EARLY RETIREMENT PAYMENTS UNDER TENURE AND FICA TAXES: TRANSFER OF A PROPERTY RIGHT OR JUST ANOTHER PAYDAY?

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I. INTRODUCTION

In 1994, a federal law prohibited the widespread university procedure of forcing professors to retire after reaching a certain age.[1] As a result, the percentage of full-time faculty members age seventy and above is three times what it was in 1995.[2] The increase of full-time faculty members working past traditional retirement age is causing concern amongst colleges and universities.[3] During his service as president of Harvard University, Lawrence H. Summers stated that "[t]he aging of the faculty, caused in large part by the absence of mandatory retirement, is one of the profound problems facing the American research university."[4] Several institutions have employed policies to encourage aging faculty to retire, including financial incentives.[5] Due to the current economic situation, universities will continue to induce their older and higher-paid faculty members to retire to reduce costs. Special issues arise when inducing tenured faculty members to retire. Tenured faculty possess a constitutionally protected property right to continued employment absent just cause for termination and, as Judge Posner has observed, "[a] contract that gives the teacher the right to be employed till he retires is special, for unless he is old or rich the present value of his tenure right is probably his biggest asset."[6]

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1. *See* 29 U.S.C. § 631(d) (1986) (providing an exemption enacted in 1986 allowing institutions of higher education to enforce mandatory retirement for faculty who reached the age of seventy. The exemption was limited to seven years and expired at the end of 1993).
2. Marcella Bombardieri, *Graying of US Academia Stirs Debate: Some Cite Brilliance; Others See Lost Opportunity in Hiring*, BOSTON GLOBE, Dec. 27, 2006, at A1. (The current percentage of full-time faculty members age 70 or above is currently at 2.1% nationwide, however the author points out that the percentage is much higher at several "major universities" such as Harvard).
3. *Id.*
4. *Id.*
5. *Id.*
6. *Id*. (quoting Vail v. Bd. of Educ. of Paris Union Sch. Dist. No. 95, 706 F.2d 1435, 1451 (7th Cir. 1983) (Posner, J., dissenting)).

Recently, a circuit split has arisen regarding whether Federal Insurance Contributions Act[7] (FICA) taxation is applicable to early retirement payments made to induce tenured college professors to retire.[8] This comment will examine the implications of whether early retirement payments made by universities to tenured faculty members should be subject to FICA taxation. Section II will explore the background of tenure rights and FICA taxation generally and will explain the position taken by the Internal Revenue Service (IRS) and the development of case law. Section III proposes that rather than employing an all-or-nothing approach, courts should utilize an approach which would make concessions to all those involved. Finally, Section IV will provide a summary of why this approach is the most desirable.

II. BACKGROUND

In order to examine whether early retirement payments made to tenured faculty should be subject to FICA taxation, it is important to understand FICA taxation generally, as well as the tenure employment relationship and the current circuit split.

A. FICA Taxation

The purpose of the Federal Insurance Contributions Act is to finance a national system of old age, survivors, disability, and hospital insurance benefits, commonly referred to as social security and Medicare.[9] To accomplish this, the government imposes FICA taxes on both employers and employees at a rate corresponding to a percentage of the employee's annual wages.[10] Additionally, the government requires employers to withhold FICA

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7. I.R.C. §§ 3121–3128 (2000).
8. *Compare* N.D. State Univ. v. United States, 255 F.3d 599, 607 (8th Cir. 2001) (holding payments intended to purchase tenure rights exempt from the definition of wages), *with* Appoloni v. United States, 450 F.3d 185, 187 (6th Cir. 2006) (holding that compensation for relinquishment of tenure constitutes wages and is subject to FICA taxation), *and* Univ. of Pittsburgh v. United States, 507 F.3d 165 (3d Cir. 2007) (holding that early retirement payments made to tenured faculty members are subject to FICA taxation).
9. *See* Social Security Act Amendment of 1939, Pub. L. No. 76-379, § 1432, 53 Stat. 1360, 1387 (codified and amended at I.R.C. §§ 3101–3128 (2002)) (initiating a program funding federal insurance for elderly and disabled persons); I.R.C. § 3101(a) (creating tax to fund national old-age, survivors, and disability insurance); I.R.C. § 3101(b) (creating tax to finance hospital insurance portion of FICA).
10. *See* I.R.C. § 3101(a)-(b) (listing tax rate for each element of FICA); 5 SOCIAL SECURITY LAW AND PRACTICE § 69:2 (2008) (posting FICA rates from 1974 to present). Currently, the FICA tax rate for old age, survivors, and disability insurance (OASDI) is 6.2% of annual wages paid to an employee. I.R.C. § 3101(a). The current FICA tax rate for hospital insurance (HI) is 1.45%. I.R.C. § 3101(b)

taxes from their employees wages,[11] as well as match the tax contributions made by the employee.[12]

In describing the amounts subject to FICA taxes, the statute defines "employment" as "any service of whatever nature, performed by an employee for the person employing him."[13] The United States Supreme Court has held that the term "employment" is to be interpreted broadly.[14] The Court states that the term "service" means "not only work actually done but the entire employer-employee relationship for which compensation is paid to the employee by the employer."[15] The phrase "any service . . . performed" is not limited to only productive activity.[16] For purposes of FICA taxation, "wages" are defined as "all remuneration for employment."[17] The term "wages," like the term "employment," has been broadly interpreted.[18] While nearly all compensation earned while at the service of another constitutes wages, wages do not necessarily include all income earned from employment.[19] The Supreme Court has stated that "[w]ages usually are income, but many items qualify as income and yet clearly are not wages."[20] Not all income is subject to FICA taxation.[21] Courts have utilized various factors to determine whether specific payments are subject to FICA taxation as wages.[22] Such factors include the employer's motivation in awarding benefits, the employee's eligibility for receiving payment, the employer's procedure for calculating payment, and the type of employer-employee relationship producing the

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(these rates apply to both the employer and employee, and as a result, the total combined rate is 15.3%).

