

FIRST-TIME FILERS: TEENS AND FINANCE

Remember the excitement of your first job? Going from little or no income to a weekly paycheck can seem like winning the lottery. This first job is not only an introduction to the working world, but also the world of finance - from paying in taxes, to filing a return, and saving (or spending) the money one earns.

Withholding

First-time wage earners are often surprised by how much money their employer withholds from each paycheck. Employers who pay wages are required to deduct and withhold various taxes and remit them to the taxing authorities. Withholding includes federal income tax, Social Security (FICA) and Medicare taxes, and depending on where the employee lives and/or works, there may be state, city, and local taxes as well.

Employees can decide how much federal and state income tax to have withheld. Form W-4 is used to determine the number of exemptions to claim, which in turn will determine the amount of tax that will be withheld by the employer. States may use the federal form to determine withholding or may provide their own form. FICA/Medicare tax is withheld at a flat 7.65 percent. The good news is that the employer matches that amount.

For most students, claiming one allowance is usually adequate. If more withholding is desired, zero allowances should be claimed.

In certain instances, an employee may be exempt from income tax withholding. Exemption from withholding may be claimed if the employee did not have a tax liability for the preceding year and anticipates having no tax liability for the current year.

Example: Susan is a high school student. Last summer, she earned \$2,000 working part time at the local ice cream shop and had \$100 withheld. Because the standard

deduction for a dependent is higher than the amount that Susan earned, she had no federal tax liability and filed only to claim a refund of the \$100 withholding. Susan is working at the ice cream shop again this summer and expects to make the same amount of money. She does not have any

other sources of income. Because she had no tax liability last year and expects to have none this year, Susan can check the box on Form W-4 to claim exemption from withholding this year.

Note: A dependent cannot claim exemption from withholding if he or she has more than \$250 of unearned income (such as interest and dividends) and has total income of more than \$750.

Working teens often don't earn enough to owe any taxes. But in many cases employers have withheld some of the earnings, and a tax return must be filed to claim a refund.

— Sheila Bartlett, CPA,
Tax Research Specialist

Self-Employed Teens Beware

Without proper planning, self-employed individuals can end up with a rather unpleasant surprise at tax time. The catch is that self-employed individuals do not have taxes withheld.

Self-employed teenagers, including those working as subcontractors, are subject to income tax. They are also subject to self-employment tax (both the employee's and employer's share of the FICA and Medicare tax) when their net self-employment income is more than \$400. (Newspaper carriers under age 18 are not subject to self-employment tax.)

Self-employed individuals generally pay in their taxes by making quarterly estimated tax payments. Unless the tax bill (income and self-employment taxes) is expected to be more than \$1,000, no estimated payments are required. However, it is a good idea to save a portion of one's income each month to pay in the tax when the return is filed.

Calculating the Tax Liability

Just like any worker, the teenager is responsible for reporting his or her income and for figuring the tax due. Even if no tax is due, a return should be filed to claim the refund of withheld income tax.

Most teenagers can be claimed as dependents on their parents' returns and, if so, cannot claim a personal exemption on his or her return, even if the parents choose to waive the exemption.

A dependent is entitled to a standard deduction. This standard deduction is limited to the greater of (1) \$750 or (2) earned income plus \$250, but not greater than \$4,750 (2003). Here are some examples that illustrate how the dependent standard deduction works.

Earned Income	\$ 0	\$2,000	\$ 2,000	\$ 2,000	\$ 4,000	\$5,000
Interest Income	1,000		50	500	50	500
Total Income	\$1,000	\$2,000	\$ 2,050	\$ 2,500	\$ 4,050	\$5,500
Standard Deduction	(750)	(2,250)	(2,250)	(2,250)	(4,250)	(4,750)
Taxable Income	\$ 250	\$ 0	\$ 0	\$ 250	\$ 0	\$ 750
Tax	\$ 26	\$ 0	\$ 0	\$ 26	\$ 0	\$ 76

Saving for a Rainy Day

The feeling of confidence and independence a teenager can gain from earning his or her own money is important. It is also important to use this opportunity to learn financial responsibility.

Understanding the requirement to pay income taxes is just the beginning. Saving or investing a portion of each week's income is another important element of financial responsibility. A savings goal, such as saving for a car or to help pay for college, makes not spending the money a lot easier. It helps to see just how much can be saved over just a few years.

Consider the following comparison between spending each week's wages and saving a portion of the wages.

	Save 0%	Save 33%	Save 50%
Earnings (\$300/wk for 16 weeks)	\$4,800	\$4,800	\$ 4,800
Amount saved each year	\$ 0	\$1,600	\$ 2,400
Total amount after 4 years	\$ 0	\$7,044	\$10,566
Interest Earned*	\$ 0	\$ 644	\$ 966

*4%, compounded monthly

The amount available at the end of four years can be used for a significant purchase, invested, or left in the account for future accumulation.

The first step in any financial plan is to establish a reasonable goal. Once the steps required to meet that goal are determined, discipline ensures successful completion of that goal. This often means forgoing small rewards in exchange for substantial ones.

Summary

Budgeting, saving, and taxes are not high priorities for most teenagers. However, they can help teach teens important skills that will be useful their entire lives. Understanding withholding and the importance of filing one's income tax return will make a lifetime of filing less stressful. Learning how to budget at an early age can help the student during his or her college years and beyond.