

PUBLICATION

Medical Residents and Other Working Graduate Students may be Subject to Social Security Taxes

February 9, 2011

The Internal Revenue Code (Code) generally includes in income any compensation received in exchange for services performed. To the extent that compensation constitutes wages for employment as those terms are defined in Code Section 3121, it is generally subject to Social Security (FICA/FUTA/Medicare) taxes in addition to income taxes. For purposes of this article, Code Section 3121(b)(10) excludes from "employment" any "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 school, college, or university...."

Historically, Treasury Regulations under Code Section 3121 have excluded from Social Security wages any compensation for services "incident to and for the purpose of pursuing a course of study." Whether the services are incident to a course of study has been determined "on the basis of the relationship of the employee with the organization for which the services are performed....The educational aspect of the relationship...as compared to the service aspect...must be predominant...based on all the relevant facts and circumstances...." While that general approach has survived in newer Treasury Regulations which became effective in 2005, those new Regulations go further to provide that any full-time employee services will not be treated as incident to study, and thus compensation for those services will be included in wages for Social Security tax purposes. Full-time status is initially described as dependent on the employer's standards and practices, but any employee whose normal work schedule is 40 hours or more per week is treated automatically as full-time. The new regulations provide that "As an employee's normal work schedule or actual number of hours worked approaches 40 hours per week, it is more likely that the service aspect of the employee's relationship with the employer is predominant." Thus, under the employer's standards and practices, it is possible that a person working fewer than 40 hours will be treated as receiving Social Security wages. An example in the new Regulations addresses a medical residency program at a teaching hospital, where a resident's normal work schedule, including "services having an educational, instructional or training aspect, is 40 or more hours per week" and concludes that the student exception for Social Security wage purposes is not available and there is "no need to consider other relevant factors...."

The Mayo Foundation for Medical Education and Research (Mayo) had a number of medical residents who were also students training in specialties for the purpose of board certification in those specialties. Those residents typically work 50 to 80 hours per week, in addition to any traditional schooling. After beginning to pay half of the Social Security taxes on the compensation paid to those residents, as would be required under the new Regulation for payments made to full-time employees, Mayo sued for a refund of the taxes it had paid. Mayo claimed that the Regulation was invalid because it imposed standards not found in the statute itself. The case eventually was argued before the U.S. Supreme Court.

Mayo's challenge was to the automatic taxation of anyone who normally works at least 40 hours per week, arguing that the services themselves were instructional. The Supreme Court held that a federal agency's Regulation should be accepted as valid when Congress has delegated authority to make rules, provided that the resulting rule is a reasonable interpretation of the statute. Under Code Section 7805(a) Congress has delegated general authority to the Treasury Department to make "all needful rules and regulations for the enforcement" of the Code. The Court found the 40 hour rule to be a reasonable way to "distinguish between workers who study and students who work." In addition, the rule was described by the Court as providing

certainty and thus helping to avoid wasteful litigation, in addition to furthering the purpose of the Social Security Act. Consequently, the Supreme Court upheld the validity of the new Treasury Regulation.

As a result, it appears essentially impossible for a full-time medical resident to argue successfully that compensation for services is not taxable as wages for Social Security purposes. For services performed before April 1, 2005, the IRS decided in mid-2010 to stop disputing the application of the "student exception" to medical residents, at least in the case of refund claims which had been timely filed by either the resident or the employing hospital.

Should you wish to further discuss these Treasury Regulations or the Supreme Court's decision, please contact any attorney in the Firm's Tax Department.