11. I.R.C. §§ 3402(a)(1), 3012(a); 13 EMPLOYMENT COORDINATOR PERSONNEL MANUAL § 9:27 (2009).
12. I.R.C. §§ 3111(a)-(b).
13. *Id.* § 3121(b).
14. *See* Soc. Sec. Bd. v. Nierotko, 327 U.S. 358, 365 (1946) ("The very words '*any service . . . performed* . . . for his employer,' with the purpose of the Social Security Act in mind import breadth of coverage.") (emphasis added).
15. *Id*. at 365–66.
16. *Id*. at 364–66.
17. I.R.C. § 3121(a) (there are several enumerated exceptions to this rule which can be found at I.R.C. § 3121(a)).
18. *See id.* (establishing broad definition of "wages"); *see also* Treas. Reg. §§ 31.3121(a)-(1)(c) (2002) (explaining types of remuneration to which FICA does and does not apply).
19. *See* Rowan Co. v. United States, 452 U.S. 247, 254 (1981) (stating that "wages" is a more limited concept than "income").
20. Cent. Ill. Pub. Serv. Co. v. United States, 435 U.S. 21, 25 (1978).
21. *See id.* at 31; Gerbec v. United States, 164 F.3d 1015, 1026 n.14 (6th Cir. 1999).
22. Redi Kasollja, Casenote, *Tax Law-Retired Tenured Professors' Early Retirement Plan Compensation Subject to Federal Insurance Contributions Act Taxation-University of Pittsburgh v. United States, 507 F.3d 165 (3d Cir. 2007)*, 42 SUFFOLK U. L. REV. 267, 269 (2008).

payments.[23] The name given to remuneration for employment is immaterial in determining whether it constitutes wages.[24] Thus, salaries, bonuses, and commissions constitute wages if given as compensation for employment.[25] In light of this, various courts have held that reduction-in-force payments, supplemental unemployment benefits, severance payments, back pay, and Employee Retirement Income Security Act (ERISA) settlements are wages subject to FICA taxation.[26]

B. Internal Revenue Service Revenue Rulings

The IRS has provided some guidance on what constitutes wages subject to FICA taxation. While courts may defer to agency rulings, they are only persuasive authority.[27] The weight given to an agency opinion "will depend upon the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control."[28] Courts are free to ignore IRS revenue rulings if they conflict with statutes, legislative

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23. *See* Appoloni v. United States, 450 F.3d 185, 191 (6th Cir. 2006) (stating that where payment is conditioned on meeting eligibility requirements, such as a minimum number of years of service, such payments constitute wages subject to FICA); N.D. State Univ. v. United States, 255 F.3d 599, 606 (8th Cir. 2001) (drawing distinctions between tenured and at-will employees in deciding whether payments are subject to FICA taxation); Assoc. Elec. Coop., v. United States, 226 F.3d 1322, 1328 (Fed. Cir. 2000) (holding that method of computing payment is a relevant factor in determining whether payments constitute wages); *Rowan*, 452 U.S. at 263 (holding that benefits given to employees are not wages because the employer's motivation was not to provide services, but to cut costs).
24. Greenwald v. United States, 85 A.F.T.R.2d 2000–766, 2000 WL 16939, at *3 (2000) (holding that all remuneration given for employment constitutes wages regardless of what the payment is labeled); Lane Processing Trust v. United States, 25 F.3d 662, 665 (8th Cir. 1994) (holding "all 'compensation for employment' is subject to FICA and FUTA taxes, regardless of what it is called) (citing Treas. Reg. § 31.3121(c)-1 (1993)); Treas. Reg. § 31.3121(c)-1 (2004).
25. STA of Baltimore-ILA Container Royal Fund v. United States, 621 F. Supp. 1567, 1575 (D. Md. 1985) (holding that how the payment is made is immaterial in whether or not it constitutes wages); Treas. Reg. § 31.3121(a)-1(d); 26 C.F.R. § 31.3306(b)-1 (1993).
26. *See, e.g.*, CSX Corp. v. United States, 52 Fed. Cl. 208, 221 (2002) (holding lump-sum payments received by employees upon entering a reduction-in-force program constitute wages); Assoc. Elec. Coop., Inc. v. United States, 226 F.3d 1322, 1328 (Fed. Cir. 2000) (holding severance payments made to employees entering an "early-out" plan constitutes wages); Hemelt v. United States, 122 F.3d 204, 209–10 (4th Cir. 1997) (holding settlement payments received subject to a class-action lawsuit under ERISA constituted wages subject to FICA taxation); Sheet Metal Workers Loc. 141 Supplemental Unemployment Benefit Trust Fund v. United States, 64 F.3d 245, 250–51 (6th Cir. 1995) (holding supplemental unemployment benefits were contingent upon past services, and therefore constitute wages); Soc. Sec. Bd. v. Nierotko, 327 U.S. 358, 364 (1946) (holding that back pay received following wrongful termination subject to FICA taxation).
27. *See* United States. v. Mead Corp., 533 U.S. 218, 234–35 (2001).
28. Skidmore v. Swift & Co., 323 U.S. 134, 140 (1944).

