

TAXING THE GREAT ACADEMIC DIVORCE

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INTRODUCTION

For many professors, the granting of tenure involves not only a promise of job security but also a promise of academic freedom. As Judge Posner notes, “A contract that gives a 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.”¹ Each college or university follows its own substantive standards and procedural rules for granting tenure, which may include years of service, academic accomplishment, service to the academic community, and recommendations by faculty members and students.² Tenure conveys not merely an academic right but a constitutionally protected property right that entitles the faculty member to continued employment as well as to procedural due process during any possible dismissal action.³ Accordingly, when a college or university cancels a faculty member’s tenure contract, either voluntarily or involuntarily, the nature of tenure rights as property rights becomes critical.

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1. *Vail v. Bd. of Educ.*, 706 F.2d 1435, 1451 (7th Cir. 1983) (Posner, J., dissenting).

2.

Tenure is a form of continuing contract, designed to create a contractually enforceable institutional commitment to appointment for an indefinite term that can be terminated only for good cause in accordance with procedures specified as part of the contract of employment. The institution’s agents can specify tenure in the institution’s governing documents, faculty handbooks, collective bargaining agreements, or individual contracts of employment. The traditional basis for award of tenure is excellence in teaching, research, and service.

CONTEMPORARY ISSUES IN HIGHER EDUCATION LAW 93 (Joseph Beckham and David Dagley eds., 2005).

3. *McDaniels v. Flick*, 59 F.3d 446, 454 (3d Cir. 1995); *San Filippo v. Bongiovanni*, 961 F.2d 1125, 1134 (3d Cir. 1992); *see also* *Morris v. Clifford*, 903 F.2d 574, 576 (8th Cir. 1990) (recognizing that a tenured faculty member has a constitutionally protected property interest in continued employment).

When examining issues surrounding tenure, courts tend to give deference to academic institutions with regard to tenure decisions, provided the institution has adopted and followed specific and relevant policies with regard to tenure. In recent years, courts have attempted to establish standards for examining the tax consequences of ending tenure, either voluntarily or involuntarily. In doing so, the Third and Sixth Circuits arrived at conclusions distinct from the result in the Eighth Circuit: two circuits finding that the payments were subject to employment taxes in *University of Pittsburgh v. United States*⁴ and *Appoloni v. United States*,⁵ the other finding that the payments were not subject to employment taxes in the *North Dakota State University v. United States*.⁶ However, in examining the reasoning behind these decisions, colleges and universities can take the lessons of all three courts and apply them to their own tenure and early retirement programs.

Part I of this note gives a brief explanation of employment taxes and explores definitions which are central to the determination of what payments the Internal Revenue Code (“IRC”) subjects to employment taxes, namely, what constitutes wages. Part II examines previous guidance from the IRS and from the courts as to when payments may fall within the definition of wages, and thus be subject to employment taxes. In particular, Part II looks at the initial case in the circuit split, *Appoloni v. United States*. Part III looks at the specific case of payments being subject to employment taxes, *University of Pittsburgh*. Part IV looks at specific circumstances in which payments from the academic institution are not subject to employment taxes—*North Dakota State University*. As the other federal courts of appeals are faced with similar problems, resolving the circuit split will give colleges and universities guidance in structuring payments in the great academic divorce.

I. EMPLOYMENT TAXES

Most employers, regardless of size, are required to withhold certain taxes from employee paychecks, including federal income tax, Social Security tax, and Medicare tax. In addition, the IRC taxes employers under the Federal Unemployment Tax Act (“FUTA”).⁷

4. 507 F.3d 165 (3d Cir. 2007).

5. 450 F.3d 185 (6th Cir. 2006).

6. 255 F.3d 599 (8th Cir. 2001), *nonacq.*, 2001-2 C.B. xv. The IRS refused to acquiesce to this decision. 2001-2 C.B. xv.

7. Internal Revenue Service, What Are Employment Taxes?, <http://www.irs.gov/govt/charities/article/0,,id=128586,00.html> (last visited Apr. 3, 2009).

A. General Overview⁸

The “Social Security tax,”⁹ which was originally enacted by the Federal Insurance Contributions Act and often referred to as the “FICA” tax, is imposed by § 3101 and § 3111 of the IRC.¹⁰ It applies to employee wages up to a maximum amount of wages.¹¹ FICA tax is composed of two parts: 1) the Social Security component of old-age, survivor, and disability insurance, and 2) the Medicare and hospitalization insurance.¹² FICA tax is paid in equal parts by the employer and the employee.¹³ The employee’s half of the FICA tax is usually withheld by the employer from the wages paid to the employee, and the employer is responsible for remitting both the employee’s contribution and the employer’s contribution to the government.¹⁴ Unlike the FICA taxes, the federal unemployment tax, FUTA, is imposed exclusively on the employer under § 3301.¹⁵

8. This general overview is meant to give a basic background on the employment tax system in the United States so that the reader may better understand the remainder of the article.

