

ARE EARLY RETIREMENT PAYMENTS MADE TO TENURED FACULTY MEMBERS TAXABLE AS WAGES UNDER THE FEDERAL INSURANCE CONTRIBUTION ACT?

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Abstract

All over America institutions of higher education are contemplating ways to deal with the aging of the faculty. Institutions see the aging of the faculty creating two problems. First, when tenured senior faculty continue to teach past the normal retirement age the opportunity to refresh the academy with younger faculty with exciting new ideas is lost. Second, and perhaps most important to administrators, the senior faculty often cost more. Administrators are always looking for ways to reduce academic costs to pay for their educational vision. One way that has been explored in several jurisdictions is to offer retirement plans to senior tenured faculty that give them payments to retire and give up tenure. Stanford University, for example, is offering substantial payments to faculty members over the age of 60 who relinquish their contractual tenure rights. This paper discusses whether the payments made by institutions to buyout tenured faculty members are considered taxable wages under the Federal Insurance Contribution Act (FICA) or should be characterized as the purchase of a property interest in tenure that is not subject to taxation under FICA. We do so by discussing the definition of tenure, FICA wages, the Internal Revenue Service's revenue rulings interpreting payment plans to buyout employment contracts, and two competing U.S Circuit Court of Appeals cases on the characterization of tenure buyout plans.

Background

We commence with a short discussion of tenure and wages. These definitions are important because they are the initial basis of the IRS and federal court's determination about whether payments for giving up tenure are considered taxable wages or a nontaxable payment for a property right. Tenure fosters an environment of free inquiry because, once conferred, it affords faculty "rights and immunities" including immunity from termination except for cause or financial exigency, *Board of Regents v. Roth*, 408 U.S. 564 (1972). Wages, under the FICA are "all wages that are received by an employee with respect to employment" (26 U.S.C. section 3101(a)-(b)). The Supreme Court has concluded that the term wages should be interpreted broadly. The high court said, "any service performed means not only work actually performed but also the entire employer-employee relationship for which compensation is paid," *Social Security Board v. Nierotko* (1946). This broad definition of wages arises again in an IRS revenue ruling discussed below. Keep in mind that any such payment for the relinquishment of tenure is clearly subject to taxation for Federal Income Tax purposes. The current discussion relates to whether such payments are subject to FICA taxation. The current rate of taxation for FICA

payments is 7.65% for the taxpayer as well as the resulting matching payment by the employer, resulting in an amount being paid to the IRS equal to 15.3% of the payment for relinquishment of tenure.

Internal Revenue Service Rulings

The IRS ruling relied on by those who characterize the buyout of tenure as nontaxable compensation for a property right rather than wages, concerned a 5 year employment contract which both parties agreed to cancel in the second year. In consideration for the employee's agreement to give up his contract rights, the employer paid the employee a lump sum. The IRS decided that the lump sum received in consideration for giving up the employee's contract rights was not subject to FICA tax because the payments were for relinquishment of a property interest in tenure and not wages (Revenue Ruling 58-301). But that is not the end of the interest of the IRS. Subsequent Revenue Rulings reveal that the Service in subsequent cases has decided to distinguish and limit the application of Rev. Rul. 58-301.

Revenue Ruling 74-252 involved a three year contract that provided that the employer could terminate the employee at any time during the period of the contract if the employer paid the employee an amount equal to six months pay. The employer terminated the contract and paid the employee the required sum. The IRS deemed these payments as dismissal payments made pursuant to the terms of the contract rather than consideration for the relinquishment of a property interest and concluded the payment was taxable wages under FICA. The IRS distinguished Revenue Ruling 74-252 from Revenue Ruling 58-301 by saying Revenue Ruling 74-252 involved consideration for cancellation of an employment contract rather than dismissal payments.

Finally, in Revenue Ruling 2004-110, a concerned IRS clearly moved to limit Revenue Ruling 58-301 to its facts and to payments made to employees prior to 2005. The taxable issue involved payments made to an employee for cancellation of an employment contract. In this ruling the IRS relied on a broad definition of wages as anything that is dependent on the employer-employee relationship. Here the IRS said that the employee received the payment as consideration for cancelling the remaining period of his contract. Consequently, the payment was dependent on cancelling the employer-employee relationship and is considered wages subject to FICA taxes. The IRS said the burden is on the employee to clearly show that the consideration for the employer's payment is not dependent on the employer-employee relationship. This is surely a difficult burden for any employee to meet and is certainly cleverly calculated to insure that almost all payment plans are considered wages subject to FICA taxes. Thankfully, the last word does not belong to the IRS. We now turn to the federal court's handling of the issue. As we shall see, two different U.S Circuit Courts of Appeal have come down squarely on both sides of the issue.

