

## **Medical Residents and the FICA Student Exemption Issue (Section 3121(b)(10) of the Internal Revenue Code)**

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*On January 11, 2010, the Supreme Court determined that resident physicians and their training institutions are responsible for paying Federal Insurance Contributions Act (FICA) taxes under revised IRS regulations promulgated on April 1, 2005. The court upheld as reasonable the IRS issuance of the regulations, which say that medical residents who work more than 40 hours per week do not qualify for the student exception under Section 3121(b)(10) of the Internal Revenue Code.*

*Note: The Supreme Court decision does not affect services performed by medical residents before April 1, 2005. In March, 2009, the IRS decided to accept the position that medical residents are excepted from FICA taxes based on the student exception for tax periods ending before April 1, 2005, when the New Student Exception Regulations went into effect. The IRS has contacted many hospitals, universities, and medical residents who had filed timely FICA refund claims for these periods regarding perfecting refund claims and/or obtaining a FICA tax refund. Only those taxpayers who filed timely claims are eligible for a refund on appropriate FICA taxes on payments made to medical residents for periods ending before April 1, 2005.*

### **What are FICA taxes?**

FICA taxes refer to Social Security and Medicare taxes. 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. The primary advantage of being exempt from FICA is higher after tax income and take home pay. 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 for an individual. Also, being exempt from FICA may prevent qualification for disability benefits provided by Social Security.

### **What are the rules?**

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. Section 3121(b)(10) of the IRS Code exempts from FICA tax withholding "service performed in the employ . . . of a school, college, or university . . . if such service is performed by a student who is enrolled and regularly attending classes at such a school, college, or university."

The IRS has consistently urged that the FICA student exemption be narrowly construed and issued revised regulations which took effect on April 1, 2005.

- In order for the employee to have student status, the employee's services "must be incident to and for the purpose of pursuing a course of study." The educational aspect of the employer-employee relationship must predominate over the service aspect.

- To qualify as a “school, college, or university,” an organization must conduct educational activities. The primary function of the institution should be formal instruction and it should maintain a regular faculty and a regularly enrolled body of students.
- A “full-time employee” cannot qualify as a student. The revised regulations define full-time as working 40 or more hours per week, regardless of the educational, instructional, or training component of the work. This makes it difficult for graduate medical students or residents to qualify.
- A definition of “professional employee” was added and, like full-time employment, professional employment is presumed to focus on service and not education, thus making professional employees ineligible for the student exemption. If the 40 hour restriction noted above wasn’t enough of a barrier, graduate medical students and residents fall into the 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.
- The receipt of certain employment benefits (e.g. healthcare, insurance, paid vacations) is considered a factor in determining whether the service aspect predominates over the educational aspect and disqualifies the employee from the exemption.

In the view of the IRS, medical residents who work over 40 hours per week are full-time employees, even if some of the resident’s services have an educational, instructional, or training aspect. Therefore, the resident does not qualify for the student exemption and the resident’s services are not incident to and for the purpose of pursuing a course of study.

### **History of Court Decisions**

For more than a decade, various universities and medical institutions challenged the disqualification of medical residents from the student exception. In some cases, this argument succeeded, as courts held for the institutions and allowed the institutions to claim refunds for taxes paid. But a 2009 Eighth Circuit Court of Appeal decision finding for the IRS created a split over the status of medical residents as students. In view of this split among the appellate courts, the United States Supreme Court agreed to resolve this issue.

The Supreme Court has now (January, 2011) upheld the revised IRS regulations providing that medical residents are not exempt from paying FICA taxes. The Supreme Court unanimously held that the IRS acted reasonably in promulgating revised regulations that medical residents are not exempt from paying FICA taxes (*Mayo Foundation for Medical Education and Research v. United States*, U.S., No. 09-837). In an opinion by Chief Justice John G. Roberts Jr., the court found the regulations, which say that medical residents who work more than 40 hours per week do not qualify for the student exception under Section 3121(b)(10) of the Internal Revenue Code, address an area “to which Congress has not directly spoken.” Further, because the IRS regulations were “a reasonable construction of what Congress has said,” they must be upheld.