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Retirement Planning? Now?

Actually, a Roth IRA Is Especially Favorable for Young People With Income

BY BRENDA L. MOORE
Special to The Wall Street Journal

Bret Hartt is your typical Southern California teenager, but for one thing—his Roth IRA.

At the age of 15, Bret has socked away $8,416 in an individual retirement account. Left untouched, and compounding at a relatively conservative 7% annually, it could be worth a quarter of a million dollars, tax-free, when he is ready to retire.

Such early planning for old age is becoming more and more common. Just about anyone who has earned income is eligible for a Roth IRA. And the number of minors who hold Roth IRAs has nearly doubled in the past year to about 903,000, according to the Investment Company Institute.

Roths are still a relatively new investment option, but more investors are coming to understand their tax benefits over traditional IRAs, financial advisers say. For youngsters, these benefits are especially favorable. And advisers say that parents searching for financial tools for both themselves and their children are increasingly making the connection.

Half a Century to Save

'We've seen a lot of interest in the last year and a half," says Peter Syslack, retirement-services manager for **Strong Financial**. Strong's Web site now includes information about Roths in a section devoted to IRAs for minors, he says, and the company likely will do more marketing in the future.

"A lot of individuals come and say their children are earning some additional money," and they ask, "What can they do with it?" Mr. Syslack says.

Bret, for example, worked part-time as a handyman at his family's mobile-home park. His parents learned about Roth IRAs from their adviser shortly after the accounts became available in 1998. They hadn't considered retirement planning for Bret and his brother, Brooks, now 20. But when they learned that their sons were eligible for Roths, they opened accounts for both of them.

In a traditional IRA, investors get an income-tax deduction for their contributions to the account; they pay taxes only when they withdraw the money from the account. A Roth is basically the opposite. Contributions are made with after-tax dollars, and the withdrawals are tax-free. That's why they're so appealing for children and teenagers. Contributions are taxed at the account holder's rate, which means little or nothing in the case of most teenagers. And the principal has the potential to compound for perhaps half a century before the account holder needs it.

There also is some flexibility: Roth contributions can be withdrawn for college expenses, and up to $10,000 can be taken out for a first-time home purchase, both without taxes or penalties.

If you're not interested in saving for something 40 or 50 years away, someone else can do it for you. The contribution can be made by parents, grandparents or others, as long as it doesn't exceed your actual earned income or the maximum allowable contribution, now capped at $3,000 a year and growing incrementally to $5,000 in 2008, according to the Internal Revenue Service.

Roths don't work for everyone under 18. The biggest barrier: Contributions are based on earned income, so young people who don't work aren't eligible. Another issue that gives parents pause is control over the account. Roth accounts are opened under a custodial arrangement, with an adult in control. But once you turn 18, the money is all yours. You will be responsible for managing the investments. And if you want to withdraw it early and go on a spending spree, you can. Your parents will be stuck with the early-withdrawal penalties and taxes.

Still, Kevin McKinley, a financial planner in Eau Claire, Wis., routinely recommends Roths to his clients. "I rank it right behind college savings plans, but a very close second," says Mr. McKinley. "You can relatively easily borrow money to go to college, but our kids can't borrow money to retire."

He opened a custodial Roth for his own daughter Ellie, age 3, funded with the $2,000 she made modeling for the cover of her father's book, "Make Your Kid a Millionaire." If that money grows at 10% annually, he says, she'll have over a million dollars to withdraw by the time she is 67, without ever paying taxes on it.

'Legitimate' Income

It doesn't matter when you started earning. But to qualify for a Roth IRA, the income has to be "legitimate." In other words, an allowance you get for household chores won't count. More unusual tasks, such as painting the house, could count. More typical would be work in a family business or in the outside world—flipping hamburgers or mowing lawns.

No matter the source of the income, it is important to keep records of exactly when and how it was earned in case the IRS ever questions the income, says Phillip Cook, a financial planner in Torrance, Calif. W-2 forms are best, but the IRS also would accept a log that covers what work was done, when and the compensation. Minors generally don't need to file a tax return unless their earned income was greater than the standard deduction ($4,550 for 2001).

There is no minimum earning requirement to open a Roth, though financial institutions that offer Roths typically have a minimum deposit. At some firms, such as Strong Financial, the minimum is as low as $250.

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Many family-finance experts say this is a perfect opportunity for young people to learn about long-term saving and how the markets work. Carrie Cooper, an investor-center manager for mutual-fund company **American Century Investments** in Kansas City, Mo., says she sees clients do just that. One grandfather regularly brings in his grandchildren and has them hand over their deposits to their financial planner, then go over their statements.

For his part, Bret Hartt says he reviews his quarterly Roth statements, and they have made an impression. "I definitely would do this for my own kids," he says.

Do you have earned income? How do you plan to use it? Write to ***letters.classroom@wsj.com.***