My teen received $2,000 from grandparents. Can we put that into an IRA?

Bob Fredrikson
FREDRIKSON FINANCIAL ADVISORS

Wow! Many 17-year-olds would be spending it on a trendy outfit or gizmo. For most, $2,000 is not life-changing money, but for a teenager it very well can be. First, your son has time on his side, and second, learning to save versus consume will greatly impact his financial future.

If his income for the tax year is at least the $2,000 contribution amount, you can get him started by opening a custodial Roth IRA. Because he is 17, an adult must be named as custodian.

The Roth IRA makes the most sense for one reason, taxes. First, we'll assume he is not a teen phenom with endorsement deals and his income tax rate is low or zero. This eliminates a traditional IRA because its main benefit over a Roth IRA is the pre-tax nature of contributions. Traditional IRA withdrawals will be taxed at his rate at the time of withdrawal, and Roth IRA withdrawals are tax-free, if taken after age 59½. A Roth offers some flexibility in that the principal can be withdrawn at any time without tax or penalty. The earnings withdrawn will be assessed a 10 percent penalty, plus income tax at his rate.

Being the smart young man he is, he'll surely avoid this mistake and allow "compound interest, the Eighth Wonder of the World" (Albert Einstein) to work for him. Assuming an 8 percent annual return, his first $2,000 will grow to $37,250 tax-free, by age 59½. By repeating the $2,000 investment annually, he will have $633,000 to withdraw tax-free at age 59½. That's real money . . . even for a teen phenom.