

A Tax Guide for the MSTP Student

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Calculating and paying Federal (IRS) and State income taxes can be challenging for the one who is new to actually having income to pay taxes on. But the issue can get particularly involved for those in the MSTP. And in Alabama, it's even trickier, since Alabama treats certain types of stipends differently than the IRS for determining taxable income. This "brief" guide is a supplement to what has been put together by Dr. Lorenz. Many items here overlap and repeat what Dr. Lorenz has written.

This document is NOT intended to be a complete, step by step protocol (although I wish such a thing were possible!) But after reading both documents, I hope that you will have 95% of the info you need to understand your taxes while in the MSTP and that you will have the tools and vocabulary to figure out the remaining 5%.

Note, you can easily find IRS documents, forms and instructions by google-ing "IRS" and the publication number, i.e. "IRS 1040" should take you right to the IRS site where you can get a .pdf copy of a 1040 form.

Disclaimer! Do NOT assume anything I have written is complete or accurate. Things change year to year, and despite my years of experience in preparing taxes, I do NOT claim to know everything. So please verify this information by reading the appropriate IRS documents. Also keep in mind that this advice is independent of the MSTP. I am personally writing this as an aid to you. And while I may ask the MSTP's help in getting this document to you, it is not vetted by the MSTP, and UAB and the MSTP will take no responsibility for what is written herein.

There are many different types of taxes: sales taxes, use taxes, real estate taxes, personal property taxes, etc. But as far as your stipend is concerned there are only two types of taxes that apply. INCOME taxes, and PAYROLL taxes. Payroll taxes are taxes that are generally assessed on ALL of your income below (for 2006) about \$97,000. Payroll taxes are also known as "FICA", of which there are two: 1) Social Security Insurance, and 2) Medicare/Medicaid. Due to a special ruling and the special situation graduate students are in, our scholarships and stipends are EXEMPT from all payroll taxes. So you do not owe any SS or Medicare/Medicaid on your stipend. (Warning, a very long aside follows, in smaller print...skip ahead if you must)

That essentially saves you about 7.5% on every dollar we are paid. But you must keep in mind that future Social Security payments we will receive WILL BE LOWER than they could be, because Social Security payments are roughly based on your last 40 years of earnings subject to payroll taxes. I.e. I'm 35 years old, and I have no contributions yet to Social Security. At age 67 I will be eligible for my "full" benefits, which will only be based on 32 years of earnings. Those years of "zero" earnings will bring down the amount I am paid monthly. Should I die at 60, then

it's been a "good deal", since I was spared the taxes as an MSTP and would never have earned any SS anyway. Should I die at 97, then I will have had 30 years of SS payments (from 67 to 97 years old) that are reduced by those "zero" years. Another thing to understand is that SS is an insurance program, where in addition to paying you when you are "old", you are covered NOW for disability, should you become disabled while working. The amount of disability insurance received for the amount one is charged is quite high...that is, it's a great deal compared to buying private disability insurance. While an MSTP you will not be paying payroll taxes so you are NOT covered by any disability insurance (assuming you don't have previous income where you have paid payroll taxes). Although morbid, you need to understand that should you get hit by a car while crossing University Ave and be unable to work in any job again, you are not insured, while essentially every other UAB employee would receive Social Security disability payments for the duration of the disability.

Since payroll taxes don't apply to the MSTP student, we are left with only income taxes.

What counts as taxable income by the IRS?

The short answer is ANY money that comes from UAB that goes into your pocket that you do not then use for 1) Tuition or 2) REQUIRED school fees and books, is taxable. Since your tuition and fees are paid by the MSTP BEFORE they show up in your check, essentially your entire stipend is taxable income. Now, the IRS clearly spells out certain items which ARE taxable to students. Those examples include reimbursement for books, reimbursement for travel, and health insurance. This is clearly explained in IRS Publication 970. Even though health insurance is required for attending classes at UAB, it is specifically addressed by the IRS and is TAXABLE if UAB pays for it (see page 34 of Pub 970). In the time since I have left UAB, I understand that UAB will be changing the method used to pay your health insurance such that it will likely appear as excess income on your paychecks which they then subtract away, making it harder for you to "forget" to claim your health insurance on your taxes. I must emphasize that the tax treatment of paid health insurance is considered by some to be controversial, and I would not take my comments as 100% accurate.

