



Resident physicians and the FICA student exception (Section 3121(b)(10) of the Internal Revenue Code)

The FICA student exemption issue and recent court decisions:

Often schools, colleges and universities employ students on a part-time or intermittent basis. Income or stipends received may be exempt from withholding of FICA taxes if the so-called "student exemption" applies. For years, the IRS has contended that medical students and residents can never be exempt from FICA, now courts in several cases have ruled they may or do qualify for the "student exemption" from FICA, depending upon the facts.

- On March 25, 2009, the U.S. Court of Appeals for the Second Circuit **rejected IRS's view that medical residents per se are ineligible for the student Federal Insurance Contribution Act (FICA) exception rule** (*United States v. Memorial Sloan-Kettering Cancer Center*, 103 AFTR 2d ¶ 2009-666), following recent decisions to that effect by the Sixth (see *U.S. v. Detroit Medical Center*, 103 AFTR 2d 2009-541) Seventh (see *University of Chicago Hospitals v. U.S.*, 102 AFTR 2d ¶ 2008-5317 and Eleventh (see *U.S. v. Mount Sinai Medical Center of Florida*, 99 AFTR 2d 2007-2800) Circuits. The Second Circuit Court has set aside two district court summary judgment rulings for the government that medical residents did not qualify for the Code Sec. 3121(b)(10) student FICA exception. It sent the cases back to the district courts to determine whether the residents qualified for the exception under the particular facts.
- On Sept. 23, 2008, the U.S. Court of Appeals for the Seventh Circuit ruled that **medical residents are not categorically excluded from claiming exemption from payment of employment taxes under the Federal Insurance Contribution Act (FICA)** (*University of Chicago Hospitals v. United States*, No. 07-1838). The court joined a series of recent district and circuit courts when it rejected the government's argument that medical residents are not eligible for a student exemption under Internal Revenue Code Section 3121(b)(10), holding instead that a case-by-case analysis is required to determine whether medical residents serving specific institutions qualify for the exemption. The court further added that medical school graduates participating in postgraduate medical residencies at university hospitals may be regarded as students within the meaning of the statute.
- On April 1, 2008, the District Court of Minnesota again held that stipends paid by the Regents of the University of Minnesota to medical residents were exempt from Federal Insurance Contribution Act (FICA) contributions. This decision reaffirms this same court's previous holding in *Mayo Foundation* (August, 2007) that residency stipends are exempt from FICA under the student exemption section of the Internal Revenue Code (Code Sec. 312(b)(10)). This posting will be updated in the event any appeal by the IRS results in a modification of the April 1, 2008 district court ruling.



How FICA taxes are paid and what paying FICA means to you:

Typically, the burden of the FICA tax is split between the employer and the employee. The employer withholds 7.65% of wages from the employee's paycheck, and then matches that with another 7.65% contributed by the employer. Independent contractors and the self-employed are expected to pay the full 15.3% out of their own pockets. If the FICA "student exemption" applies, neither the medical student or resident nor the medical school or residency program is obligated to make these employment tax contributions.

- **Advantages:** The primary advantage of exemption from FICA is higher after tax income and take home pay.
- **Disadvantages:** The major disadvantage is that exemption from FICA taxes can lower the "average earnings" on which Social Security benefits are based and reduce the amount of retirement benefits. Also, being exempt from FICA may prevent qualification for disability benefits provided by Social Security.

The following is a brief history of the issue:

The IRS has consistently urged that the "student exemption" from FICA be narrowly construed. In two cases decided in the mid 1990s where two institutions had sued to recover a refund of FICA taxes paid, the question arose whether employees performing services in the nature of on-the-job training are students and thus exempt from FICA. The University of Minnesota claimed that residents working in a hospital setting can qualify for the student exemption, and won both in the federal district court and the Eighth Circuit Court of Appeals. The second institution, Mayo Clinic, won a similar refund claim in the same Minnesota federal district court. In response, the IRS further tightened regulations in late 2004 to restrict the use of the "student exemption."