history, or are otherwise unreasonable.[29] However, it is important to note that the Supreme Court has long held the IRS the primary authority in interpreting the Internal Revenue Code.[30]

1. Revenue Ruling 58-301

In Revenue Ruling 58-301, the IRS was asked to determine whether an amount paid by an employer to an employee as consideration for repudiating an employment contract was ordinary income or capital gain.[31] The taxpayer had entered into an employment contract for a period of five years, and during the second year, the employer and employee mutually agreed to terminate the contract.[32] The employer made a payment to the employee in consideration of the relinquishments of his contractual rights.[33] The IRS determined that the payment was income to the employee but did not constitute wages for purposes of tax withholdings.[34]

2. Revenue Ruling 75-44

In Revenue Ruling 75-44, the IRS was faced with the issue of whether a payment made to an employee to induce him to relinquish seniority rights acquired through prior service constituted wages subject to FICA.[35] The IRS ultimately ruled that the payment constituted wages for purposes of FICA.[36] The employee was entitled to seniority rights as well as other benefits as agreed upon in a general contract of employment.[37] The employee agreed to change positions as requested by the employer.[38] As part of the position

29. Geisinger Health Plan v. C.I.R., 985 F.2d 1210, 1216 (3d Cir. 1993); Threkeld v. Comm'r, 848 F.2d 81, 84 (6th Cir. 1988); Brook Inc. v. Comm'r, 799 F.2d 833, 836 n.4 (2d Cir. 1986); Carle Found. v. United States, 611 F.2d 1192, 1195 (7th Cir.1979).
30. *See* Bob Jones Univ. v. United States, 461 U.S. 574, 596 (1983).
31. Rev. Rul. 58-301, 1958-1 C.B. 23. The IRS answers questions submitted from individuals and/or organizations "whenever appropriate in the interest of sound tax administration" to shed light on the consequences of specific transactions and/or a taxpayer's status. Treas. Reg. § 601.201(a) (2004). These rulings do not carry the force of a regulation due to a lack of notice and comment procedures. 5 U.S.C. §§ 553(b)-(d) (2006).
32. Rev. Rul. 58-301, 1958-1 C.B. 23.
33. *Id.*
34. *Id.*
35. Rev. Rul. 75-44, 1975-1 C.B. 15.
36. *Id.*
37. *Id.*
38. *Id.*

change, the employee agreed to surrender seniority rights he had previously earned in exchange for a lump-sum payment.[39]

Revenue Ruling 58-301 was distinguished from Revenue Ruling 75-44 on account that the latter was a payment involving the relinquishment of rights, while the former involved terminating an original agreement.[40] The IRS determined that Revenue Ruling 75-44 dealt with an indefinite employer-employee relationship that could be canceled by either party, whereas Revenue Ruling 58-301 dealt with an employment relationship where both parties were bound for a specific period of time.[41]

3. Revenue Ruling 2004-110

In 2004, the IRS issued Revenue Ruling 2004-110 in which it expressly modified and superseded Revenue Ruling 58-301.[42] The IRS was once again faced with the issue of whether a payment made to an employee in exchange for the relinquishment of an employment contract and relinquishment of contractual rights constitutes wages for the purposes of FICA.[43] The IRS held that it would no longer follow Revenue Ruling 58-301 after January 2005.[44] The IRS stated that Revenue Ruling 58-301 erred in its analysis and failed to determine that the payment made in cancellation of the employment contract constituted wages.[45]

C. Tenure

Tenure is a constitutionally protected property interest which entitles an individual to continued employment.[46] Tenure is often heralded as a protector of academic freedom;[47] however, it has also been criticized due to the costs it places on institutions, society, and the recipient.[48] Tenured faculty members

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39. *Id.*
40. *Id.*
41. *Id.*
42. Rev. Rul. 2004-110, 2004-2 C.B. 960 (holding the IRS would no longer follow Rev. Rul. 58-301 which had been in force for forty-six years).
43. *Id.*
44. *Id.*
45. *Id.*
46. *See* Cleveland Bd. of Educ. v. Loudermill, 470 U.S. 532, 538 (1985); Bd. of Regents v. Roth, 408 U.S. 565, 573–75 (1972); Perry v. Sinderman, 408 U.S. 593, 601–03 (1972); Morris v. Clifford, 903 F.2d 574, 576 (8th Cir. 1990).
47. *See* Ralph S. Brown & Jordan E. Kurkland, *Freedom and Tenure in the Academy: The Fiftieth Anniversary of the 1940 Statement Principles*, 53 LAW & CONTEMP. PROBS. 325, 355 (1990).
48. *Id*. at 331–33.

possess procedural due process rights, as well as substantive due process rights "to be free from discharge for reasons that are 'arbitrary and capricious' or in other words, for reasons that are trivial, unrelated to the education process, or wholly unsupported by basis in fact."[49] The Eighth Circuit has held that an individual possessing tenure may only be terminated if there is "adequate cause"[50] for dismissal.[51] Property interests are created by state law.[52] Federal constitutional law, however, governs whether the property interest is a "protected property interest."[53]

Based on various authorities, it is arguable that the purchase of an individual's constitutionally protected property right to tenure is not remuneration for services and, therefore, not taxable wages under FICA. The next section will discuss the recently developed circuit split.