9. Two separate taxes comprise the Social Security tax. The Old Age and Survivors Insurance portion comprises 5.3% while Disability Insurance comprises 0.9%, for a total withholding of 6.2%. Social Security Administration, Social Security Tax Rates, <http://www.ssa.gov/OACT/ProgData/oasdiRates.html> (last visited Apr. 3, 2009).

10. I.R.C. §§ 3101, 3111 (2000 & Supp. IV 2004 & Supp. V 2006).

11. See *infra* Part I.B. for a discussion of what constitutes wages for purposes of employment tax withholding.

12. See *supra* note 9 and accompanying text.

13. See I.R.C. §§ 3101(a) (2006), 3102 (2006).

14. *Id.* The current tax rate is 6.2% for the portion of FICA representing Social Security taxes and 1.45% for the portion representing Medicare taxes, for a total withholding of 7.65% for the employee and the employer, resulting in a total withholding of 15.3%. For 2008, the Social Security tax was capped at gross compensation of \$102,000, which results in the maximum amount of Social Security tax being paid of \$6,324.00. There is no cap on the amount of Medicare tax withheld. The limit on Social Security taxes increases with each increase in the national average wage index. Social Security Administration, Contribution and Benefit Base, <http://www.ssa.gov/OACT/COLA/cbb.html#Series> (last visited Apr. 3, 2009).

15. For calendar years 1988–2007, the FUTA rate is 6.2% of the first \$7,000 of taxable wages paid during a calendar year. Energy Independence and Security Act of 2007, Pub. L. No. 110-140, § 1501(a), 121 Stat. 1492 (2007) (extending the 0.2% FUTA surtax through 2008). For 2009 and thereafter, the rate remains to 6.2% of taxable wages due to changes implemented by the bailout packing in October 2008. See I.R.C. §§ 3301(1), (2) (2006), *amended by* Act of Oct. 3, 2008, Pub. L. No. 110-343, Div. B, Title IV, § 404(a) (122 Stat.) 3860. (West Supp. 2008); I.R.C. § 3306 (b)(1) (2006), *amended by* Act of June 17, 2008, Pub. L. No. 110-245, Title I, § 115(b) (122 Stat.) 1636. (West Supp. 2008); Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008). See also Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1035, 111 Stat. 788, 937 (1997). Employers may be entitled to certain credits against the unemployment taxes imposed if the employer pays contributions into a state unemployment fund. See I.R.C. § 3302 (2006).

FICA and FUTA taxes are imposed on a percentage of wages paid by the employer during the calendar year.¹⁶ Similarly, federal income tax withholding is an obligation of the employer with respect to wages received by the employee during the calendar year.¹⁷ Proper classification of any benefits conferred on an employee by an employer as wages or as non-wages is crucial for determination of employment tax withholding.

B. What Exactly Constitutes Wages?

Tax law imposes significant financial and administrative burdens on employers with respect to the payment of payroll taxes on wages earned by employees. While most people consider wages to encompass a weekly paycheck for hours worked, the tax code takes a different stance. For the purposes of tax law, identifying what constitutes wages is more a process of identifying what does not constitute wages. In identifying wages for the purposes of all three payroll taxes—income tax, FICA, and FUTA—the IRC defines “wages” in similar terms. Before listing a series of exceptions, § 3401(a) defines wages for the purposes of income tax withholding as “all remuneration (other than fees paid to a public official) for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash.”¹⁸ Similarly, § 3121(a) defines wages for FICA tax purposes as “all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash.”¹⁹ The statute then goes on to list several exceptions. For the purposes of FUTA tax purposes, wages are defined as “all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash,”²⁰ with this expansive definition being followed by a list of exceptions. Thus, absent the applicability of one of the enumerated exceptions, any amount paid by an employer to an employee for services performed should be considered wages for federal employment tax purposes.

It is important to note that it does not matter how the wages are designated. Treasury regulations provide, “The name by which the remuneration for employment is designated is immaterial. Thus, salaries, fees, bonuses, and commissions on sales or on insurance premiums, are

16. I.R.C. § 3101(a) (2006).

17. I.R.C. § 3401(a) (2006), *amended by* Act of June 17, 2008, Pub. L. No. 110-245, Title I, §§ 105(a)(1), 115(c) (122 Stat.) 1628, 1637. (West Supp. 2008).

