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IRS Concedes That Medical Resident Stipends Are Not Subject To FICA Taxes For Quarters Before April 1, 2005: Now What?

*By Thomas D. Sykes and Michael N. Fine, McDermott, Will & Emery LLP**

Hospitals, universities, and medical residents may soon receive billions of dollars in Federal Insurance Contributions Act (FICA) tax refunds for their pending claims, some of which date back to the mid-1990s. No doubt sensing the growing momentum for teaching hospitals and their residents, the Internal Revenue Service (IRS) announced on March 2 that it would agree to exclude medical residents and fellows (Residents) from FICA taxes for taxable quarters beginning before April 1, 2005, for those teaching hospitals that have timely filed pending refund claims.[\[1\]](#) This IRS concession should prove to be worth several billion dollars in refunds to taxpayers and Residents.

The IRS' three-paragraph press release and supplemental Frequently Asked Questions (FAQs) offer few details on how refund payments, which will include interest, will be processed, stating that over the next 90 days, the IRS will contact teaching hospitals with pending FICA refund claims and provide them with more information.

While the IRS states that they need to take no action now, teaching hospitals should (1) preserve the data necessary to determine the dollar amounts of the stipends upon which a tax refund is sought; (2) begin the tabulation of that data into quarterly tax amounts, if that tabulation has not been done; (3) determine the identity of the Residents who are in the taxable quarters for which a timely claim is pending and a refund is sought; (4) begin ascertaining, from the teaching hospital's own records, the last known address of the relevant Residents; and (5) consider the possible structure of the fairly complex "consent letters" that will need to be sent to the Residents. (Consent letters will be used to give the relevant Residents, from whom "employee portion" FICA was withheld and paid over to the IRS, notice of their opportunity to "piggyback" on the teaching hospital's efforts to obtain a refund of the teaching hospital's "employer-portion" tax.)

Almost as important as what the announcement did say is what it did not say. The IRS' announcement did not surrender refund claims for quarters after the first quarter of 2005. For those quarters, the IRS has on its side a Treasury Regulation that took effect on April 1, 2005. This regulation purports to subject all Resident stipends to FICA, regardless of the facts and circumstances,^[2] and the IRS believes that the regulation ends the discussion, despite the fact that a Minnesota district court, in decisions that were later reversed, has already held that regulation to be invalid.

Teaching hospitals thus need to focus almost immediately upon the task of preparing claims for refund (Forms 941X and 8275-R) that seek to recover FICA paid for taxable quarters after the first quarter of 2005. Claims for quarters in 2006 are due not later than April 15, 2010. Beyond timely filing these claims, teaching hospitals should promptly consider their strategy and next steps as to these claims.

Before discussing strategy and next steps in some detail, it is useful to sketch out the circumstances and events that led to the recent developments.

Background

The Internal Revenue Code, as amended (the Code), imposes FICA tax, consisting of Social Security and Medicare taxes, on all "wages" paid to an employee by an employer during a calendar quarter. Employers and employees both are required to pay FICA tax, in equal shares. The employer is obliged to withhold from the employee's paycheck the "employee-portion" tax necessary to satisfy the employee's obligation.

Although "wages" include all remuneration for "employment," the Code expressly excludes certain services from the definition of "employment."^[3] Specifically, a statutory provision has long relieved students employed by a school, college, or university from the financial burden of paying FICA taxes. This provision is known as the "Student Exemption."^[4]

Following a 1998 decision by the Eighth Circuit that applied the Student Exemption to Residents,^[5] many teaching hospitals filed tax-refund claims with the IRS. These claims typically addressed both the employer and the employee portion of the tax and extended back to taxable quarters in the mid-1990s. By now, it is not uncommon for a single teaching hospital to have pending claims for refund that seek tax and interest totaling tens of millions of dollars. Until March 2, 2010, it was the policy of the IRS neither to allow nor disallow the pending claims.