D. Current Circuit Split

In recent years, a circuit split has developed between the Eighth, Sixth, and Third Circuits. The Eighth Circuit has taken the position that payments made to individuals with tenure under an early retirement program are not subject to FICA taxation.[54] Conversely, the Sixth and Third Circuits have held that payments made to tenured faculty members constitute wages, and as such, are subject to FICA taxation.[55] This section will analyze these decisions in the order they were decided.

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49. *Morris*, 903 F.2d at 577 (citing Fisher v. Snyder, 476 F.2d 375, 376–77 (8th Cir. 1977); Honore v. Douglas, 833 F.2d 565, 568–69 (5th Cir. 1987)).
50. Some university handbooks list offenses that may constitute "adequate cause," however others may not. The 1973 Commission on Academic Tenure stated that "'adequate cause' in faculty dismissal proceedings should be restricted to (a) demonstrated incompetence or dishonesty in teaching or research, (b) substantial and manifest neglect of duty, and (c) personal conduct which substantially impairs the individual's fulfillment of his institutional responsibilities." *See* COMMISSION ON ACADEMIC TENURE IN HIGHER EDUCATION, *Faculty Tenure* 93 (1973). This is a fairly typical definition of "adequate cause." *See* Brown & Kurkland, *supra* note 47, at 328.
51. *Morris*, 903 F.2d at 577.
52. *See* Bishop v. Wood, 426 U.S. 341, 344 (1976); Eddings v. City of Hot Springs, Ark., 323 F.3d 596, 601 (8th Cir. 2003); Riley v. St. Louis County of Mo., 153 F.3d 627, 630 (8th Cir. 1998).
53. Memphis Light, Gas & Water Div. v. Craft, 436 U.S. 1, 9 (1978); Bd. of Regents v. Roth, 408 U.S. 565, 577 (1972).
54. *See* N.D. State Univ. v. United States, 255 F.3d 599 (8th Cir. 2001).
55. *See* Univ. of Pittsburgh v. United States, 507 F.3d 165 (3d Cir. 2007); Appoloni v. United States, 450 F.3d 185 (6th Cir. 2006).

1. North Dakota State University v. United States (8th Cir. 2001)

North Dakota State University ("NDSU") is a publicly funded university located in Fargo, North Dakota.[56] NDSU offered an early retirement program to tenured faculty as well as high-level administrators.[57] NDSU utilized the early retirement program to confront a variety of issues including curriculum needs and budgetary constraints.[58] The plan was also used to induce tenured faculty to retire when the university lacked good cause to terminate them.[59] Employees entering into the early retirement agreement agreed to relinquish any tenure, contract, or other employment rights.[60] In order for an employee to participate in the early retirement program, the employee and the administration were required to consent in writing.[61] Neither party was able to unilaterally participate in the program.[62] Employees wishing to take part in the early retirement program would generally enter into negotiations with a dean, vice-president, or department chair regarding payment.[63] The amount of the payment received by a faculty member could vary based upon past performance, current salary, or the university's budget constraints or curriculum needs.[64]

Until 1999, NDSU withheld FICA taxes from payments made under the early retirement program.[65] Some individuals who were participating in the program questioned the applicability of FICA taxes to payments made under the program.[66] NDSU contacted the Social Security Administration (SSA) and asked whether a sum of money offered to an employee to sell their tenure to the University constitutes wages for FICA purposes.[67] The SSA responded in writing stating that "in effect, a payment to secure the release of an unexpired contract of employment," which the SSA found the early retirement program

56. N.D. State Univ v. United States, 84 F. Supp. 2d 1043, 1045 (D. N.D. 1999).
57. *Id.*
58. *N.D. State Univ.*, 255 F.3d at 600.
59. *Id*. (other factors were also considered if necessary).
60. *Id*. (In addition, an employee would have to agree to forgo seeking employment with any public university or college in North Dakota as well as forgo any claim against NDSU involving the Age Discrimination in Employment Act.)
61. N.D. STATE BD. OF HIGHER EDUC., POLICY MANUAL § 703.1(2)(b).
62. *Id.*
63. *Id.* § 703.1(b)(V).
64. N.D. State Univ. v. United States, 84 F. Supp. 2d 1043, 1045–46 (D. N.D. 1999); N.D. STATE BD. OF HIGHER EDUC., POLICY MANUAL § 703.1(3)(b)(II).
65. *N.D. State Univ.*, 255 F.3d at 602.
66. *Id.*
67. *Id.*

to be, is not considered wages for purposes of FICA taxation.[68] NDSU subsequently stopped withholding FICA taxes on payments made under the early retirement plan.[69] In 1995, the IRS assessed deficiencies for unpaid FICA taxes in regards to early retirement payments for the years 1991 through 1994.[70] NDSU paid the deficiency and later filed for a refund which the IRS denied.[71]

NDSU subsequently filed suit seeking a refund for FICA taxes paid from 1991 through 1997.[72] The federal district court held that the payments made to administrators constituted wages which were subject to FICA taxation because faculty members were at-will employees.[73] However, the court held that payments made to tenured faculty members were not subject to FICA taxation.[74] Rather, these payments were made in "in exchange for the relinquishment of a property or contract interest rather than for compensation."[75] The IRS appealed to the Eighth Circuit arguing that the trial court erred in holding payments made to tenured faculty members did not constitute wages subject to FICA taxation.[76]