18. *Id.*

19. I.R.C. § 3121(a) (2006), *amended by* Act of Dec. 23, 2008, Pub. L. No. 110-458, Title I, § 108(k)(1) (122 Stat.) 5110. (West Supp. 2008).

20. I.R.C. § 3306(b) (2006), *amended by* Act of June 17, 2008, Pub. L. No. 110-245, Title I, § 115(b) (122 Stat.) 1636. (West Supp. 2008).

wages if paid as compensation for employment.”²¹ Furthermore, “the basis upon which the remuneration is paid is immaterial in determining whether the remuneration constitutes wages.”²² Courts have interpreted § 3121(a) broadly²³ finding that almost anything paid as compensation for employment constitutes wages.²⁴ In many instances, courts have found FICA and FUTA taxes applicable to unlawful termination payments for past and future earnings.²⁵ Not all payments, however, made to an employee in connection with employment have been found to be wages.²⁶

In the case of voluntary termination,²⁷ such as early retirement, whether payments are subject to FICA and FUTA taxes depends on the nature of the

21. Treas. Reg. § 31.3121(a)-1(c) (2002).

22. *Id.* at § 31.3121(a)-1(d). For example, the remuneration “may be paid on the basis of piecework, or a percentage of profits; and it may be paid hourly, daily, weekly, monthly, or annually.” *Id.*

23. *See* Soc. Sec. Bd. v. Nierotko, 327 U.S. 358 (1946) (including back pay within the definition of wages); *see also* Gerbec v. United States, 164 F.3d 1015, 1026 (6th Cir. 1999) (finding that the term wages should be interpreted broadly to include certain compensation for which no services were performed); Lane Processing Trust v. United States, 25 F.3d 662, 665 (8th Cir. 1994) (finding that distributions to employees constituted wages as they were based on factors traditionally used to determine employee compensation, including the value of services performed, the length of employment, and the employee’s prior wages); Charlotte’s Office Boutique, Inc. v. Comm’r, 121 T.C. 89, 106 (2003), *supplemented by* T.C. Memo 2004-43, *aff’d* 425 F.3d 1203 (9th Cir. 2005) (finding that a corporation’s payments which were characterized as royalties constituted wages because the shareholder performed services for the corporation which generated income for the corporation and the payments were based on the services performed).

24. *See* Sheet Metal Workers Local 141 Supplemental Unemployment Benefit Trust Fund v. United States, 64 F.3d 245, 248–50 (6th Cir. 1995) (finding that the source of payments is not dispositive in determining whether payments constitute wages and that payments to employees upon liquidation of a supplemental unemployment benefit trust fund constituted wages); Rev. Rul. 96-65, 1996-2 C.B. 6 (finding that back pay includible in gross income under § 104(a)(2) constitutes wages for FICA and FUTA purposes). *But see* Cent. Ill. Pub. Serv. Co. v. United States, 435 U.S. 21, 31 (1978) (finding lunch reimbursements did not constitute wages); Dotson v. United States, 87 F.3d 682, 690 (5th Cir. 1996) (finding that an award which compensated for loss in earning capacity, not for services performed, was not subject to taxation as “wages”); Churchill v. Star Enters., 3 F. Supp. 2d 622, 624 (E.D. Pa. 1998) (holding that an employer paying a judgment under the Family Medical Leave Act may not withhold a portion of the payment it deems to represent FICA taxes as the employee was not employed by the company during the relevant time frame).

25. *See Gerbec*, 164 F.3d at 1016 (finding that “remuneration for employment” in § 3121 should be interpreted broadly and should include certain compensation within the employer-employee relationship for which no actual services were performed).

26. *See Cent. Ill. Pub. Serv. Co.*, 435 U.S. at 31 (finding that reimbursed lunch expenses that were incurred during day trips were includible in income but were not “wages” subject to withholding); *Dotson*, 87 F.3d at 690 (finding that an award which compensated for loss in earning capacity, not for services performed, was not subject to taxation as “wages”).

27. *See infra* Part II.B. for a discussion of dismissal payments in cases of involuntary separation from employment.

payment. If the payment is remuneration for past services, it is treated as wages and subject to employment tax.²⁸ While the IRS once took the position that payments to buy out an employee's right to future compensation could be considered the purchase of a contract right, it has since reversed this position.²⁹ Severance payments tied to an employee's salary and years of service are generally deemed to be remuneration for past service and subject to employment taxes. For instance, payments made to an employee, even in exchange for a waiver of rights to bring an employment related lawsuit, are subject to FICA taxes. Even if payments are not tied to the relinquishment of a specific claim, unlike settlement payments, these payments are usually subject to FICA.³⁰