After a number of taxpayer favorable decisions, the Treasury Department issued a regulation that took effect on April 1, 2005 (the 2005 Regulation), that purports to

narrow the scope of the Student Exemption so that Residents are categorically ineligible for it. The regulation has no application to stipends paid in quarters before the second quarter of 2005.

After the regulation was issued, but for court cases addressing earlier taxable quarters that were not controlled by the regulation, the Department of Justice (DOJ) argued that Residents were categorically ineligible for the Student Exception. DOJ based its argument on legislative history. After winning some initial battles in the lower federal courts, a series of four opinions, issued by the federal courts of appeals in 2008 and 2009, rejected the "categorically ineligible" position. It should be noted that this is essentially the position now codified in the 2005 Regulation (applicable to quarters after the first quarter of 2005).

After losing in the four courts of appeals and losing a ten-day trial that focused on the facts and circumstances surrounding residency programs, DOJ became willing to settle, on a highly favorable basis, refund suits that focused on quarters before the second quarter of 2005. At the same time, the IRS continued to refuse to settle these disputes, as it had for almost a decade.

In 2006, two Minnesota teaching hospitals commenced litigation addressing taxable quarters after the first quarter of 2005 – quarters to which the 2005 Regulation applied. They fared well in the federal district court in Minnesota: it ruled that the 2005 Regulation was invalid and that the two teaching hospitals were entitled to refunds notwithstanding the 2005 Regulation.

DOJ took an appeal to the Eighth Circuit, in St. Louis. That court reversed, holding the 2005 Regulation valid and that a tax refund was not available. In January 2010, after losing in the Eighth Circuit, the two Minnesota teaching hospitals asked the U.S. Supreme Court to agree to review the case. That request, supported by several industry groups, remains pending. The request emphasizes the differences in reasoning between the two cases decided by the Eighth Circuit (*i.e.*, the 1998 case and the 2009 case) and the four pre-2005 Regulation decisions that rejected the "categorically ineligible" position advanced by DOJ. The request argues that the 2005 Regulation is not permitted to codify the "categorically ineligible" position that was rejected by the four other circuits on the basis of the plain meaning of the Code's Student Exemption.

In the papers filed supporting the request for Supreme Court review, the various teaching hospitals and related trade associations emphasize the unfairness and expense associated with having to bring suit to recover a refund – especially in view of the plethora of decided cases that have granted a FICA refund. With that request for Supreme Court review of the 2005 Regulation pending, the IRS issued the announcement stating that it

would no longer contest the applicability of the Student Exemption to periods before the effective date of the 2005 Regulation.

The Pre-2005 Regulation Claims Addressed by the March 2, 2010 IRS Announcement

The IRS' surrender on FICA claims for quarters before the 2005 Regulation took effect comes after roughly eleven substantive decisions, most of which have been taxpayer favorable. Though it is a watershed event, the short release leaves unresolved how the IRS will settle these claims for quarters before the second quarter of 2005. Again, the IRS promises to contact the taxpayers that have pre-2005 Regulation claims on file. In addition, the IRS reportedly will issue additional guidance within the next 45 or 60 days setting out procedures for processing the announced concessions.

Teaching hospitals should consider the following aspects of the announcement and its implications:

- **Only Timely Filed Claims Will Be Paid:** As the FAQs explain, the IRS will only refund FICA claims for institutions and Residents that timely filed FICA refund claims. Residents need not have filed themselves to be eligible for a refund, but those whose stipends are addressed by a teaching hospital's timely claim will be eligible, provided that they inform the teaching hospitals of their intentions at the appropriate future point. To be timely, a refund claim (even if it was only a "protective," or incomplete, claim) had to have been filed by the third April 15th after the year of the calendar quarters addressed by the claim, absent an extension set out in an executed Form SS-10. The process for resolving disputes over whether a claim was or was not timely filed have not been established, but a teaching hospital will always retain the right to proceed to court on that dispute.
- **Don't Ignore a Notice of Disallowance from the IRS:** If the IRS, during its handling of these claims, issues a notice of disallowance (typically set out in a letter that is sent by certified mail), a taxpayer will be "on the clock." Certain steps must be taken in timely fashion to avoid forfeiting rights to challenge the disallowance. (This also applies if a notice of disallowance was received at some earlier point.)
- **Identify Residents Covered by Pre-2005 Regulation Claims:** Teaching hospitals should review their filed FICA claims and their payroll records to determine the Residents to whom their pending claims relate. They should confirm that documents indentifying the Residents are not destroyed through routine document-management policies.
- **Determine Stipend Amounts for the Identified Residents, and Prepare to Support Determinations with Back-Up Documentation, If Possible:** The payroll departments of teaching hospitals should gather documents that support their stipend