Note, that although your mentor or department may "require" you to attend that scientific meeting in DC, San Diego or the Bahamas, you STILL will owe income taxes on the money paid to offset your costs of going on the trip (hotel, airfare, meals, etc...see section 1 of Pub 970). I'm not sure I can find another grad student that actually reports and pays taxes on that money, but I just needed to warn you. Because, like your health insurance, UAB may change the method used to pay you such that the IRS will see those payments even if you don't report it on your own.

For Federal/IRS purposes, it does not matter what your stipend is called. Regardless of whether it is a scholarship, an assistantship, a fellowship, etc, it's all the same to them as long as you are a student and receive money in excess of tuition and required fees. As I will explain later, for FEDERAL purposes, your classification by UAB and "who actually pays you" (i.e. which grant) affects only how you REPORT and PAY your taxes, but NOT what you will owe. But for

ALABAMA income taxes, there IS a difference in what you owe, which you can read about below.

What counts as taxable income by Alabama?

In general, states generally count as income everything that the IRS does. But for reasons unknown, Alabama taxes ASSISTANTships like regular income, but traineeships and Fellowships are EXEMPT from Alabama income taxes. You will not find this explicitly stated in any Alabama tax document, but it has been settled in Alabama "Revenue Court". So you will save roughly 5% (the Alabama tax rate) when not on an assistantship. Anyway see below for the ways in which you can be classified by UAB which affects how you report and pay taxes.

What about "local" taxes?

Local taxes are income taxes assessed by the city of Birmingham and Jefferson County. Together they amount to 1.5% of your income. They are taken directly "off the top" of your stipend. That is, you don't have to do anything to file or pay your taxes. If you owe them, they've already been taken out of your check. You don't have to file a city or county tax return. If I recall correctly, if you owe Alabama taxes then local taxes will be automatically paid from each paycheck. But if you do not owe Alabama taxes (i.e. you are on a traineeship or fellowship) then local taxes will not be subtracted....

What's the difference between "withholding" taxes, "paying" taxes, and "owing" taxes?

This is a good time to mention that when you have Federal or State taxes withheld from your paycheck you MAY OR MAY NOT ACTUALLY OWE that money. Until you file your taxes, neither you nor the government knows how much you owe in taxes. Tax withholding is supposed to be your best guess at what you might owe, and then you "square up" in April. If you paid more than you owe, you get a refund. If you paid too little, you have to send a check. If you paid WAY too little, you MAY owe a penalty-More on this later. The reason I brought this up now is to distinguish that LOCAL taxes that come out of your paycheck ARE what you owe. You don't file later. In a sense, your paystub IS your tax return and the local taxes get paid on the spot. But for Federal and State taxes, any money that is withheld from your paycheck is calculated based on the guidelines that YOU provide to UAB (via a W-4 form). JUST BECAUSE MONEY IS WITHHELD FROM YOUR TAXES DOES NOT MEAN THAT YOU OWE THAT AMOUNT. BUT ALSO REMEMBER THAT JUST BECAUSE NOTHING IS WITHHELD FROM YOUR PAYCHECK IT DOES NOT MEAN THAT YOU DON'T OWE. It simply means that you are responsible for getting the IRS its money and UAB will not act as the middle man. This is covered rather well in the document provided by Dr. Lorenz.

What will my total taxes be when I finally do file?

I can only cover the most basic of instances here, namely that of a non-married student, no children, with only MSTP income, and no significant tax deductions. Let's start with Federal taxes. Follow along with a printed copy of form 1040. I have provided a sample 1040 form you can use. You may be eligible to use simpler forms like the 1040A, or the 1040 EZ; the 1040 just has more lines, most of which you skip and ignore.

MSTP students are NOT eligible for either the Lifetime Learning Credits or the Hope Education Credits.