Because of the lack of relevant case law, the court examined IRS Revenue Rulings to discover the tax law principles relevant to the issue at hand.[77] The court determined that payments made for the relinquishment of rights formed pursuant to a contract are not considered wages for purposes of FICA.[78] The court further found that payments made under a contract are not considered wages for FICA purposes according to the IRS.[79] Lastly, the court

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68. *Id.*
69. *Id*. (NDSU claimed that they had contacted the IRS who informed them to contact the SSA. However, the IRS claimed that they were never contacted by NDSU. Ultimately, the Eighth Circuit found this fact to be immaterial in deciding the case.)
70. *Id.*
71. *Id.*
72. *Id*. (Only one other federal district court had addressed the issue of whether payments made to tenured faculty in exchange for the release of their tenure rights was subject to FICA taxes); Slotta v. Texas A&M Univ. Sys., No. Civ. A G-93-92, 1994 WL 16170227 (S.D. Tex. Aug. 10, 1994) (holding that the payment was not wages for FICA purposes).
73. *N.D. State Univ.*, 255 F.3d at 602. (At-will employees were only protected form termination by extended notice provisions, which were not as protective as tenure. Additionally, the district court determined that the payments made to administrators were based on factors which are traditionally used for compensation.)
74. *Id.*
75. *Id.*
76. *Id.*
77. *Id*. at 603–05.
78. *Id*. at 603–04. *See* Rev. Rul. 58-301, 1958-1 C.B. 23 (this Revenue Ruling was later repealed by the IRS, but was still being followed at the time of the decision).
79. *N.D. State Univ.*, 255 F.3d at 604. *See* Rev. Rul. 74-252, 1974-1 C.B. 287.

found that remuneration for services rendered or for seniority rights are considered wages subject to FICA taxation.[80]

The court first addressed the government's argument that tenure rights are not contract rights that can be relinquished.[81] The government contended that, unlike contract rights, tenure rights cannot be bought and sold and therefore have no economic value.[82] The court disagreed, holding that employment contracts do have economic value, even if only to the employee.[83] The court found the fact that tenure rights cannot be bought and sold on an open market does not mean those rights have no economic value to a tenured faculty member.[84] The court made reference to Judge Posner's observation that tenure is probably a tenured faculty member's largest asset.[85]

Next, the court addressed the government's contention that tenure rights are acquired over time and therefore are analogous to seniority rights which are considered wages subject to FICA.[86] The court found that tenure is granted for more than just acknowledgment of services previously rendered.[87] The court distinguished tenure from seniority rights on the ground that tenure is not granted automatically after a fixed period of service.[88] Rather, the court found that a tenured faculty member experiences an at-will relationship and later, a tenured relationship.[89] According to the court, these are two distinct employment relationships.[90] The tenure relationship, and the rights associated with it, is created when tenure is granted forming a new employment relationship.[91] Therefore, the court rejected the argument that tenure is acquired over a period of time.[92]

Ultimately, the Eighth Circuit ruled that the tenured professors received early retirement payments in exchange for the relinquishment of their contractual tenure rights.[93] Thus, the payments were made in exchange for the surrender of a contract right rather than for services previously rendered.[94] The

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80. *N.D. State Univ*., 255 F.3d at 604.
81. *Id*. at 605.
82. *Id.*
83. *Id.*
84. *Id.*
85. *Id*. (citing Vail v. Bd. of Educ. of Paris Union Sch. Dist. No. 95, 706 F.2d 1435, 1451 (7th Cir. 1983) (Posner, J., dissenting)).
86. *Id.*
87. *Id.*
88. *Id.*
89. *Id*. at 606.
90. *Id.*
91. *Id.*
92. *Id.* at 607.
93. *Id.*
94. *Id.*

early retirement payments made to tenured faculty were therefore not subject to FICA taxation.[95]

2. Appoloni v. United States (6th Cir. 2006)

In 2002, two class action lawsuits were brought in Michigan regarding the issue of whether payments made to public school teachers in exchange for relinquishment of tenure rights are considered wages subject to FICA taxation.[96] Both cases, *Appoloni v. United States* and *Klender v. United States*, involved former employees of Michigan school districts who received early retirement payments.[97] All parties involved had been granted tenure subject to the Michigan Teachers' Act under which teachers automatically receive tenure by successfully completing a probationary period.[98] The early retirement payments were offered to tenured teachers who had served for a certain period of years depending on the plan.[99] The purposes of the plans were to prevent layoffs, lower the cost of staffing, and induce retirement.[100] Parties in both cases applied for refunds of FICA taxes withheld from the payments which were subsequently denied by the IRS.[101] In *Appoloni*, the trial court granted the government's motion for summary judgment, while in *Klender* the trial court granted the Plaintiffs' motion for summary judgment.[102] Both cases were consolidated upon appeal.[103]

The Sixth Circuit first analyzed the eligibility requirements mandated by the early retirement payments.[104] The court held that when a payment made by an employer to an employee is dependent upon a specific time period of service, the payment constitutes wages subject to FICA taxation.[105] The court found that the principal factor in being eligible for an early retirement payment was time served teaching, not tenure.[106] Therefore, the eligibility requirements were based on prior services rather than the purchase of a tenure right.[107]

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95. *Id.*
96. Appoloni v. United States, 450 F.3d 185, 187 (6th Cir. 2006).
97. *Id.*
98. Michigan Teachers' Act, MICH. COMP. LAWS § 38.71 (2000).
99. *Appoloni*, 450 F.3d at 188–89.
100. *Id.*
101. *Id.* at 187.
102. *Id.* at 189.
103. *Id.* at 187.
104. *Id.* at 191.
105. *Id.*
106. *Id.* at 192.
107. *Id.* at 191–92.

