FICA Tax Student Exemption Resolution: Fifth Circuit Decision About Refunds of FICA Taxes Paid by Medical Residents Stands

May 8, 2015

FICA taxes, which fund the Social Security program, are not levied on state employees unless a state voluntarily opts in to the program. A state opts in by executing an agreement, commonly referred to as a "section 218 agreement," with the Social Security Administration. In section 218 agreements, states may define—to a certain extent—which state employees participate in the Social Security program and are subject to FICA taxation. States also may employ certain exclusions in the section 218 agreement to ensure that specified subsets of employees are not opted in.

One of the optional exclusions that a state may include in its section 218 agreement is the student exemption, which is for "service performed by a student." "Service performed by a student" refers to service performed in the employ of a school, college, or university performed by a student enrolled and regularly attending classes at that school, college, or university.

In the 1998 decision, State of Minnesota v. Apfel, 151 F.3d 742, 747, the Eighth Circuit Court of Appeals applied the student exemption defined in the state of Minnesota's section 218 agreement to medical residents. Following this decision, many teaching hospitals filed tax-refund claims with the Internal Revenue Service (IRS).

In response to several ensuing decisions that were favorable to taxpayers, the U.S. Department of the Treasury adopted regulations that took effect on April 1, 2005, which narrowed the student exemption. Under the "full-time employment rule" of the 2005 regulations, school employees who work 40 or more hours per week are not exempt from FICA taxes.

In 2010, after lawsuits were filed resulting in lengthy litigation related to the application of the 2005 regulations to medical residents, the IRS announced that it was taking the position that medical residents were exempt from FICA taxes for the period of time before the 2005 regulations took effect. Based on the Supreme Court's decision in Mayo Foundation for Medical Education and Research v. United States, 566 F.3d 675 (2009), aff'd, 562 U.S. 44 (2011), which upheld the validity of those regulations, many people believed that medical residents (and the universities filing tax-refund claims on their behalf) would be foreclosed from obtaining FICA tax refunds for the periods of time after the effective date of the 2005 regulations.

The University of Texas System et al. v. the United States

Like the section 218 agreements of many states, Texas's section 218 agreement explicitly opts out students employed at state institutions.
In 2009, the University of Texas brought suit claiming that the IRS had mistakenly levied $11 million in FICA taxes on stipends that the university had paid to medical residents at five of its hospitals in 2005. The government accepted the university's position with regard to those stipends that the university had paid in 2005 prior to the effective date of the 2005 regulations and invited the university to obtain a refund for that period.

The university, however, maintained its lawsuit against the government claiming that it also is entitled to FICA tax refunds on wages paid to medical residents in 2005 after the 2005 regulations took effect. In the lawsuit, the university stated that the Social Security Administration regulations (rather than the IRS regulations) govern the definition of "student" in its section 218 agreement, and medical residents were eligible for the student FICA taxation exemption under this definition.

The District Court for the Western District of Texas held that the medical residents were governed by the section 218 agreement but that the residents did not meet the definition of "student" in that contract to qualify for the exemption. The university appealed this decision. The Fifth Circuit denied the petition by upholding the district court's ruling.

In January of 2015, the university petitioned the Supreme Court of the United States claiming that the Fifth Circuit's decision created a conflict with the Eighth Circuit's pre-2005 decision in State of Minnesota v. Aggel, which held that medical residents were exempt from FICA taxation based on the student exemption in Minnesota's section 218 agreement. The government responded by arguing that residents are not students entitled to a refund based on both the IRS regulations and the Social Security Administration's longstanding position (and position at the time that the student exception was added to Texas's section 218 agreement) that medical residents do not fall within the student exception.

The Supreme Court declined to review the Fifth Circuit decision affirming the district court. Accordingly, the Fifth Circuit's decision that medical residents do not meet the section 218 agreement's definition of student and thus do not qualify for the student exemption from FICA taxation is final.