In recent years, cases have emerged in which an educational institution paid a faculty member for the surrender of tenure rights as part of an early retirement program. While the Treasury Regulations contemplate that retirement pay constitutes wages for the purpose of FICA and FUTA,³¹ surrendering of tenure has been framed as a debate over property rights arising under the employment contract and whether the employment contract at issue creates property rights that when surrendered are not included in wages. Both the IRS and the courts have grappled with the issue of defining the boundaries of what constitutes wages in the context of relinquishment of tenure, and while no concrete boundaries have emerged, the issue seems to turn more on the contract itself. Courts have considered certain factors in determining what constitutes wages such as whether tenure was automatically given as a seniority right, whether the granting of tenure resulted in a new employment contract, and how payments were calculated upon dismissal.

II. PREVIOUS GUIDANCE

Prior to *University of Pittsburgh* and *North Dakota State University*, the IRS considered issues surrounding various payments given as part of severance, early retirement plans, and other situations surrounding the

28. IRC §§ 3401(a) (2006), *amended by* Act of June 17, 2008, Pub. L. No. 110-245, Title I, §§ 105(a)(1), 115(c) (122 Stat.) 1628, 1637. (West Supp. 2008), 3121(a)(2) (2006), *amended by* Act of Dec. 23, 2008, Pub. L. No. 110-458, Title I, § 108(k)(1) (122 Stat.) 5110. (West Supp. 2008), 3306(b) (2006), *amended by* Act of June 17, 2008, Pub. L. No. 110-245, Title I, § 115(b) (122 Stat.) 1636. (West Supp. 2008).

29. Rev. Rul. 2004-110, 2004-2 C.B. 960.

30. *Abrahamsen v. United States*, 228 F.3d 1360, 1364-65 (Fed. Cir. 2000).

31. Treas. Reg. § 31.3401(a)-1(b)(1)(i) (2008).

In general, pensions and retired pay are wages subject to withholding. However, no withholding is required with respect to amounts paid to an employee upon retirement which are taxable as annuities under the provisions of section 72 or 403. So-called pensions awarded by one to whom no services have been rendered are mere gifts or gratuities and do not constitute wages.

Treas. Reg. § 31.3401(a)-1(b)(1)(i).

termination of employment, both voluntary and involuntary.

A. Guidance as to When Payments Are Not Subject to Employment Taxes

1. Revenue Ruling 58-301

The courts in both *University of Pittsburgh* and *North Dakota State University* examined Revenue Ruling 58-301,³² which addresses a cancellation of a five-year written employment contract. It is important to note before beginning a discussion of the particular facts of the revenue ruling that it has been superseded by Revenue Ruling 2004-110.³³ However, Revenue Ruling 58-301 applies to any payments made before January 12, 2005 and is thus still relevant to a discussion of employment tax on payments made pursuant to the relinquishment of tenure rights.³⁴

Revenue Ruling 58-301 concerned payments made to the taxpayer under a written contract providing for five years of employment.³⁵ During the second year of employment, the taxpayer and his employer agreed to cancel the employment contract.³⁶ In consideration for the taxpayer relinquishing his contract rights, the employer paid him a sum of money during the taxable year.³⁷ Guidance was requested as to whether the payments were gross income to the taxpayer in the taxable year. While the IRS found that the payments constituted gross income to the recipient in the taxable year of receipt, the IRS held that “a lump sum payment received by an employee as consideration for the cancellation of his employment contract . . . is not subject to the [FICA] tax.”³⁸ It is important to note that in issuing its decision, the IRS noted that the employee was given the payment in consideration for the “taxpayer’s relinquishment of his contract rights”³⁹ and not as payment for services rendered, severance, or another reason.

2. *Slotta v. Texas A&M University System*⁴⁰

In *Slotta v. Texas A&M University System*, the court looked at payments given to Larry Slotta made as part of a settlement pursuant to his resignation.⁴¹ Slotta sued his employer, Texas A&M University (“Texas

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

33. Rev. Rul. 2004-110, 2004-2 C.B. 960.

34. *Id.*

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

36. *Id.*

37. *Id.*

38. *Id.*

39. *Id.*

40. No. Civ.A. G-93-92, Civ.A. G-93-125, 1994 WL 16170227 (S.D. Tex. 1994).

41. *Id.* at *1.

A&M”) asserting various constitutional and state tort claims. After a mediation session, Slotta and Texas A&M settled upon a payment of \$150,000 in exchange for which Slotta agreed to resign.⁴² Seven months after reaching the settlement, Texas A&M remitted \$125,395 to Slotta, withholding the remaining amount for income and employment taxes under the good faith belief that the amount represented “payment for the relinquishment of Slotta’s tenure rights”⁴³ and was therefore “subject to mandatory federal income and employment tax withholding.”⁴⁴ In finding that the payments were not subject to withholding, the court noted the distinctive features of tenure.

