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Summertime Tax Tips For Teens And Parents

School is out and many parents and students are beginning to make summer plans. Whether the child works for his or her parent's business, spends a semester overseas or gets a head start on college classes, there are tax benefits from these activities in addition to the life-experiences that they provide.

Withholding break

Young adults are often in a position to claim a complete or a partial exemption from federal tax withholding. A student or a child under age 19 may claim a withholding exemption even though a dependency exemption is claimed by his or her parent. Generally, an individual who may be claimed as a dependent by another person is exempt from withholding unless (1) income exceeds \$800 and includes more than \$250 in unearned income such as interest or dividends or (2) the taxpayer has no tax liability for 2004 and 2005 because total income was not more than \$4,850 for 2004 or projected to be not more than \$5,000 in 2005. A claim for this exemption is made on Form W-4.

Family Business

If the teenager works in a family business, everyone could benefit. Business expenses are deductible from gross income, and include expenses for labor. That includes wages for *bona fide* labor of children of the proprietor. Since many teenagers do not meet threshold minimum income for having income taxes withheld, it is likely the teenager will not have to pay taxes on his or her salary, while giving the family business a deduction against income.

Additionally, if a teenager works in his or her parent's sole proprietorship, or in a partnership where each partner is the teenager's parent, the young adult may not be liable for FICA or FUTA taxes, as employment for Social Security generally does not include services performed by an employee under 18 working for a parent. In the case of unemployment taxes, an employee under 21 is not liable when working for a parent. Again, this means that the teenager will see more of his or her paycheck.

Example. Connie and David own a dry cleaning business, which they operate as a partnership. They are the only partners. This summer, their 17-year old daughter Alexis is going to work part-time as a cashier at the shop. Connie and David will not have to pay FICA and FUTA taxes on Alexis' earnings.

IRAs

Another benefit not to be overlooked when a teenager works for the summer and recognizes earned income is the opportunity to open an individual retirement account (IRA). To contribute to an IRA, regardless of the type, an individual must have earned income, so a summer job is a great time to open one. While saving for retirement is probably not the first use that the teenager has in mind for his or her summer earnings, it's never too soon to start saving. Short-term, the funds are available for withdrawal should they be needed to cover college expenses, without triggering a 10 percent early distribution penalty. If it is a Roth IRA, withdrawal of after-tax contributions also avoid income tax on those withdrawals. The maximum amount that can be deposited in either a Roth or traditional IRA is the lesser of earned income or \$4,000 in 2005.

Since retirement seems so far off to many young people, parent-employers may have better luck getting their teenagers to think long-term with an IRA if they match the child's pay with a gift. The origin of the IRA contribution is not restricted beyond the amount of income the owner has and it does not exceed the annual cap.

Caution. One cautionary note to parents is in order, however. Even if the parent matches funds contributed to the teenager's IRA, the child owns the IRA, and may withdraw the money at any time. A penalty may be incurred, but ultimately the owner decides what should be done with IRA assets.

Studying Abroad

For many students summer bring trips abroad to take classes immersed in another culture. For their parents, tax planning may help lessen the financial impact the trip can have. While they're unlikely to cover the entire cost, the tax benefits are often worth examining.

Educational savings accounts, also known as Coverdell Education Savings Accounts, may be used for tuition, accommodation and various other expenses related to education. The accounts may be funded with up to \$2,000 annually, and any distribution used for qualifying expenses is tax-free. The definition of qualifying expenses is broad, and includes tuition, fees, books, supplies, equipment, computer equipment, tutoring and room and board. Travel, however, even to the selected educational institution overseas, is not a qualifying expense.

The rules on qualifying uses also are quite liberal as they apply to enrollment and school eligibility. With a Coverdell ESA, the student need not be enrolled half-time to utilize the funds, unless the funding is for room and board. A degree need not be sought to use the funds. Virtually all accredited U.S. schools are eligible, and many overseas schools are as well. If the student chooses to study at an institution abroad that does not qualify during the academic year, the student should check to see if the summer program qualifies independently.

If the student's parent does not have an ESA set up, his or her parents may be able to use other tax incentives to offset some educational expenses. The HOPE Scholarship and Lifetime Learning credit may be available for college-level tuition costs. The Hope credit allows for a 100 percent credit for the first \$1,000 in tuition and 50 percent for the second \$1,000. Alternatively, the Lifetime Learning credit is available for 20 percent of the first \$10,000 in tuition but is only available if the HOPE Scholarship is not used. These credits are generally only available for tuition, however. Books and supplies may

qualify if those expenses are part of a mandatory enrollment fee but, ordinarily, books, supplies, computer equipment, and other items eligible under ESAs are not available under the HOPE or Lifetime Learning credits.

Head start on college

A Coverdell ESA may be used for expenses of students attending summer classes and study programs at colleges and universities. Distributions may be used for the costs associated with those classes, including room and board, tuition, fees, and supplies. Other tax credits like HOPE and Lifetime Learning will not be available in this case, however, because the student will not be enrolled half-time, as is necessary to utilize those tax breaks.