The court then examined the teachers' argument that because the payments were made in exchange for the relinquishment of their tenure right, they did not constitute taxable wages subject to FICA.[108] The court ruled that when an individual with tenure rights relinquishes those rights by accepting early retirement, the relinquishment does not transform wages under FICA to something different.[109] Furthermore, the court looked at how the tenure right was relinquished rather than focusing only on the fact that it was relinquished.[110] In the case at hand, teachers had earned tenure through completing a statutory probationary period rather than having tenure rights conferred upon them at the onset.[111] Therefore, tenure rights were earned by services rendered like any other employment benefit.[112] The court found that even though tenure rights are protected, it does not alter the fact that they must be earned through services previously rendered to the employer.[113] In addition, the court ruled that the public schools' primary purpose in offering the early retirement payments was to induce retirement, not to purchase teacher's tenure rights.[114] The purchase of tenure was ancillary to persuading teachers to retire to meet budgetary constraints.[115] Therefore, the court found that the payments constituted wages subject to FICA taxation.[116]

The Sixth Circuit distinguished their case from the decision made by the Eighth Circuit in *North Dakota*.[117] In *North Dakota*, tenure rights were formed when the tenure relationship was created.[118] Moreover, NDSU faculty members were not awarded tenure automatically after a specified period of time.[119] Whereas in *Appoloni*, tenure rights were earned after a specified period of service instead of being contracted for at the onset of employment.

108. *Id*. at 192.
109. *Id.*
110. *Id.*
111. *Id.*
112. *Id.*
113. *Id.*
114. *Id.* at 195–96.
115. *Id.*
116. *Id.* at 196.
117. *Id.* at 195.
118. N.D. State Univ. v. United States, 255 F.3d 599, 601 (8th Cir. 2001).
119. *Id.*

3. University of Pittsburgh (3d Cir. 2007)

Between 1989 and 1999, the University of Pittsburgh (University) offered early retirement payments to tenured faculty members.[120] Under the plans, the publicly funded University paid eligible employees an amount based upon their length of employment with the university as well as their salary at the time of retirement.[121] In order to be eligible for the early retirement payments, employees had to relinquish their right to tenure.[122] These payments allowed the University to offer compensation packages similar to other universities, provide retirement options to faculty, and induce retirement to bring in new faculty.[123]

As a result of these payments, the University paid more than two million dollars in FICA taxes between 1996 and 2001.[124] In 2001, the University filed claims for refunds for the entire amount of FICA tax withholdings since 1996.[125] The IRS denied the University's request for a refund and as a result, the University filed suit.[126] The district court ruled in favor of the University holding that early retirement payments made to tenured faculty members did not constitute wages and were not taxable under FICA.[127]

The Third Circuit reviewed the current circuit split and agreed with the Sixth Circuit, concluding that the University's early retirement payments were wages and therefore subject to FICA taxation.[128] The court first determined that the eligibility requirements were directly linked to employees' past services rather than relinquishment of tenure.[129] The court noted that the University relied on past services rather than on numerous factors as was done in *North Dakota*.[130] Second, the court concluded that the University considered the payments to be compensation for prior services because the University had created the payments to maintain competitive compensation packages compared to similar universities.[131] Next, the court reasoned that the

120. Univ. of Pittsburgh v. United States, 507 F.3d 165, 166 (3d Cir. 2007).
121. *Id.*
122. *Id.*
123. *Id.* at 172.
124. *Id.* at 167.
125. *Id.* (the University's request for refunds included employee-paid portions and was sought with employees' consent).
126. *Id.*
127. *Id.*
128. *Id.* at 170–74.
129. *Id.* at 171–72.
130. *Id.* at 172 n.9.
131. *Id.* at 172.

University's main goal in giving the payments was to provide opportunities for employees to retire early.[132] The court compared the University's early retirement payments to severance payments which are generally taxed as wages subject to FICA.[133] The court found no distinction between severance payments involving tenure rights and those that involved at-will employees.[134] Finally, the court found that tenure is not the beginning of a new employment relationship.[135] It equated tenure to a promotion rather than a completely new and distinct employment relationship.[136] It held that although tenure is granted on a discretionary basis, it is still awarded as a result of services previously rendered to the University.[137]

IV. ANALYSIS

The IRS argues that early retirement payments made to tenured faculty members should be taxed in their entirety. Conversely, employers and employees contend that no amount of such payments should be taxed. Rather than employing an all-or-nothing approach, courts should recognize that both sides raise strong arguments because these payments possess a dual character. As a result, courts should utilize an approach which would make concessions to all those involved.

The relevant cases conclude that early retirement payments made to tenured faculty fall in one of two categories. They are either (i) exclusively made in consideration of prior services rendered to the employer or (ii) in return for the employees' relinquishment of tenure. There is an inherent unfairness, however, in either extreme position. A more practical conclusion is that in the great majority of cases, part of the payment is in consideration of prior services and part is for the relinquishment of tenure.