A university does not owe tenure to any non-tenured employee. The possibility of tenure is offered to attract and retain quality personnel. Although under university guidelines a young faculty member may not be eligible for tenure until a certain number of years have passed, the offer of tenure can only reasonably be considered an offer for a contract of more stable *future* employment, and not as payment for past services. When the tenure contract is breached, the professor’s damages are for lost future employment, not the loss of remuneration for services already performed. Furthermore, the fact that the contract is not generally reached through negotiation is immaterial; a contract reached through the acceptance of a unilateral offer is no less a contract than one reached after lengthy haggling.⁴⁵

In addition, the court notes that unlike in the Private Letter Ruling relied upon by Texas A&M finding that the payments were subject to

42. *Id.*

43. *Id.*

44. *Id.* In arriving at this decision, Texas A&M relied primarily upon Private Letter Ruling 86-48-027:

The tenure system of the University is designed to attract and retain professors who perform services at the desired level of proficiency, and to maintain academic freedom. Tenure is a crucial element in enabling the University to hire able professors and is a considerable incentive for them to achieve high quality performance. Because the individual’s prior performance of services for the University (or another academic institution) is the primary determinant for a grant of tenure, the grant of tenure is derived primarily from the employee’s past performance of services. Thus, the employment right surrendered by the faculty members is primarily derived from prior work performed and more closely resembles wages for FICA purposes than mere payment for surrender of a contract right. The fact that tenure is granted selectively based on prior performance, does not vitiate its origin in the performance of prior services.

Therefore, we conclude that the payments made by the University to terminate employment agreements with tenured faculty members of the University are wages for purposes of the FICA.

I.R.S. Priv. Ltr. Rul. 86-48-027 (Aug. 28, 1986).

45. *Slotta*, 1994 WL 16170227, at *2 (emphasis in original).

employment tax withholding,⁴⁶ the payments are not for services rendered. “The theory that tenure could be the payment by one university to an individual for his past services to *another* employer is simply ridiculous. The university makes the offer of tenure, like the offer of any other attractive contract, simply to entice the individual to perform future services.”⁴⁷ Slotta, as a new employee at Texas A&M did not “earn” tenure, it was part of his initial employment. However, a problem arises when tenure is granted to a professor who has been employed at the college or university, as opposed to a professor who is granted tenure with his initial employment contract at a new educational institution.

B. Guidance as to When the Payments are Subject to Employment Taxes

1. Relinquishment of Seniority Rights

In Revenue Ruling 75-44⁴⁸ the IRS addressed the case of a lump-sum payment made to a railroad employee “in recognition of his agreement to relinquish certain rights with respect to his employment acquired through prior service as an employee.”⁴⁹ The IRS distinguished payments made in Rev. Rul. 58-301 primarily on the grounds that the employee in this case acquired rights through his previous performance of services as opposed to acquiring the rights at the original negotiation of the contract which had been cancelled.

Unlike [Rev. Rul. 58-301], the present case does not involve the cancellation of an employment contract which, at the outset, bound the parties for a specific period of time. Instead, the instant case is one of an employment contract which contemplated a relation between the parties that was to continue indefinitely, but that, except as might otherwise be specially provided under certain circumstances, was generally terminable by either party without liability to the other solely for the failure to maintain the relationship for the specified period. Hence, in this case, the amount received by the employee was a lump-sum settlement for the past performance of services reflected in the employment rights he was giving up, and was money remuneration for his services.⁵⁰

Thus, the IRS found that the receipt of payment was compensation for past services and constituted wages.

46. I.R.S. Priv. Ltr. Rul. 86-48-027 (Aug. 28, 1986).

47. *Slotta*, 1994 WL 16170227, at *2 (emphasis in original).

48. Rev. Rul. 75-44, 1975-1 C.B. 15.

49. *Id.*

50. *Id.*

2. Dismissal Payments

In cases involving dismissal payments, § 31.3401(a)-1(b)(4) of the Treasury Regulations sets firm boundaries and specifically provides that for the purposes of income tax withholding (which is only one aspect of the overall tax consequences), “Any payments made by an employer to an employee on account of dismissal, that is, involuntary separation from the service of the employer, constitute wages regardless of whether the employer is legally bound by contract, statute, or otherwise to make such payments.”⁵¹ In distinguishing Rev. Rul. 58-301 in *University of Pittsburgh*,⁵² the IRS first noted Revenue Ruling 74-252⁵³ which involved payment made to an employee under the terms of a three-year contract following the involuntary termination of the employee.⁵⁴ The contract noted that the employer was permitted to terminate the employment relationship provided that the employee was paid an amount equal to six months salary.⁵⁵ In distinguishing the payments made from those in Rev. Rul. 58-301, the IRS noted,

In this case the payments were made by the company to the employee upon his involuntary separation from the service of the company and were in the nature of dismissal payments. They were made pursuant to the provisions of the contract rather than as consideration for the relinquishment of interests the employee had in his employment contract in the nature of property.⁵⁶

Thus, the IRS found that the payments also constituted wages for the purpose of FICA and FUTA based on the nature of the payments being dismissal payments.

