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The Long and Winding Medical Resident FICA Road for Academic Medical Centers

Elizabeth M. Mills, Esquire
Proskauer Rose LLP
Chicago, IL

For the past eleven years, many academic medical centers have wondered whether they are entitled to refunds of Social Security and Medicare (FICA) taxes paid on medical residents' stipends. Those organizations in quest of FICA refunds have argued that medical residents are not employees for purposes of FICA taxes, but instead are properly classified as students not subject to such taxes. This issue has snaked through numerous federal circuits at both the trial and appellate levels, but took a sharp turn earlier this month when the Eighth Circuit Court of Appeals upheld a Treasury Regulation that explicitly precludes residents from qualifying for the student exception.[1] This appears to be the end of the road for those seeking refund claims for tax periods following the regulatory change. Still unresolved, however, are thousands of refund claims now pending for the eight to ten years preceding the regulation's effective date of April 1, 2005.

This article begins with a review of the technical argument driving the FICA refund claims. It then examines the counter argument asserted by the Internal Revenue Service (IRS) and surveys the winding journey through the courts. The article concludes with a prediction of the possible future twists in the road.

[1] Mayo Foundation for Medical Education and Research v. United States, Nos. 07-3242, 08-2193 (8th Cir. June 12, 2009).

Background

Employers are obligated to withhold from their employees' wages certain employment taxes, including federal and state income taxes and the employees' share of FICA taxes. Other employment taxes are levied on employers such as federal unemployment (FUTA) taxes and the employers' share of FICA taxes. These withholding obligations and tax liabilities represent a significant sum of money: the combined Social Security and Medicare tax rates are currently 7.65% for employers and 7.65% for employees.[2]

Medical residents in graduate education programs are considered employees for employment tax purposes. But employee status does not automatically mean an individual's wages are subject to FICA taxes. Section 3121 of the Internal Revenue Code (Code) defines "wages" as "all remuneration for employment," but there is an array of exclusions. Code Section 3121(b)(10), for example, excludes from the term "employment" services performed in the employ of a school, college, or university (or a supporting organization thereof) if the service is performed by a student who is enrolled and regularly attending classes at such organization. Thus, if a medical resident is a "student" who is enrolled and regularly attending classes at a school, college, or university, neither the resident nor his or her employer is subject to FICA taxes on the resident's stipend—even though the resident is considered an employee for other employment tax purposes.

In 1998, the United States Court of Appeals for the Eighth Circuit determined just that, holding that medical residents in University of Minnesota hospitals were students exempt from FICA tax. A number of academic medical centers immediately began filing FICA tax-refund claims with the IRS for open tax years.

[2] The employee component is imposed by Code Section 3101, while the employer component is imposed by Code Section 3111. While Social Security tax is not imposed on wages over an annual dollar amount (more than $100,000 in 2009), resident stipends are typically below this wage base, and thus Social Security and Medicare taxes are not differentiated in this discussion. It should be noted, however, that while governmental employers may be exempt from Social Security taxes, they are generally not exempt from Medicare tax.

(In 1998, open years could go back to 1995.)[3] And many academic medical centers have continued to file refund claims for each calendar quarter—some larger programs have accumulated tens of millions of dollars of claims.

A FICA tax-refund claim consists of two parts: (1) the academic medical center's demand for repayment of the employer component of FICA taxes paid; and (2) each individual resident's demand for repayment of FICA taxes withheld from their stipend. Some academic medical centers pursue only the employer component,[4] but programs can also request refunds of the employee component on behalf of their residents,[5] provided that each resident individually consents to such representation and agrees not to submit a separate individual claim for refund. Refund claims can enter the court system in two ways. A taxpayer can pursue a refund claim in federal court if the claim was denied by the IRS or if the IRS did not act on the claim within six months of its submission. Alternatively, the IRS can pay a refund claim but then sue the taxpayer to recover what it determines to be an erroneous refund. The cases discussed below have arisen in both ways.

The IRS has periodically indicated over the past decade that it might develop a settlement program or other uniform resolution for outstanding claims. This has not happened, nor has the IRS acted on most of the existing pending claims. Some employers have pursued their refund claims in federal court (or defended erroneous refund claims) and, at least on a preliminary basis, have been found to be entitled to claim the student exemption.