Early retirement payments are made for a myriad of reasons. Undoubtedly, many times a large portion of the payment is offered as severance. Employers may wish to induce retirement to cut costs or make room for new faculty. Severance payments are common in all types of employment. However, individuals with tenure have a legally protected property right to continued employment absent just cause for termination. In order to induce tenured faculty members to retire, employers must pay an

132. *Id.*
133. *Id.*
134. *Id.* at 173–74.
135. *Id.*
136. *Id.*
137. *Id.* at 174.

increased amount for the relinquishment of the tenure right. Therefore, early retirement payments to tenured faculty serve a dual purpose. One purpose is to recognize services previously rendered to the employer, while a secondary purpose is to obtain relinquishment of tenure.

The first step is to determine whether tenure has any economic value at all. At one extreme, the IRS argues that tenure rights have no economic value because there is no market in which they may be bought or sold.[138] However, the fact that there is no market for tenure rights does not mean that tenure has no economic value. Examples abound of benefits that have no market, but yet courts award monetary damages for the loss of the benefits. Workers compensation arrangements pay fixed dollar amounts for physical injuries to various body parts; juries fix damage awards for pain and suffering or lack of reputation; and appellate courts review damage awards for loss of consortium or wrongful death.

The right to continued employment is an extremely valuable contract right for those faculty members who possess it. In fact, as previously mentioned, Judge Posner believes that tenure may be an individual's largest asset.[139] The fact that tenure has economic value is also evidenced by how motivated non-tenured faculty members are to work hard to obtain it. Non-tenured faculty are driven by promotional interests which leads them to publish work in academic journals in greater number and in greater detail than their tenured counterparts.[140] Some non-tenured faculty likely would not devote the large amount of time and energy to publish work in academic journals unless their reward of tenure provides some economic value. Therefore, the right of tenure does have some economic value.

After determining that tenure has economic value, the next step is to determine how much value it possesses, or what percentage of gross early retirement payments are allocable to the release of tenure rights. It is very difficult to place an exact dollar value on tenure. The value of tenure is affected by several factors including age, location, and how it is earned. Younger faculty members, who have the potential to work for many more years, would place a larger value on tenure than elderly faculty members who plan to retire soon. However, an employer may be willing to pay an older tenured faculty member more to retire early than they would a younger faculty member because older faculty would tend to earn more due to seniority.

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138. *See* N.D. State Univ. v. United States, 255 F.3d 599, 605 (8th Cir. 2001).

139. *See* Vail v. Bd. of Educ. of Paris Union Sch. Dist. No. 95, 706 F.2d 1435, 1451 (7th Cir. 1983) (Posner, J., dissenting).

140. *See* Philip F. Postlewaite, *Life After Tenure: Where Have All the Articles Gone?*, 48 J. LEGAL EDUC. 558, 566 (1998).

Location would also play a large factor in placing a dollar value on tenure. Tenured faculty members at prestigious universities, where they are more likely to command larger salaries and receive more accolades, would place a higher value on their tenure right than a faculty member at a publicly-funded community college where salaries and prestige are much lower. Lastly, how tenure was earned may be a factor in how much it is worth. If tenure is awarded sparingly and only to those individuals who have met strenuous criteria, recipients will place a higher value on tenure. However, if tenure is awarded automatically upon completion of a specified period of service, recipients may not value tenure to the same degree.

Because the value of tenure rights can differ based on the circumstances, one approach to determine their value would be to analyze each circumstance on a case-by-case basis. For example, if a mathematics professor at Harvard accepts an early retirement buy-out, the IRS and the taxpayers would argue on the allocation between FICA-free payments for tenure, and severance payments subject to FICA. Similarly, when a tenured biology professor at a state university accepts a buy-out, the IRS and the taxpayers would engage in a similar argument focusing on the facts involving the biology professor. Such an assessment might provide a more equitable estimation of the economic value of tenure in each case, but such an approach is highly impractical. A case-by-case evaluation would increase the accuracy of every determination but would increase complexity and administrative costs. As more steps are added to increase accuracy, ease of administration is abandoned. Even if every situation is analyzed on a case-by-case basis, disagreements would arise regarding the methods of calculating the value of tenure. Thus, evaluating each individual case is not an appropriate solution.

The evaluation problem created by tenure may be overcome by establishing a threshold amount which should not be subject to FICA taxation. Determining this threshold is an exercise in accommodating two valid competing points of view. There is an inherent sense of inequity in subjecting the entire amount of an early retirement payment to FICA taxation when a tenure right is involved because tenure is valuable. However, there is a similar sense of inequity if no portion of such a payment were subject to FICA tax when the payment has arisen out of the employment relationship. This subjective judgment would need to be resolved in the realm of politics by the implementation of a statute. A favorable approach would be to tax only eighty percent of early retirement payments made to tenured faculty members. This would establish a twenty percent threshold that escapes FICA taxation because it is received in exchange for relinquishment of tenure rather than in recognition of services previously rendered. Such a rule would prevent the inherent unfairness of the all-or-nothing approach and strike a compromise

between the two considerations for the payment, prior services, and relinquishment of tenure. This twenty percent threshold amount would make concessions to the IRS as well as the taxpayers. It would be a more equitable outcome than an all-or-nothing approach while being less complex than evaluating each situation individually. The ease of administration would benefit both the IRS as well as employers because it would create a bright-line test that could be implemented with ease.