3. Modification of Rev. Rul. 58-301

In Rev. Rul. 2004-110, the IRS modified and superseded Rev. Rul. 58-301.⁵⁷ The IRS looked at a situation in which an employee performed services under a written employment contract providing for a specified number of years of employment.⁵⁸ The contract did not provide that any payments would be made by either party if the contract was cancelled by mutual agreement.⁵⁹ The employer and employee agreed to cancel the employment contract and negotiated a payment made to the employee in

51. Treas. Reg. § 31.3401(a)-1(b)(4) (2009).

52. *Univ. of Pittsburgh v. United States*, 507 F.3d 165 (3d Cir. 2007).

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

54. *Id.*

55. *Id.* at 288.

56. *Id.*

57. Rev. Rul. 2004-110, 2004-2 C.B. 960.

58. *Id.*

59. *Id.*

consideration for the employee's relinquishment of his contract rights to the remaining period of employment.⁶⁰ The IRS outlined the boundaries of employment to encompass "the establishment, maintenance, furtherance, alteration, or cancellation of the employer-employee relationship or any of the terms and conditions thereof."⁶¹ The IRS further stated, "If the employee provides clear, separate, and adequate consideration for the employer's payment that is not dependent upon the employer-employee relationship and its component terms and conditions, the payment is not wages for purposes of FICA, FUTA, or Federal income tax withholding."⁶² Thus, any payment in cancellation of the employer-employee relationship would be subject to FICA and FUTA tax:

Under the facts presented in this ruling, the employee receives the payment as consideration for canceling the remaining period of his employment contract and relinquishing his contract rights. As such, the payment is part of the compensation the employer pays as remuneration for employment. The employee does not provide clear, separate, and adequate consideration for the employer's payment that is not dependent upon the employer-employee relationship and its component terms and conditions. Thus, the payment provided by the employer to the employee is wages for purposes of FICA, FUTA, and Federal income tax withholding. *This conclusion applies regardless of the name by which the remuneration is designated or whether the employment relationship still exists at the time the payment is made.*⁶³

However, for cases arising in the future, it is important to note that the Ruling limits Rev. Rul. 58-301 to its specific facts and to any payment made before January 12, 2005.⁶⁴ Payments made before that time are subject to the previous murky standards.

60. *Id.*

61. *Id.* at 961.

62. *Id.* The employee in this instance was performing services under a written employment contract which provided for a specified number of years of service but did not provide for any payments to be made upon termination of the agreement. When the agreement was terminated prior to the expiration of the contract period, the employer and employee negotiated a payment to be made "in consideration for the employee's relinquishment of his contract rights to the remaining period of employment." *Id.* at 960. The employee did not provide any consideration for the payment independent of the employer-employee relationship.

63. *Id.* (emphasis added).

64. *Id.* Payments made before January 12, 2005 must be made in circumstances analogous to those in Rev. Rul. 58-301 and Rev. Rul. 55-520. *Id.*

4. *Appoloni*—the Initial Circuit Split

In *Appoloni v. United States*,⁶⁵ the court considered the case of public school teachers who relinquished statutory tenure rights in exchange for early retirement incentive payments. The employees were given tenure by the Dowagiac Union Public School District (“the District”) pursuant to the Michigan Teachers’ Act⁶⁶ under which “a teacher automatically earns tenure by successfully completing a probationary period.”⁶⁷ During the 2000–2001 school year, the District offered an early employee severance plan to its most senior teachers under which teachers who had at least ten years of service were able to voluntarily participate in the plan.⁶⁸ If accepted into the plan, the teachers were required to resign and to agree to a waiver providing that the teacher waived all claims against the District.⁶⁹

The court broadly interpreted the definition of wages for purposes of FICA withholding under § 3121 and found that the payments to the teachers constituted wages for the following reasons. “First, the eligibility requirements for qualifying for a payment—that a teacher served a minimum number of years—indicate the payments were for services performed rather than for the relinquishment of tenure rights.”⁷⁰ The court stated, “We have consistently held that where a payment arises out of the employment relationship, and is conditioned on a minimum number of years of service, such a payment constitutes FICA wages.”⁷¹ Under the early retirement plan, if more employees applied for the program than there were spots available, the spots were allocated to those teachers with the most years of service. Thus, in this case, “longevity—not tenure—was the key factor for determining eligibility because these early retirement payments were offered to encourage teachers at a high pay rate to retire.”⁷² Second, the court in *Appoloni* focused on the motivation behind the payments—whether the payments were made in exchange for tenure rights or whether the relinquishment of tenure rights was merely incidental to the

65. 450 F.3d 185 (6th Cir. 2006).