In 2004, however, the treasury amended the regulations under Code Section 3121, effective as of the second calendar quarter of 2005, to specifically indicate that medical residents do not qualify as students for purposes of the FICA

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[3] A claim for refund of tax paid must be filed within two years of the time of payment or three years from the due date of the return, whichever is later. Code Section 6511. Employment taxes are filed on a quarterly basis—the relevant return is Form 941, filed quarterly—but all returns for one calendar year are deemed filed and taxes are considered paid on April 15 of the following year. Code Section 6513.

[4] See*, e.g., Univ. of Utah v. United States,* No. 2:06-cv-00595 (D. Utah 2008).

[5] Treasury Regulations Section 31.6402(a)-2(a).

student exception. It is the validity of those regulations that the Eighth Circuit recently decided.

The First Case

Minnesota v. Apfel,[6] decided in 1998, was the kickoff event for the current round of debates on the medical resident FICA issue. Interestingly, *Apfel* involved the Social Security Administration as the interested government agency rather than the IRS. State and local governmental entities, as well as tax-exempt organizations, have enjoyed various degrees of exemption from the Social Security program and accompanying taxes over the years. The Social Security commissioner had assessed FICA tax on the University's residents, and the University, a state institution, sought a redetermination of its liability in order to establish that the residents in its graduate medical education programs were not subject to FICA taxes under the agreement between the University and the Social Security Administration. The lower court held that the residents were exempt from FICA tax under the agreement, or even if they were not exempt under the agreement, they were exempt under the student exception of Code Section 3121(b)(10). The Eighth Circuit affirmed on both alternative grounds. The court explained that even though the residents were considered employees for income tax purposes—because the residents' wages were a quid pro quo for their services—the FICA student question focused not on the nature of the payment, but on the relationship between the resident and the University. Residents were considered students if the purpose of their employment with the University was primarily educational, rather than to earn a living. The court agreed with the University that the primary purpose of the residents' activities was to pursue a course of study. The court noted that the Social Security commissioner had issued a 1978 ruling that residents were not students, but observed that the Commissioner could not establish a bright-line rule and thereby avoid a case-by-case analysis of the facts.

[6] 151 F.3d 742 (8th Cir. 1998).

The IRS Deliberations

After the Eighth Circuit affirmed the exemption of medical residents from the FICA tax, many academic medical institutions began to file claims for all open years. The IRS began to formulate its position, first articulated in a 2000 Chief Counsel's Advice (CCA).[7] The CCA directs field agents to first identify the employer. This is important because if the employer is a governmental entity, services may be covered under an agreement with the Social Security Administration; further, because the resident must be an employee of a school, college, university, or a related Section 509(a)(3) organization for the exemption to potentially apply. The CCA observes that a medical school is a school, college, or university, but a hospital generally is not. Second, the CCA directs agents to examine the facts and circumstances, but explains that the student exception is available only for students who are enrolled and regularly attending classes. Interestingly, the CCA states that a *per se* position that medical residents are not students for Code 3121(b)(10) purposes would be inconsistent with the applicable regulations.

Subsequently, in Chief Counsel's Advice 200212029 (March 22, 2002), the IRS Chief Counsel's office concluded that residents should not be considered "students" because they are engaged in on-the-job training. In Chief Counsel's Advice 200145040 (November 21, 2001), the Chief Counsel's office concluded that a teaching hospital should generally not be considered to qualify as a "school, college, or university" for purposes of Code Section 3121(b)(10).

In 2005, there was some discussion that the IRS would issue settlement guidelines for medical resident FICA cases, but these did not materialize.

The Pre-2005 Regulation Cases

In litigated cases involving years before April 1, 2005, the government originally won some victories on summary judgment on the theory that residents were excluded from student status for FICA tax purposes, no matter what the facts or

[7] Chief Counsel's Advice 200029030 (July 21, 2000).

circumstances. However, in the past two years, this theory has been rejected by the Courts of Appeals in the Second, Sixth, Seventh, and Eleventh Circuits, and the refund claims have been allowed to proceed in district court. Further, after moving to the facts and circumstances analysis, lower courts in the Eighth and Eleventh Circuits have determined that residents are in fact students based on the particular facts presented. The cases falling into these categories are as follows:

Category	**Cases**
District court cases (not overturned on appeal) holding that residents are categorically precluded from being students	None
District court cases holding that residents are *not* categorically precluded from being students	*United States v. Univ. Hosp.*, No. 1:05-CV-445 (S.D. Ohio July 26, 2006); *Ctr. for Family Med. v. United States*, 456 F.Supp.2d 1115 (D.S.D. 2006); *United States v. Partners Healthcare Sys.*, 05-11576-DPW (D. Mass. September 30, 2008).
Appellate court cases holding that residents are *not* categorically precluded from being students	*United States v. Mem'l Sloan-Kettering Cancer Ctr.*, 563 F.3d 19 (2d Cir. 2009); *United States v. Detroit Med. Ctr.*, 557 F.3d 412 (6th Cir. 2009); *Univ. of Chicago Hosps. v. United States*, 545 F.3d 564 (7th Cir. 2008); *United States v. Mount Sinai Med. Ctr. of Florida*, 486 F.3d 1248 (11th Cir. 2007).
District court cases holding that residents are students under the facts and circumstances analysis	*Ctr. for Family Med. v. United States*, 05-4049-KES (D.S.D. August 6, 2008); *United States v. Mount Sinai Med. Ctr. of Florida*, 102 AFTR 2d 2008-5373 (S.D. Fla. July 28, 2008).

There has been some discussion in 2009 that the Department of Justice (DOJ) has settled or is in the process of settling cases in the circuits with positive circuit court decisions. Settlement terms have not been made public.

The Post-2005 Regulation Cases

As noted above, a new regulation defining the student exception was promulgated effective April 1, 2005.[8] The language of the regulation[9] has several provisions that affect the applicability of the student exception to residents. First, it provides that a person whose normal workweek is forty or more hours will not be considered a student. Second, for purposes of determining whether the student is enrolled in a course of study at a school, college, or university, it uses the narrow definition of "school, college, or university" found in Code Section 170(b)(1)(A)(ii). Finally, Example Four of the regulation describes a medical resident fact pattern and states that the individual is not a student in this case.

A lower court in the Eighth Circuit twice determined that the new regulation (effective on April 1, 2005) was invalid and did not preclude residents from being considered students.[10] It is those decisions that are reversed by the recent Eighth Circuit decision in *Mayo*. The Eighth Circuit determined that it was permissible for the Treasury to define terms in the statute, such as "students," and that the new regulations were therefore not inconsistent with the statute. The court rested its decision that residents could not be students on the full-time condition and did not reach the question of whether the narrower definition of "school, college, or university" was valid.

What's Next?

Even if the government ultimately prevails for both pre- and post-2005 periods and residents' stipends are determined to be subject to FICA tax, most academic medical centers will not face an out-of-pocket cost. Academic medical centers that have paid and withheld FICA taxes on an ongoing basis—and have not received a refund—have fulfilled their FICA obligation. What would be lost in that situation is the opportunity for academic medical centers to recover the

[8] T.D. 9167, December 20, 2004.
[9] Treasury Regulations Section 31.3121(b)(10)-2.
[10] *Mayo Found. for Med. Edu. and Research v. United States*, 503 F.Supp. 2d 1164 (D. Minn. 2007); *Regents of the Univ. of Minn. v. United States*, 2008 WL 906799 (D. Minn. April 1, 2008).

potentially large amounts paid, funds that would be very welcome in these economic times.

With respect to pre-2005 claims, the IRS has not indicated that it plans to craft or offer a global settlement. Cases that are in litigation are under the control of the DOJ, not the IRS. Unlike Tax Court litigation, in district court or Court of Federal Claims litigation, the DOJ (not the IRS) represents the government. The DOJ is obligated to consult with the IRS if it wishes to settle a case. It is possible that the DOJ could determine that it will settle some or all outstanding court cases. The recent Eighth Circuit case does not create a split of the circuits because the pre-2005 cases were not decided based on the regulation, although it remains to be seen whether the Eighth Circuit case will have any impact on courts' interpretation of pre-2005 provisions or DOJ's approach to cases.

The prospects for wins or settlements in post-2005 cases, however, have been dimmed by the Eighth Circuit ruling last week. As can be seen from the aforementioned discussion of cases, courts in the Eighth Circuit have until now consistently found for the taxpayer in medical resident FICA cases. In addition, legislative proposals to address the issue may re-emerge. Already, the Senate Finance Committee has included as one option for funding a part of health reform the codification of the 2005 regulation. If such a provision is enacted, the medical resident FICA saga (for periods after April 1, 2005) may come to the end of its long and winding journey.