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SUPREME COURT UPHOLDS REGULATION REQUIRING MEDICAL RESIDENTS TO PAY FICA TAXES

On January 11, 2011, the United States Supreme Court unanimously upheld a Treasury Department regulation that treats wages paid to medical residents as subject to FICA taxes. This decision in Mayo Foundation for Medical Education and Research v. United States, Sup. Ct. Dkt. No. 09-837 (January 11, 2011), should mark the end of many years of litigation over the proper FICA tax treatment of medical residents, but it will not adversely affect properly filed FICA tax refund claims for tax periods ending before April 1, 2005 (the date of enactment of the regulation at the heart of the current dispute).

HISTORY OF THE "STUDENT" FICA EXCEPTION

The Federal Insurance Contribution Act ("FICA") imposes taxes on wages earned by employees to fund the Social Security and Medicare Trust Funds pursuant to Sections 3101 and 3111 of the Internal Revenue Code of 1986, as amended (the "Code"). Both the employer and the employee pay FICA taxes, unless a specific exception applies. Code Section 3121(b)(10) contains an exception for students performing services for a school, college or university in which they are enrolled.

The position that medical residents should be considered "students" excepted from FICA taxes was introduced in 1998 by Minnesota v. Apfel, 151 F.3d 742 (8th Cir. 1998). In Apfel, the Social Security Administration ("SSA") had sought to treat stipends paid to medical residents as subject to FICA taxes. These stipends had not been subject to FICA taxes because the State of Minnesota had an agreement with the SSA, which specifically excluded any service performed by a student. The Eighth Circuit upheld the district court's decision that medical residents were excluded students under the agreement.

The Apfel case did not directly reach the statutory exception for students found in the Code, but it spurred many to consider the student FICA exception found in Code Section 3121(b)(10) and file for refunds or stop paying FICA taxes on medical resident remuneration. Thereafter, the IRS routinely sought to recover unpaid or refunded FICA taxes from organizations that claimed the student FICA exception as applied to medical residents. On August 4, 2003, a United States District Court rendered a decision favoring medical residents in the case U.S. v. Mayo Foundation, 282 F. Supp. 2d 997 (D. Minn. 2003). The Court found that the medical residents qualified for the student FICA exception in Code Section 3121(b)(10). The Court in this case construed the application of the student FICA exception broadly in order to reach its conclusion. The Court found that the Mayo Foundation was a "school" and the medical residents were there to further their post-graduate education.

IRS POSITION ON MEDICAL RESIDENTS

Following the Mayo Foundation case, the IRS continued to challenge refund claims made in other jurisdictions for FICA taxes relating to medical residents. Throughout the development of the medical resident FICA tax issue, the IRS claimed that the history of amendments to the Social Security Act made it clear that Congress did not intend that medical residents could qualify under the student exemption when it eliminated a separate exemption for interns. However, after losing several cases on this and similar arguments, the IRS announced in March 2010 that it had made an administrative determination to accept the position that medical residents qualify for the student FICA exception for tax periods ending before April 1, 2005.

AMENDED TREASURY REGULATION §31.3121(B)(10)-2

Meanwhile, the Department of Treasury had issued a final regulation on December 21, 2004 that amended the qualifications for the student FICA exception, which had the effect of denying the student FICA exception to medical residents. This spurred a new round of litigation concerning the application of the student FICA exception to medical residents.

Under amended Treasury Regulation §31.3121(b)(10)-2 (the "Regulation"), which was effective April 1, 2005, the services of a student normally scheduled to work 40 or more hours a week for the school, college or university are not incident to or for the purpose of pursuing a course of study. Any such student will be considered a full-time employee and will not be eligible for the student FICA exception. As a result, most medical residents will not be eligible for the student FICA exception because they typically work more than 40 hours per week in a residency program.

In addition, many hospitals that had claimed to be classified as a "school" for purposes of the student FICA exception no longer qualify as a school under the Regulation. An organization is a "school, college or university" if its primary function is the presentation of formal instruction, it normally maintains a regular faculty and curriculum, and it normally has a regularly enrolled body of students in attendance at the place where its educational activities are regularly carried on. For an institution to be a school, college or university, its primary purpose must be education.

SUPREME COURT DECISION

The ensuing litigation over the Regulation produced the case just recently decided by the United States Supreme Court. Using the principles set forth in Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984), for granting deference to reasonable interpretations of federal law by government agencies, the Supreme Court held that the "Treasury Department's full-time employee rule is a reasonable construction of §3121(b)(10)." The Supreme Court determined that using objective measures such as the number of hours worked was a "perfectly sensible" method for determining who qualifies for the student FICA exception. In addition, the Supreme Court determined that an important public policy was served by having medical residents contribute to and benefit from the Social Security system.

CONCLUSION AND EFFECT ON PRE-APRIL 1, 2005 CLAIMS

Absent a change in the law enacted by Congress, medical residents described in the Regulation are subject to FICA taxes on their wages earned in a residency program for tax periods ending on or after April 1, 2005. However, the decision in this case will not adversely affect properly filed FICA refund claims for tax periods ending before April 1, 2005 because such tax periods were not subject to the Regulation.

Should you have any questions, please do not hesitate to contact **Calvin Chambers** (cchambers@hallrender.com or 317-977-1459) or your regular Hall Render attorney.

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