Federal Taxes

Assuming that you've been in the MSTP for the whole tax year (i.e. 2nd year students and up) then your income for the year will be your stipend (\$23,000 I believe for 2007, but of course the increase came mid-year 2006 so that your total for 2006 will be less...). Regardless of your status as a student (fellowship, assistantship, etc) you put your income, \$23,000 on line 7. If you were a student for part of the year, then, of course, your income will be less. Your total monies from the MSTP stipend goes on line 7 whether you received a W-2 or not. The amount on line 7 is going to be the total you got paid for the year in stipend, which should be shown on your last paystub of the year, the December check. Now this is where the options can diverge. If you received a W-2 for your entire stipend amount (i.e. your amount on your W-2 matches the "year to date" amount on your paystub), you do nothing further. But if you DID NOT receive a W-2, or if the W-2 only show a PORTION of your stipend for the year then you must indicate on line 7 HOW MUCH of the \$23,000 (or whatever) that you placed in line 7 is actually from stipend received that is NOT on a W-2. For example, for most of you in the labs, the MSTP pays for part of your stipend, and the mentor pays the rest. In this case, only your mentor's contribution will be reported on a W-2. For the sake of illustration, let's say your mentor paid \$13,000 of the stipend, and the MSTP program paid the rest. You would then receive a W-2 in the amount of \$13,000. But your TOTAL goes on line 7 (\$23,000) and then you must write in, to the left of the "\$23,000" the amount that was NOT reported on a W-2. You do this by simply handwriting "SCH \$10,000) there on "dots" to the left. The SCH stands for scholarship or course. What the IRS wants to know is what amount of line 7 they should NOT expect to see a W-2 for. That is, in most cases for most people, line 7 is simply the addition of all their W-2s. But in the case of scholarships, this alerts them NOT to expect line 7 to match your W-2s.

Now, for those who file online, you can't really "write in" anything on the form. But most software allows you to associate "details" with each line, similar to writing it on the form, or attaching a footnote. So add a note/detail/whatever in your tax software that says "SCH \$XX,XXX". If you are following along on the .pdf I filled out, I could not enter any info on the dots, so it's missing in that sample 1040.

Keep in mind that I don't know how UAB is handling health insurance and student health fee payments. They may report this on a W-2, in which case it gets reported on line 7.

Now let's go down the page of the 1040. As you can see, lines 8 to 21 don't likely apply to you. So you just ignore them. But line 21 is where you would list reimbursements for books, travel, and health insurance paid by UAB PROVIDED ITS NOT ALREADY ON THE W-2. Total up the lines and this goes on line 22. I'm not going to include any "other income" for this illustration. You can then see that lines 23 to 35 likely don't apply to you. So leave them blank (blanks are the same as zeros) and you end up with \$23,000 on line 37, which carried to line 38.

On line 40 you take the "standard deduction" which is available to every tax filer. The amount differs based on your filing status. But for single folks it's \$5150 for 2006, so enter this amount here. Of course, you MAY OPT to take an "itemized deduction" instead and use it if it exceeds \$5150. Look up "schedule A" which deals with itemized deductions so you can see what types of items are deductible. But in 99% of the cases with MSTP students, the standard deduction exceeds the itemized.

Line 41 is the standard deduction deducted from your income, for a total of \$17,850.

Line 42 is where you get to account for the number of "dependents" you have. In most cases, the number is "1", you depend on yourself. If you are married and filing jointly, this would be "2". If you are married with 3 children, this could be "5". But keep in mind that some parents will claim their post-college children as dependents. If you claim yourself as a dependent AND your parents ALSO claim you as a dependent, then someone is going to be in trouble. Verify with your parents that they are not claiming you as a dependent before you claim yourself. I think they are only allowed to claim you up until age 24 (not positive about this) and there are other rules. But talk to them first. Anyway, each dependent allows you to subtract \$3300 from your income, so your net "taxable income" on line 43 is now \$14550. In order to figure out your tax due to the IRS, go to page 67 of the 1040 Instructions and use the tax tables. In this case, the federal tax on your income is \$1794. The rest of the 1040 is self-explanatory.

The IRS expect to be paid this amount by April 15 through a combination of three ways 1) direct withholding from your paycheck 2) checks mailed to them quarterly as estimated payments and 3) a check mailed with your tax return when you file. In general though, the US tax system is a "pay as you go" system, where the IRS expects to receive taxes from you as you earn the income. So don't expect to be allowed to wait until April to pay all of your taxes, or you will be penalized. Dr. Lorenz covers this a bit in her tax document. I'll also discuss it a little more here. But please read form 1040-ES which covers paying estimated taxes to avoid under-withholding penalties.

How do I pay?

As I mentioned you pay your taxes through a combination of telling UAB how much to withhold from your paycheck, estimated taxes you mail to the IRS, and a check you mail when you file. HERE ARE THE (simplified) RULES YOU NEED TO KNOW in order to avoid penalties (found in form 1040-ES).