- On May 18, 2007, the Eleventh Circuit Court of Appeals reversed a Florida federal district court that had held residents automatically are ineligible for the FICA "student exemption." Thus Mount Sinai Medical Center was told it could pursue its refund claim for FICA taxes paid. The Eleventh Circuit held that whether a resident is a "student" for purposes of the FICA exemption and whether the resident is employed by a school, college, or university (SCU) are separate factual inquiries that depend on the nature of the residency program and the employer's status. The court rejected the IRS's view that a hospital is – as a matter of law – precluded from attempting to prove that its residents' services qualify for the student exemption. The Eleventh Circuit's decision is that residents may qualify for the FICA "student exemption" notwithstanding the IRS's tightened regulations issued in late 2004. A case-by-case approach is required to determine whether particular services qualify for the student exemption.
- On August 14, 2007, a Minnesota federal district court affirmed an earlier ruling that stipends to residents do qualify for the FICA exemption. The court ruled the IRS's 2004 regulations were invalid, as they contradict the 65 year-old Social Security statute they were supposed to interpret. The court ordered the IRS to



refund more than \$1.6 million, plus interest, to Mayo. The IRS has appealed the court's ruling voiding the 2004 regulations, and the IRS appeal remains pending. Whether the exemption applies depends on the facts and circumstances of the case. The Mayo residents in graduate-level medical programs were required to attend a significant number of lectures and conferences on primary care, morbidity, mortality, and to participate in "grand rounds." Instructors graded and evaluated them at each rotation. The court decided these activities constituted being "enrolled" and "regularly attending classes." The fact that the residents were not registered for credit hours and were not pursuing a degree did not undermine this conclusion. This echoed the prior Florida district court ruling that there is no "per se" basis in the Social Security statute that prevents stipends paid by a hospital to medical residents from qualifying for the student FICA exception.

Some 2004 Amended IRS Regulations deemed "invalid":

The August 2007 district court ruling summarized above was a strong rebuke of IRS efforts to limit application of the FICA student exemption. Links to the IRS's 2004 regulations (effective April 1, 2005) can be found on the RFS web site. The following is a description of some of the amended IRS regulations at issue.

- To qualify as a "school, college, or university," an organization must conduct educational activities. The 2004 regulations stated that education had to be its primary function, but the Minnesota court said only Congress could add requirements that changed the original intent of the law.
- A "full-time employee" cannot qualify as a student, and the 2004 definition stated full-time means 40 or more hours per week.
- A definition of "professional employee" was added, and like full-time time employees, they are presumed to be focused on service and not education, thus ineligible. Most graduate medical students and residents would fall into the new definition of "professional employee" when duties consist of: (1) performing services that require advanced knowledge in a field of science or learning, (2) work requiring the consistent exercise of discretion and judgment, and (3) work that is predominately intellectual and varied in character. If an employee is a professional employee, then that suggests the employee is not a student.
- According to the IRS, if a resident is deemed a "professional employee" or works 40 or more hours a week in the "on the job" training experiences typical in residency programs, the resident ceases to be a student.

The Minnesota federal district court found that these regulations arbitrarily narrowed the plain English definitions of student and SCU in the underlying statute, something only Congress has the authority to change. The court rejected the IRS's argument that residents are never students as a matter of law.

Conclusion



After reviewing this information in this document and on the RFS Web site, you can:

1. Contact your residency program/institution for more information and determine what steps, if any, they have taken regarding FICA refunds for residents. If the residency program has filed for a refund, you may let it proceed on your behalf, but make sure they have your forwarding address.
2. Consult an independent tax advisor, attorney, or accountant. They can advise you on the best course of action given your particular circumstances.
3. Do nothing: FICA taxes exist to fund certain Social Security disability and retirement pension funds. You may prefer to pay the taxes so you are not at risk of losing your eligibility for these benefits.