determinations and tax-refund determinations. Again, efforts should be made to insure that relevant documents are not destroyed.

- **Consider Starting to Gather Consents from Residents:** The IRS will not pay refunds to Residents who do not consent to the refund because acceptance of a refund may have a bearing upon a Resident's eligibility for Social Security benefits. Accordingly, a teaching hospital will be obliged, at some point during the refund process, to contact the Residents who are in the relevant "cohort." IRS may well devise a standard or recommended consent letter that teaching hospitals are obliged to send to Residents. It is not too early to consider the numerous risk-management issues that are raised by the obligation to notify the relevant Residents in the cohort that they have a right to participate.

- **Keep Any Pre-2005 Regulation Credits Received:** If a teaching hospital has received a credit by way of Form 941c for stipend-related FICA paid in pre-2005 Regulation periods, it will be permitted to keep the employer-portion tax and should make arrangements to distribute to Residents the employee-portion tax. DOJ will no longer bring erroneous-refund suits against teaching hospitals to recover credits (i.e., refunds) received for pre-2005 Regulation quarters. Questions remain about the payment of interest (by teaching hospitals) to Residents and the way in which the Consent Letter requirements will apply to the distributions of employee-portion tax to the relevant Residents. If credits were obtained via a Form 941c for Resident-related FICA tax paid for periods addressed by the 2005 Regulation, the teaching hospital promptly should have discussions with an advisor knowledgeable about erroneous refund suits (brought by DOJ) and certain other uncommon issues.

- **Remain Patient:** There likely are several hundred teaching hospitals with pending claims. It is unclear how many IRS examiners will be assigned to the claim-verification process, so it is very difficult to predict the speed with which the IRS will be able to take action on a particular teaching hospital's pending claims. The backlog is large. The IRS examiners assigned to the claim-processing task force will presumably have to be trained – and since the IRS has not been settling these claims, there is little or no institutional knowledge about this claim type among IRS examiners. (Cases in this area that previously were settled were settled with DOJ, not the IRS; it is DOJ that has the bulk of the institutional knowledge at present.) When examining the claims, these IRS examiners will likely be required to do a greater or lesser degree of verification with respect to the precise dollar amounts that a teaching hospital requests for: (1) employer-portion tax; and (2) employee-portion tax respecting those Residents who have opted in to the settlement via the obligatory Consent-Letter process. Knowledge of DOJ's settlement and verification process, upon which the IRS' verification process will surely

be based, will likely be helpful, especially given that the IRS examiners will be new to the field.

The Claims Addressed by the 2005 Regulation and Ignored by the IRS Announcement

As noted above, the recent IRS concession of pre-2005 Regulation claims ignores claims addressed by the 2005 Regulation. The recent announcement makes it clear that the IRS will not be conceding or compromising tax claims made for quarters governed by the 2005 Regulation. This is underscored by the two Minnesota teaching hospitals that had to fully litigate their cases (through the Eight Circuit and now to the Supreme Court), even though they each had won cases addressing the pre-2005 Regulation quarters. The only way for a teaching hospital to obtain a recovery for quarters under the 2005 Regulation is to bring a suit challenging it.

Without going into detail, there are likely powerful reasons for proceeding quickly to court on these quarters, including that: (1) the district court in the two Minnesota cases held the 2005 Regulation invalid; and (2) the papers filed by the two Minnesota teaching hospitals with the Supreme Court set out a powerful argument that the 2005 Regulation is invalid based on the plain meaning of the Code's Student Exemption, as interpreted by the four courts of appeal that rejected the "categorically ineligible" argument that is enshrined in the 2005 Regulation.

Accordingly, teaching hospitals should, while always continuing to pay the employer-portion tax and remit the employee-portion tax, as dictated by the 2005 Regulation, insure that they: (1) do not let any deadlines expire for the filing of refund claims (*i.e.*, Forms 941X and 8275-R, for each quarter); (2) make sure that the refund claims set out the proper grounds for challenging the 2005 Regulation – an exercise not involved in claims for periods to which the 2005 Regulation is inapplicable; (3) consider whether previously filed refund claims should be amended, after consulting experienced tax-litigation counsel (see item (5), *infra*); (4) respond in timely fashion to any notices of disallowance that the IRS might decide to start issuing in response to pending claims; and (5) obtain advice from tax-litigation counsel, experienced in handling FICA refund cases in the federal trial courts *and* in the federal courts of appeals, and experienced with regulation-validity issues, about the advisability of commencing a tax-refund suit, in the proper forum (there are two to choose), that challenges the 2005 Regulation.

The statement in the announcement that the IRS will no longer dispute that Residents come within the Student Exemption statute for quarters before April 1, 2005, should make it very difficult for DOJ to defend a tax-refund case brought for quarters that are purportedly controlled by the 2005 Regulation. That is, the suit challenging the 2005

Regulation will be primarily “legal” in nature, not “factual.” This probably reduces the cost of pursuing that suit because it will be practically impossible for DOJ to insist that the teaching hospital prove the facts and circumstances that bring it within the Student Exemption’s standards.

While it is satisfying for teaching hospitals to sit back and enjoy the rewards of their extensive in-court battle with the IRS over tax paid for quarters that are not addressed by the 2005 Regulation, teaching hospitals should not be complacent. They must be attentive to the steps that should be taken to obtain a refund via litigation of the tax paid over the past five years. If they are not attentive, they may place their refund claims at risk. Attentiveness is certainly dictated by the large amount of tax that is in play. One does not have to be one of the largest teaching hospitals (for which the post-1Q 2005 tax by now totals roughly \$30 million, with an equal amount of tax at stake for their Residents) for the dollars at stake to be well worth chasing, and promptly so.

Conclusion

The courtroom battles that have played out over the last 15 years have finally borne fruit for all teaching hospitals that were prescient enough to file timely tax refund claims for quarters before April 1, 2005. Satisfying as this is, teaching hospitals should now consider an issue ignored by the IRS’ announcement: whether, when, and how to pursue FICA tax refunds for quarters after March 31, 2005. Surely the signs respecting the latter category of refunds are at least as favorable as those that were visible back in the early 2000s for the refunds that the IRS has now agreed to pay.

* *Thomas D. Sykes* is a partner, and *Michael N. Fine* is an associate, at McDermott, Will & Emery LLP in Chicago, IL. The views expressed herein are the views of the authors, and not necessarily of McDermott, Will & Emery LLP. These views are not intended to constitute legal or tax advice, which the authors are permitted to provide only to clients who have properly engaged them for that purpose. © 2010 Thomas D. Sykes and Michael N. Fine.

[1] “IRS To Honor Medical Resident FICA Refund Claims,” IR-2010-25 (March 2, 2010). The press release and the related FAQs may be found at www.irs.gov/charities.

[2] See T.D. 9167 at 69 Fed. Reg. 76404 (published Dec. 21, 2004; corrected Mar. 4, 2005) (revising Treas. Reg. § 31.3121(b)(10)-2 and adding Example 4 on medical residents).

[3] 26 U.S.C. § 3121(b).

[4] 26 U.S.C. § 3121(b)(10).

[5] See *State of Minnesota v. Kenneth S. Apfel, Comm'r of Social Security*, 151 F.3d 742 (8th Cir. 1998).

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Suite 600, 1025 Connecticut Avenue NW

Washington, DC 20036-5405

Phone: 202-833-1100 Fax: 202-833-1105