RULE #1: If you will owe less than \$1000 when you file, NO PROBLEM. You simply mail the IRS a check when you file. For example, first year students who have income for half a year will owe less than \$1000, so there is no penalty for not withholding taxes or making estimated payments. So anytime you will owe LESS THAN \$1000 when you file, you will pay no penalties. Keep in mind that when I say “owe” in this case, I DON’T mean your total tax as shown on line 63 of the 1040. I mean the amount of line 63 that the IRS has NOT YET GOTTEN WHEN YOU FILE, i.e. line 76. Of course, if your total tax is less than \$1000, you cannot owe more than that. That means that all you have to do to avoid penalties is have taxes withheld to get you within \$1000 by the time you do your taxes. Alternately, you can pay estimated taxes to get you within \$1000. But if you simply don’t pay any taxes and then find at tax time you owe \$1794, then you will have to pay some penalty.

RULE #2: IF YOU OWE MORE THAN \$1000 come tax time, as shown on line 76, then to avoid penalties you must have paid, via a combination of estimated taxes and withholding, AT LEAST AS MUCH AS YOU PAID THE PREVIOUS TAX YEAR. This rule generally only comes into effect if you get a big raise, win the lottery, etc. It simply means that in any given year, if you paid estimated taxes and/or withheld as least as much as you did last year, you are safe and owe no penalties, whether you owe \$1100 or \$11 Million.

In general, rule #1 is what you want to shoot for...get your payments within \$1000 and avoid all potential penalties.

The reason this is important to you is that depending on how you are classified by UAB, you may not be ABLE to have taxes withheld. For example, anyone paid solely through MSTP funds will not be eligible for having taxes taken directly out of their paycheck, so must make estimated taxes to avoid penalties. Estimated taxes have 4 due dates, and you must pay roughly 25% of your tax liability at each due date. What you need to do is estimate how much you will owe in taxes for the year, and divide by 4, and pay this amount quarterly (very clearly explained how to do this on form 1040-ES). Remember, you only need to get within \$1000. And if you can do this via withholding, then you don’t need to pay estimated taxes at all.

Alabama Taxes

Look at a copy of Alabama form 40 and follow along. I could not get a filled-out sample form to print.

The basics in reporting and paying state taxes are the same as federal taxes. But there is one notable difference. Alabama only taxes the portion of your stipend that shows up on a W-2. It doesn’t make any sense, but it’s to your benefit so accept it. But REPORTING this difference can be confusing. Basically, in line 6 of form 40 you report ONLY THE AMOUNT that is reported to you on a W-2. From our example above, this is \$13000. You then follow the instructions for the form as written. Note, if you did not receive a W-2, your Alabama income is ZERO and you owe no Alabama income tax on your stipend.

But pay attention...you MUST tell Alabama WHY the amount you report to them differs from the amount on your FEDERAL 1040. That is because the IRS supplies a copy of your 1040 to the states, so that they can be sure everything matches. Therefore, you must make sure you fill out "Part IV" on Page 2 of form 40. Here on line 6 you write in the amounts from your Federal tax form, and then you get to explain why you claimed less for Alabama. Essentially, you have to tell them you reported \$10,000 less to them, because Alabama does not tax the non W-2 portion of the scholarship. So on line 6 I write is "Scholarship not taxable by AL" and then the amount "\$10,000" in the given space. Just make sure the amount you place on line 6 of Part IV, when added to line 6 of part I, adds up to the total amount you reported on your IRS 1040 on line 7. This means that even if you have no taxable income for Alabama, you must still file state taxes, because otherwise Alabama will assume you just neglected to pay them, since they'll get a copy of your 1040 which shows federal tax due.

Other issues such as withholding and estimated taxes are the same. That is, Alabama wants its money as you go. In order to avoid STATE penalties you must be within \$100. This can be very hard to estimate in advance, so be careful. One almost always overpays state taxes and gets a refund. Or, you can avoid the penalty by withholding at least as much as you owed the previous year.

Final notes

There is no way for me to possibly cover everyone's scenario and answer everyone's questions. But I hope this gives you some additional insight into the US tax system as it pertains to MSTP students. If you have any questions at all, please do not hesitate to contact me. I will make every attempt to answer your specific question. Also, if anyone finds any errors, or feel something needs additional clarification, let me know and I can update/modify this document.