

Background Information on the Final Regulations and Revenue Procedure Providing Guidance on the Student FICA Exception (Section 3121(b)(10) of the Internal Revenue Code)

The issue:

- Often schools, colleges and universities employ students on a part-time or intermittent basis. Many of these students qualify for a statutory exception to FICA taxes, and those work periods are not credited to the earning of social security and related benefits. In two cases heard by the United States district court in Minnesota, the question arose whether employees performing services in the nature of on-the-job training are students and thus not subject to FICA taxes. The University of Minnesota claimed that medical residents working in a hospital setting can qualify for the student FICA exception, and won both in the district court and the Eighth Circuit appellate court. The second taxpayer, Mayo Clinic, won in the same district court.
- More recently, a federal district court in Florida held that medical residents are subject to FICA tax. This case is currently on appeal.
- As a result of the court decisions, many taxpayers have inquired about the application of the student FICA exception. In addition, many universities and hospitals that employed medical residents, and individual medical residents, have filed claims asking for refunds of FICA paid.

Guidance provided by Treasury and the IRS:

- To clarify the exception to withholding and paying FICA taxes for students, Treasury and the IRS have issued final regulations and a revenue procedure, both effective April 1, 2005, which provide guidance on this subject. Because the student FICA exception is linked to eligibility for Social Security benefits, including disability benefits, survivorship benefits, and retirement benefits, the IRS and Treasury coordinated with the Social Security Administration in developing the final regulations. The regulations and the revenue procedure are intended to give schools, colleges, and universities, and their employees, specific information about when an employee can or cannot qualify for the student FICA exception.
- **The regulations:** The regulations provide guidance on whether an organization is a “school, college or university” and whether an employee is a “student” for purposes of the student exception from employment taxes. The regulations affect a significant number of taxpayers (not just medical residents) and include examples that cover a wide array of

situations, ranging from the undergraduate student working part-time in the administration office, to graduate teaching assistants, to students getting on-the-job training at a cosmetology school, and to medical residents and other professionals in training. The following summarizes the main provisions of the regulations:

- To qualify as a “school, college, or university,” an organization must conduct educational activities as its primary function.
- The employee must be enrolled and regularly attending classes in pursuit of an educational credential.
- A “full-time employee” cannot qualify as a student. A full-time employee is an employee who is classified by the employer as such, or whose normal work schedule is 40 hours or more per week.
- If an employee is not a full-time employee, then whether the employee qualifies as a student depends on all the relevant facts and circumstances. An individual is a student if education, not employment, is the predominant aspect of the employee’s relationship with the employer. The regulations include a nonexclusive list of factors to consider in evaluating the educational and service aspects of an employee’s relationship with the employer. These factors include:
 - The employee’s course workload relative to a full-time course workload at the school, college, or university where the employee is enrolled and regularly attending classes. If an employee carries a substantial course workload relative to a full-time course workload, then that suggests the employee is a student.
 - The employee’s normal work schedule and actual number of hours worked. If an employee’s normal work schedule or actual number of hours worked approaches 40 hours per week, then that suggests the employee is not a student.
 - Whether the employee is a “professional employee.” A professional employee is an employee whose primary duty consists of: (1) performing services that require advanced knowledge in a field of science or learning, (2) work requiring the consistent exercise of discretion and judgment, and (3) work that is predominately intellectual and varied in character. If an employee is a professional employee, then that suggests the employee is not a student.

- If a professional employee is licensed under state or local law to perform the services, then that further suggests the employee is not a student.
 - If an employee is eligible to receive retirement and other employee benefits, then that suggests the employee is not a student.

- **Rev. Proc. 98-16.** Since 1998, Rev. Proc. 98-16 has provided institutions of higher education with an administrable mechanism (a “safe harbor”) for applying the student FICA exception to a student employee who is enrolled at least half-time and is not a “career employee.” Under Rev. Proc. 98-16, a career employee is an employee who is eligible to participate in certain retirement plans, eligible for reduced tuition (with certain exceptions), or otherwise classified by the employer as a career employee. Institutions of higher education, and their students, may rely on Rev. Proc. 98-16 until April 1, 2005.

- **Rev. Proc. 2005-11 replaces Rev. Proc. 98-16.** Rev. Proc. 2005-11 modifies the safe harbor rules in Rev. Proc. 98-16 in order to align it with the final regulations. Rev Proc 2005-11 is effective for services performed on or after April 1, 2005, and contains the following changes.
 - The safe harbor is available only if the employer’s primary function is that of a school, college, or university.
 - The safe harbor is not available if the employee is a full-time employee.
 - A professional employee, as defined in the regulations, is not eligible for the safe harbor. However, a professional employee may qualify for the student FICA exception based on all the facts and circumstances.
 - The safe harbor is not available if the employee is eligible to receive certain employment benefits, unless mandated by state or local law. However, an employee who is ineligible for the safe harbor because of employment benefits may qualify for the student FICA exception based on all the facts and circumstances.