The Cases

We first discuss the University of Pittsburg v. United States of America (2007). Here, the court concluded that relinquishment of tenure rights, although a condition precedent to the payments for a buyout of tenure, does not alter the payments' character as compensation for services. As a consequence, the court characterized the payments as wages subject to FICA taxes. The appellate

court gave four reasons for its findings. First, the court said that eligibility for the buyout plan was linked to age and length of service to the university. These requirements link the plan to past services to the University, not the specific tenure rights being relinquished, and weigh heavily in favor of treating the payments as wages. Second, the plan itself made clear that the payments were offered to senior faculty as a reward for their faithful service to the university. The Board of Trustee's Resolution approving the plan said the university offered the plan to provide maximum opportunities for senior faculty members to voluntarily retire. Thus, to the extent that the plan was a reward for past service it qualifies as wages for hard work and faithful service. Third, even if the University made payments in part to secure relinquishment of tenure contract rights, their main purpose was to provide for the tenured faculty's early retirement. In this way, claimed the court, they are indistinguishable from employee severance payments that are generally taxed as wages. The court refused to treat these payments differently from other employee severance packages just because tenure rights were involved. The court rejected the University's argument that tenure is a special relationship between the university and the faculty member because the faculty member has "due process" rights before the relationship can be ended. Not so said the court. This is because the relationship still arises primarily from the tenured faculty member's past services to the university. Finally, the court said that just because tenure affords new rights to the recipient, it is not the start of a new employment relationship because it is contingent on past performance and is more like a promotion than a new contract. The fact that tenure is awarded on a limited basis does not change the fact that it is based on service to the University. In sum, said the court, because tenure is a form of compensation based on past service to the University, payments offered to buyout tenure are compensation and taxable as wages (*University of Pittsburg v. United States of America* 2007)). Senior tenured faculty members take heart, because this was not the end of the matter.

Tenured faculty members in Arkansas and those within the jurisdiction of the 8th Circuit Court of Appeals can look to the case of *North Dakota State University v. United States of America* (2001) for encouragement. The court in this case carefully examined the purpose of tenure and its value to the institution and the faculty member. The court reasoned that a tenured professor experiences two successive employment relationships with the University. First, there is an initial at will relationship and then a distinctly different tenured relationship. The court recognized that there is "a significantly different status-effectively a new job" when a professor receives tenure. So said the court, contrary to the government's argument that tenure rights are earned by past service to the university, tenure contract rights are established at the onset of the tenured relationship. The court quickly found that the buyout of tenured professors in the *North Dakota State* case resulted in the payment of money in exchange for their constitutional and contractual rights to tenure. This was a purchase of a constitutionally protected property right in tenure rather than taxable compensation for past services. Thus, the buyout of tenure is analogous to Revenue Ruling 58-301 that recognized lump sum payments given in consideration for an employee giving up contract rights should be characterized as consideration for giving up a protected property interest rather than considered as wages. The government also argued that tenure rights are not contract rights that can be relinquished because they have no economic value that can be bought and sold in an open market (*North Dakota State University v. United States of America* 2001). The court was not impressed stating that the lack of a market does not prevent those rights from having value to the tenured faculty member. Citing Judge Richard Posner that "A contract that gives a teacher a 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,”(Vail v. Board of Education 1983).

Conclusion

Astute university administrators who are contemplating offering early retirement payments in return for the relinquishment of tenure will insure that the early retirement agreement clearly refers to the early retirement payments as being “made in exchange for the faculty member’s relinquishment of a contractual and constitutionally protected property interest in tenure rather than remuneration for past or future services to the university.” The agreement might even state how long that the contractual tenure relationship might have existed absent the early retirement. Finally, the agreement should clearly indicate that the sum of the payments for relinquishment of tenure are not directly dependant on the past or future wages of the tenured faculty member. This approach will help negate the government’s argument that the payments are wages because they are somehow tied to past or future services to the university and are dependent on the total employment relationship.

References

North Dakota State University v. United States of America, 255 F.3d 599 (8th Cir. 2001).

Social Security Board v. Nierotko, 327 U.S. 358 (1946).

University of Pittsburg v. United States of America, 507 F.3d 165 (3d Cir. 2007).

Vail v. Board of Education, 706 F.2d 1435 (7th Cir. 1983).

Rev. Rul.58-301, 1958-1 C.B. 23.

Rev. Rul. 74-252, 1974-1 C.B. 287.

Rev. Rul. 2004-110, 2004 C.B. 960.

26 U.S.C. section 3101(a)-(b)