66. MICH. COMP. LAWS § 38.71 (1996).

67. *Appoloni*, 450 F.3d at 187.

68. *Id.*

69. *Id.* at 188.

70. *Id.* at 191.

71. *Id.*

Plaintiffs necessarily had to have tenure to be eligible for the buyout. However, longevity—not tenure—was the key factor for determining eligibility because these early retirement payments were offered to encourage teachers at a high pay rate to retire. Thus, the payments at issue in this case . . . arose out of the employment relationship, and were conditioned on a minimum number of years of service.

Id. at 192.

72. *Id.* at 192.

nature of the early retirement plan, making the relinquishment more akin to the relinquishment of rights to sue under certain employment statutes.

In this case, the school district's motivation was not to buy tenure rights—the motivation was to induce those teachers at the highest pay scales to retire early. Relinquishment of tenure rights was simply a necessary and incidental part of accepting the buyout. In other words, in order to offer the teachers a buyout, the school districts had to ask that [the teachers] give up their right to future employment—the same as with any severance package[.] Thus, especially in light of the school district's purpose in offering these severance payments, we see no reason to differentiate the relinquishment of tenure rights from the relinquishment of other benefits earned during the course of employment, like the right to bring suit, or rights associated with seniority.⁷³

If the payments are made *solely* in exchange for the relinquishment of tenure rights, the payments appear more like the purchase of property rights, and thus are less likely to be subject to employment tax. Finally, the court found that the most analogous revenue ruling was Rev. Rul. 75-44 and not Rev. Rul. 58-301, as argued by the District. The court agreed that like in Rev. Rul. 75-44 the employees “had acquired [their] relinquished employment rights though [their] previous performance of services,” thus the payments were taxable for FICA purposes.⁷⁴

II. UNIVERSITY OF PITTSBURGH

In 2007, the Third Circuit considered whether payments made by the University of Pittsburgh to certain tenured faculty members under early retirement plans constituted wages for FICA purposes.⁷⁵ Between 1982 and 1999, the University offered five successive Early Retirement Plans to tenured faculty members and administrators, as well as to non-tenured librarians whose employment contracts contained a provision providing for

73. *Id.* at 193.

74. *Id.* at 194 (citing Rev. Rul. 75-44, 1975-1 C.B. 15). The court refuted the District's argument that the payments were more analogous to those in Revenue Ruling 58-301, stating:

In Revenue Ruling 58-301, the employee was granted, at the time of employment, a *contractual right* to employment for five years. In contrast, the Plaintiffs received their statutorily-granted tenure rights after a certain requisite number of *years of service*. As previously emphasized, in Michigan, tenure is automatically granted, pursuant to a statute, after a teacher completes a probationary period. We see this case as one where the teacher earned tenure through his/her “previous performance of services.” Rev. Rul. 75-44. Thus, the most analogous revenue ruling, Revenue Ruling 75-44, also indicates that the severance payments at issue are FICA wages.

Id. (emphasis in original).

75. *Univ. of Pittsburgh v. United States*, 507 F.3d 165, 166 (3d Cir. 2007).

an “expectation of continued employment.”⁷⁶ Under all five plans, monthly payments were based on the employee’s salary at the time of retirement as well as the employee’s length of service.⁷⁷ In four of the five plans, participation was limited to employees within the groups who had attained at least ten years of service and who were between sixty-two and sixty-nine years of age. In the fifth plan, participation was limited to employees within the groups who had attained at least twelve years of service and were at least sixty years of age or employees whose sum of years of service and age equaled eighty-five.⁷⁸ To participate in the Early Retirement Plans, the University required employees who met the qualifications to sign an irrevocable Contract for Participation, and the University required employees with tenure to relinquish tenure rights.⁷⁹ The University paid two million dollars in FICA taxes on payments under the Early Retirement Plans between 1996 and 2001 but then filed claims with the IRS for refunds of these payments, which the IRS promptly denied.⁸⁰

