubling of the account value.[1]

Good Money Habits

A Custodial IRA is one of the best ways to introduce your child to investing and other good money habits. By teaching your child about investing at an early age, you can demonstrate many important financial concepts such as long-term planning, compounding, risk management, and diversification, as well as other broadly applied lessons such as ownership, responsibility, goal setting, and patience. If anything, your child may soon become fascinated with saving and investing if his or her account balance grows over time.

What are the Requirements to Opening a Custodial IRA?

Custodial IRAs follow many of the same rules as a non-custodial account of the same type (meaning Traditional vs. Roth). Notably, the money contributed to the account must be from the earned income of the minor, who is the beneficiary of the account. A parent cannot fund a Custodial IRA on behalf of a child.

Minors of all ages can be the beneficiary of a Custodial IRA so long as the minor has **earned income**. Earned income in this age group is likely to include money earned from jobs such as babysitting, dog walking, lifeguarding, mowing lawns, or being a camp counselor, but can also come from other jobs. Money earned from household chores does not qualify as earned income.

One question you may be pondering is whether you can hire your child for the purpose of establishing earned income. Opportunely, the answer is yes, but there are certain conditions that need to be met. Parents can hire their child at their own business (as either an employee or contractor) but your child must (a) do legitimate and necessary work for the business, and (b) receive a reasonable wage for the task(s) completed in order to establish earned income. You cannot pay your child thousands of dollars for one "marketing" photo, for example.

How Much Money Can Be Contributed to a Custodial IRA?

In 2024, the maximum contribution to a Custodial IRA is $7,000. This limit is revised over time to adjust for cost of living and inflation. But remember, contributions are restricted to the earned income of the minor, only, which may be lower than the $7,000 contribution threshold. It is the custodian's responsibility to ensure contributions do not exceed this amount.

It should be noted that most minors do not make $7,000 in earned income annually to contribute to a Custodial IRA. Even so, your child can reap the benefits of a Custodial IRA by contributing any amount he or she can to this account, even if it is only a few hundred dollars.

Can Contributions to Custodial IRAs be Deducted on Taxes?

Contributions to Custodial Traditional IRAs may be tax-deductible depending on various factors. However, given the superiority and practicability of Custodial Roth IRAs for most, it is usually ideal to choose a Custodial Roth IRA for your child so that the investments grow tax-free rather than tax-deferred. Tax-deductibility of contributions is a non-factor for Custodial Roth IRAs.

What Happens to a Custodial IRA When My Child is No Longer a Minor?

Once your child reaches the **age of majority** (aka legal adulthood), he or she is entitled to control all previously held custodial assets, such as those in a Custodial Roth IRA. The custodian of the account is responsible for transferring the assets to the child, and this process can usually be accomplished in a few simple steps.

First, the custodian should contact the financial institution where the custodial account is active and provide required documentation (such as a birth certificate or driver's license) proving the beneficiary's age of majority. Then, a new non-custodial account of the same type can be opened in the name of the beneficiary and the assets can be transferred into this new account, which your child—now a legal adult—has full control over.

The age of majority, which is governed by state law, typically ranges from 18 to 21 years old, but may extend up to 25 years old under certain circumstances.

What are the Withdrawal Rules of a Custodial IRA?

The withdrawal rules for a Custodial IRA are the exact same as a non-custodial account of the same type (meaning Traditional vs. Roth). You can familiarize yourself with those exact rules using the following links: Traditional IRA and Roth IRA.

If your child's Custodial IRA is opened with a Roth designation, your child can access all contributions to his or her Custodial Roth IRA at any point without tax or penalty. The money that is put into a Custodial IRA can be accessed to pay for college, as a downpayment on a house, or for any other expense, at any time.

The investment earnings on the account, however, are subject to withdrawal rules that may impose taxes and penalties on non-qualified withdrawals of assets.

What Types of Assets Can be Invested in with a Custodial IRA?

A Custodial IRA allows for the custodian of the account to invest in a fairly broad spectrum of assets. Just like a non-custodial IRA, stocks, exchange-traded funds (ETFs), mutual funds, bonds, money market funds, and certificates of deposit (CDs) are all permitted investments. Examples of investments that are prohibited in a Custodial IRA include life insurance, artwork and collectibles, S corporation stock, and real estate for personal use, among others.

It is important to establish an allocation of assets in a Custodial IRA that matches your child's long-term financial trajectory. A dynamic portfolio that evolves over time can help your child meet his or her financial goals.

<u>How Can I Open a Custodial IRA?</u>

If you think a Custodial IRA is best for your child, reach out to us at **FreeMind Financial Advisory** and we would be happy to answer any questions you have about the account type. If a Custodial IRA is a good option for you and your child (spoiler: it almost always is!), we can assist in setting up an account, choosing an initial investment allocation, and actively monitoring and managing the investments of the account.

Unlike other financial advisors, **<u>FreeMind Financial Advisory does not charge any fees on Custodial IRA accounts</u>** that are attached to a household with at least one funded non-custodial investment account.[2] Reach out today to learn more!

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<u>Footnotes</u>

[1] Hypothetical account values calculated assuming a 8.0% annual return on portfolio.

[2] In order to be eligible for a Custodial IRA without fees, your total non-custodial household assets invested with FreeMind Financial Advisory must be greater than the total household Custodial IRA assets invested with FreeMind Financial Advisory.