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Supreme Court Upholds IRS Rule that Hospitals Must Pay FICA Taxes on Resident Stipends

By: [Mark A. Stanley](#)

The United States Supreme Court issued its decision this month in [Mayo Foundation for Medical Education v. U.S.](#) [PDF], No. 09-837 (Jan. 11, 2011), upholding IRS regulations that treat medical residents as employees, as opposed to students. As a result, teaching hospitals must pay FICA taxes on their residents' earnings. The Mayo Foundation opinion brushes aside precedents that constrained agency rulemaking authority, and thereby further entrenches the Court's deferential approach to judicial review of agency rulemaking, which was announced in *Chevron U.S.A. v. National Resources Defense Council*, 467 U.S. 837 (1984).

The decision in *Mayo Foundation* affirms an IRS shift in its analysis of whether a worker is primarily a student, and thus exempt from FICA withholding, or an employee. The prior rule required a case-by-case analysis in order to determine whether a worker was primarily a student, but in 2004 the IRS changed its approach and created a bright line rule that treats anyone who works at least 40 hours per week as an employee. [69 Fed. Reg. 8604](#) [PDF] (Feb. 24, 2004). The newly announced rule was a response to the Eighth Circuit's ruling in *Minnesota v. Apfel*, 151 F.3d 742 (8th Cir. 1998), which stated that the Social Security Administration's categorical treatment of residents as employees was not allowed under existing regulations. By establishing a bright line rule — i.e., anyone who works 40 or more hours a week is an employee — the IRS sought to avoid litigating each individual claim that an individual is a student, rather than an employee.

Applying the two-step approach articulated in *Chevron*, the *Mayo Foundation* Court held that: (1) Congress had not spoken to the precise question at issue — whether medical residents are primarily employees or students; and (2) the IRS's interpretation of the statute was reasonable. By analyzing the case under the *Chevron* rule, the Court rejected the significantly less deferential rules announced

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in *National Muffler Dealers v. U.S.*, 440 U.S. 472 (1979) and *Rowan v. United States*, 452 U. S. 247, 253 (1981). The rule in *National Muffler* gave less deference to IRS regulations when the regulations depart from the agency's initial interpretation of the statute. The rule in *Rowan* limited the deference due to an agency when it promulgates regulations under a general rulemaking authority, as opposed to a specific grant of rulemaking authority regarding the area being regulated.

Ober|Kaler's Comments

From an employment standpoint, teaching hospitals will now need to begin treating residents as employees. Looking at the broader legal ramifications, the Mayo Foundation case raised a novel challenge to the deferential Chevron rule, but the unsurprising result is that the agency came out on top. By elevating Chevron above its other precedents, the Supreme Court has signaled that agencies will continue to enjoy the benefit of the doubt when promulgating regulations..