



Supreme Court Upholds Treasury Rule that Medical Residents Are Employees for FICA Purposes

On January 11, 2011, the Supreme Court unanimously upheld the Treasury Department's regulations providing that doctors who are in medical residency programs are employees rather than students for purposes of FICA taxation.

Background

To fund Social Security and Medicare, the Federal Insurance Contributions Act (FICA) imposes on both employees and employers a tax on the wages earned by employees for services performed, with certain exceptions. FICA excludes from taxation the wages of students employed by a school if the student is enrolled and regularly attending classes at the school.

The Department of the Treasury (Treasury) has long held that the student exemption from FICA taxes applies only to students who work for their schools “as an incident to and for the purpose of pursuing a course of study.” Until 2005, the Internal Revenue Service (IRS) applied this standard on a case-by-case basis to determine whether an individual's work was “incident to” his or her studies. Treasury issued final [regulations](#) on the student FICA exemption in late 2004 (applicable to work performed on or after April 1, 2005) that changed that approach.

The regulations provide that the services of a full-time employee are not incident to and for the purpose of pursuing a course of study, and thus do not qualify for the student exemption even if the services have an “educational, instructional, or training aspect.” A “full-time employee” is defined generally as an employee who is considered to be a full-time employee under the employer's policies. The regulations automatically include as a full-time employee any employee normally scheduled to work 40 hours or more per week, and specifically cite medical residents as an example of full-time employees who would not qualify as students for FICA purposes.

Lower Court Decisions

The Mayo Foundation for Medical Education and Research, Mayo Clinic, and the Regents for the University of Minnesota (collectively Mayo) offer medical residency programs to provide specialty training for doctors. Residents spend the bulk of their time (often 50 to 80 hours per week) providing patient care under the supervision of more senior residents and faculty, and they are also required to take part in formal education activities. They receive annual stipends along with health insurance, malpractice insurance, and paid vacation.

Mayo challenged the Treasury regulation provision that categorically excluded medical residents from FICA's student exemption based on the number of hours they worked rather than requiring a case-by-case analysis. Finding that the student exception in the statute was unambiguous, the District Court held that the regulation was invalid. The United States Court of Appeals for the Eighth Circuit [reversed](#) on appeal, concluding that the statute was ambiguous and Treasury's regulation was a permissible interpretation of the statute.

Mayo Foundation for Medical Education and Research et al. v. U.S.

The question before the Supreme Court in [Mayo Foundation for Medical Research et al. v. U.S.](#) (No. 09-837, January 11, 2011) was whether Treasury could provide categorically by regulation that medical residents are not "students" for purposes of the student exception from FICA taxes provided under Internal Revenue Code §3121(b)(10). In a unanimous decision, the Court upheld the Treasury's regulation.

The Court said that the tax regulations promulgated by the Treasury interpreting FICA were entitled to the same level of deference as regulations issued by other federal agencies. Applying the two-prong *Chevron* analysis ([Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.](#), 467 U. S. 837 (1984)), the Court first considered whether Congress had defined the term "student" and whether medical residents were subject to FICA. The Court found that Congress had not statutorily defined the term "student" or otherwise addressed the applicability of FICA to medical residents. The Court next considered whether the Treasury's interpretation of the student rule was reasonable, which the Court defined as whether the rule is "arbitrary or capricious in substance, or manifestly contrary to the statute." Concluding that the Treasury's rule was a reasonable construction of the statute, the Court upheld the categorical exclusion of medical residents from FICA's student exemption based on hours worked.

BUCK COMMENT. *Hospitals, medical schools and medical residents began filing FICA refund claims in the 1990's based on the student exception. The IRS held the claims in suspense for some time because there was a dispute over the applicability of the FICA exception to medical residents. On March 2, 2010, the IRS [announced](#) that it would honor pending medical resident refund claims for tax periods ending before April 1, 2005 (when the regulations went into effect). Thus, the tax obligation upheld by the Court will apply to wages paid to medical residents on or after that date.*

Conclusion

The Court's decision upholding Treasury's regulation providing that medical residents are categorically ineligible for the student exemption from FICA taxation directly and significantly affects teaching hospitals, other health care institutions, and medical residents. The Treasury estimates that the medical resident exemption involves approximately \$700 million in FICA taxes annually. It is now settled that medical residents and other students who are enrolled and regularly attending classes but normally work 40 hours or more per week (full-time) for a

school, college or university will be subject to FICA taxation regardless of the educational, instructional, or training aspects involved. Thus, hospitals and other institutions will have to factor any additional FICA costs into their future financial planning.

The Court's decision that Treasury regulations are entitled to broad "*Chevron*" deference also has important implications for employers and individuals who may want to challenge other interpretive regulations. After *Mayo*, any challenged Treasury regulation will be reviewed under a very deferential standard.

Buck's consultants are prepared to discuss the impact of this decision on your workplace.

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic