

Expert View

Teaching Hospitals, Ex-Residents, In Line For Billions In Tax Refunds



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After a dozen court losses, IRS concedes old FICA cases. Thousands of doctors will be able to piggyback on hospitals' refund claims.

Most of the teaching hospitals in the United States have had pending, for more than a decade, tax refund claims that seek to recover from the Internal Revenue Service (IRS) millions of dollars in Social Security and Medicare (Federal Insurance Contributions Act or FICA tax) paid on stipends provided to their medical residents. These claims typically reach back to tax quarters as early as 1995 and address both the employers' and the employees' shares of FICA since that time.

Now, following a string of court victories, hospitals, universities, and medical residents may soon receive billions of dollars in FICA tax refunds to satisfy some of their pending claims. No doubt sensing the growing momentum in the courts for both hospitals and their residents, the IRS announced on March 2, 2010, that it would agree to exclude medical residents and fellows from FICA taxes for taxable quarters beginning before April 1, 2005, for those teaching hospitals that had timely filed pending refund claims. (Claims for later years are the subject of a different set of litigation that the IRS has yet to concede.)

Huge Significance

The IRS' decision has a huge impact, as most of the United States' 375 teaching hospitals, have had pending FICA claims. For years the IRS refused to take any administrative action on most of these claims. Starting more than 10 years ago, a few teaching hospitals brought suit in federal courts, on behalf of themselves and their residents, to recover tax refunds, while the government brought suit against a few teaching hospitals that had managed to obtain refunds.

After a few initial IRS victories, the taxpayers racked up a very impressive string of victories. Of the last 15 substantive decisions issued by the federal courts, 12 have gone in favor of the teaching hospitals.

A pivotal case spurred the change of heart by the IRS. The first key taxpayer victory was handed down in 2007 by the 11th Circuit Court of Appeals, in *United States v. Mt. Sinai Medical Center of Florida, Inc.* which reversed the district court and rejected the IRS's argument that the "student exception" from FICA tax, upon which the teaching hospitals and their residents had relied, is "categorically off limits" to medical residents. On remand, the district court noted that the regulations require the application of a "case-by-case approach to determine whether particular services qualified for the student exception." In September 2008, after an 11-day trial, the district court found that Mount Sinai's residents were "students," and Mount Sinai was a "school," for purposes of the student exception. In the wake of this decision, the government entered into settlement negotiations in other pending litigation and on March 2, 2010, the IRS announced a full concession for taxable quarters beginning before April 1, 2005, for those teaching hospitals that have timely-filed pending refund claims.

Refund Process

Under the March 2 IRS announcement, teaching hospitals with timely-filed tax refund claims (including "protective" refund claims) asserting that medical resident stipends are tax-exempt under the student exception [26 U.S.C. § 3121(b)(10)]

could expect further guidance from the IRS by June 2010. Teaching hospitals already in federal court pursuing a refund will also receive the benefit of this IRS concession, and will receive expedited consideration by the IRS if they choose to forego their refund action in favor of administrative proceedings with the agency. Thus, each teaching hospital should assess the state of its administrative refund claims in order to be prepared for contact from the IRS under this settlement initiative.

While the IRS states that they need to take no immediate action, teaching hospitals can take the following steps to prepare:

- Preserve the data necessary to determine the dollar amounts of the stipends upon which a tax refund is sought;
- Begin the tabulation of that data into quarterly tax amounts, if that tabulation has not been done;
- Determine the identity of the residents who were subjected to FICA tax in the taxable quarters for which a timely-filed claim is pending and a refund is sought;
- Begin compiling, from the teaching hospital's own records, the last known address of the affected residents;

And,

- 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 affected residents, from whom the "employee portion" of FICA tax 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" of FICA tax.

Meanwhile, doctors should make sure that any hospitals where they served as residents after 1995 have their current addresses. Based on our experience with IRS procedures, the IRS administrative process to evaluate the refund claim will take some time. Doctors should not expect a refund check until sometime in 2011 or later.

Later Claims

The IRS announcement makes clear that it is not conceding the applicability of the student exception for quarters beginning on or after April 1, 2005, when new IRS regulations went into effect that purport to place the student exception categorically off limits to medical residents. Many teaching hospitals have filed claims asserting that this regulation is invalid and that refunds are due. A federal district court in Minnesota twice held that the 2005 regulation is invalid, although that decision was subsequently overturned by the Eighth Circuit Court of Appeals. With regard to quarters that are purportedly governed by the regulation, teaching hospitals with significant amounts at stake should, after consulting with tax litigation counsel, seriously consider filing claims for refund for all quarters in 2005 and subsequent employment tax years. Refund claims for quarters in 2006 – which should be set out on Forms 941X and 8275-R – are due not later than April 15, 2010. Hospitals should bear in mind that neither the IRS nor the Department of Justice is expected to settle, within the foreseeable future, cases that involve quarters addressed by the 2005 regulation.



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