Such a twenty percent threshold would be analogous to an existing statute in the Internal Revenue Code. Just as in the realm of tenure, evaluation problems create confusion as to what should be allowed as a charitable deduction. Instances where a taxpayer makes a charitable donation but directly or indirectly receives a benefit as a result have created questions of whether a charitable deduction should be allowed. Section 170(l) of the Internal Revenue Code involves the treatment of charitable donations made to institutions of higher education where the taxpayer directly or indirectly receives the benefit of being able to purchase tickets for athletic events of the school.[141] Some schools require that individuals pay money to a university's athletic booster clubs in order to purchase tickets, or to purchase tickets in certain areas of the stadium.[142] In essence section 170(l) allows an eighty percent charitable deduction of payments made to a university when the taxpayer receives the benefit of being able to purchase tickets for athletic events. If the taxpayer did not receive the benefit in exchange for their payment, they would be able to deduct one hundred percent of the payment rather than just eighty percent.

The benefit of being able to purchase tickets for seats at university athletic events is similar to the tenure situation in that it is difficult to value. The right to purchase tickets would be much more valuable at some schools than others. Obtaining tickets for events at schools which have a rich tradition of excellent athletic programs would be of far greater benefit than obtaining tickets at a school with poor athletics. Also, having the ability to purchase tickets in particular parts of a stadium would have greater value in sold-out stadiums than in stadiums where similar seating could be easily obtained. While it would be more equitable to examine each case individually and determine how much of a benefit was received, this would be costly and administratively inefficient. Instead, Congress decided to allow an eighty percent deduction and mandate that twenty percent be disallowed as a

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141. *See* I.R.C. § 170(l) (2002).

142. The IRS first attempted to address this issue by adopting a facts and circumstances test, but later abandoned it in favor of a bright-line test resulting in § 170(l). *See* Rev. Rul. 86-63, 1986-1 C.B. 88; I.R.C. § 170(l).

deduction. The same principal could be used to address the taxation of early retirement payments to tenured faculty. Because of the difficulty in determining the value of tenure, a fixed percentage approach would allow employees and employers to escape FICA taxation to a degree without escaping completely.

History reveals that a fixed percentage approach may be an acceptable alternative to the IRS. In *Hernandez v. Commissioner*, the United States Supreme Court addressed the issue of whether taxpayers could deduct payments made to the Church of Scientology in exchange for services known as "auditing" and "training."[143] The Court held that the payments were not deductible because they did not qualify as contributions or gifts.[144] Instead, the Court found such payments to be a "quid pro quo exchange" in which taxpayers received benefits in exchange for their payment.[145] The Court's majority opinion in *Hernandez* hinged on the particular facts and circumstances, and if the Church of Scientology changed the terms of their programs, the opinion could have been distinguished in future cases.[146] In the weeks following the opinion, the IRS entered into a settlement agreement with the Church of Scientology, allowing individuals to claim eighty percent of the cost of qualified religious services as a charitable contribution.[147] This is a prime example of a situation in which a valuation problem has arisen and the IRS has entered into an agreement where concessions are made on both sides.

A fixed percentage approach, such as a twenty percent threshold, would create a bright-line test that would aid in settling federal tax law in a reasonably fair, equitable, and simplistic fashion. A fixed percentage approach would allow for easy administration of FICA tax in regards to early retirement payments made to tenured faculty. Employers and employees would be able to predict with precision how much of each payment would be subject to FICA taxation. The IRS would be able to quickly discover whether all taxes subject to FICA had been paid. Overall, a fixed percentage approach would allow for much easier implementation and execution than the current situation. As it now stands, only early retirement payments made to tenured faculty in the Third, Sixth, and Eighth Circuits are known to be subject, or not subject, to FICA taxation. A fixed percentage approach would bring much needed uniformity to this area of federal tax law.

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143. Hernandez v. Comm'r, 490 U.S. 680, 680–81 (1989).
144. *Id.* at 684.
145. *Id.* at 691.
146. *Id.* at 710.
147. *See* Sklar v. Comm'r, 282 F.3d 610, 617 (9th Cir. 2002).

V. CONCLUSION

Rather than employing on an all-or-nothing approach that ignores economic reality, courts should utilize an approach which would make concessions to all those involved. A better approach would be for Congress to adopt a fixed percentage approach, such as allowing twenty percent of these payments to escape FICA taxation because a portion of the school's payment is in exchange for the relinquishment of tenure rather than for recognition of services previously rendered. This approach would recognize that tenure, as Judge Posner observed, has economic value. This approach also would recognize the difficulty that comes with attempting to place a value on tenure. A current section of the Internal Revenue Code and a previous settlement agreement adopted by the IRS suggest that a fixed percentage approach would be a workable option for all parties involved. Most importantly, a fixed percentage approach would prevent the inherent unfairness of an all-or-nothing approach. Because tenure has value, it is patently incorrect to conclude that relinquishment of tenure plays no role in the calculation of an early retirement payment. However, it is also patently incorrect to conclude that relinquishment of tenure is the only consideration in calculating an early retirement payment. Rather than debating over whether one hundred percent or zero percent of the payment should be subject to FICA, a middle-of-the-road approach should be utilized. A fixed percentage, such as twenty percent, should be implemented in order to remedy the current situation.