Under the University of Pittsburgh’s tenure policy, tenure “constitutes recognition by the University that a person so identified is qualified by achievements and contributions to knowledge as to be ranked among the most worthy of the members of the faculty engaged in scholarly endeavors: research, teaching, professional training, or creative intellectual activities of other kinds.”⁸¹ It is important to note that under the University’s tenure policy, a non-tenured faculty member can serve without tenure for a maximum of seven years, at which time the faculty member can either be granted tenure or can be terminated for failing to meet the requirements for tenure.⁸² Under the tenure plan, a tenured faculty member may not be terminated without a hearing that comports with the due process standards of the Fourteenth Amendment.⁸³ In addressing the case, the University primarily relied upon Revenue Ruling 58-301,⁸⁴ while the IRS offered counterarguments using Revenue Ruling 74-252, Revenue Ruling 75-44 and Revenue Ruling 2004-110.

The court in *University of Pittsburgh* found the payments to be most analogous to those in Rev. Rul. 75-44. “First, the eligibility requirements for payments under the Plans are linked to past services at the University,

76. *Id.*

77. *Id.*

78. *Id.*

79. *Id.*

80. *Id.* at 167.

81. *Id.* at 166.

82. *Id.*

83. *Id.* at 166–67.

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

not relinquishment of tenure.”⁸⁵ Eligibility to participate in the plans for both tenured and non-tenured employees was based on their age and years of service, which link the plans to past services for the employer, thus making the payments appear more like wages. “Second, the Plans themselves make clear that the payments were viewed as compensation for service to the University.”⁸⁶ The court noted that the plans were implemented with the goals of making room for new faculty and keeping the University competitive with its peers.⁸⁷ Also, the court noted that the University offered the plans because it wanted to provide the opportunity for faculty members to retire prior to the retirement age.⁸⁸ Third, the court stated that “even if the University made the payments *in part* to secure relinquishment of tenure rights, their main purpose was to provide for employees’ early retirement.”⁸⁹ In this way, the payments were indistinguishable from severance payments, which are usually taxed as wages.⁹⁰

The University tried to distinguish the contracts by saying that while in other cases the contracts at issue were at-will employment contracts, here “tenure is obligatory for the University, optional for the faculty member.”⁹¹ However, the court explained that the nature of the employment contract being at will or obligatory is not determinative. The focus is on the rights relinquished. “Regardless of whether an employee voluntarily ended the employment relationship, or whether the employee had a due process right to maintain his employment, the rights relinquished were gained through the employee’s past services to the employer.”⁹² Based on those factors, the court found that the tenure rights relinquished were most like the seniority rights relinquished in Rev. Rul. 75-44 as they “compensate

85. *Univ. of Pittsburgh*, 507 F.3d at 171.

86. *Id.* at 172.

87. *Id.*

88. *Id.*; *see also* *Assoc. Elec. Coop., Inc. v. United States*, 226 F.3d 1322, 1327 (Fed. Cir. 2000) (“Payments for hard work and faithful service arise directly from the employee-employer relationship and are payments which recognize the value or character of the services performed for the employer.”).

89. *Univ. of Pittsburgh*, 507 F.3d at 172 (emphasis in original).

90. *See supra* notes 23–25 and accompanying text; *see also* *Appoloni v. United States*, 450 F.3d 185, 193 (6th Cir. 2006). In that case, the court

fail[ed] to see how this is different from other severance packages just because a ‘tenure’ right was exchanged. In almost all severance packages an employee gives up something, and we have a hard time distinguishing this case from similar cases where an employee, pursuant to a severance package, gives up rights in exchange. *Courts have consistently held that severance payments for the relinquishment of rights in the course of an employment relationship are FICA wages.*

Id. (emphasis added).

91. *Univ. of Pittsburgh*, 507 F.3d at 173 (citations omitted).

92. *Id.*

employees for relinquishment of tenure rights acquired through past service.”⁹³

The dissent in *University of Pittsburgh* raised similar arguments to the court in *North Dakota State University*. The dissent based its opinion on the premise that the payments were not wages because they “were given primarily in exchange for the faculty members’ relinquishment of tenure, which is a property interest in continued employment absent cause or financial exigency.”⁹⁴ Unlike seniority rights, tenure did not resemble the rights earned through service during the employment relationship.

The University’s “tenure stream” is composed of faculty who are eligible to receive tenure and those who already have tenure. The tenure stream includes instructors, assistant professors, associate professors, and professors. Only associate professors and professors can have tenure. A faculty member without tenure can serve only for a limited time in the tenure stream—usually seven years. At the end of that period, either the faculty member receives tenure or his or her service in the tenure stream is terminated. But this “probationary” period is a prerequisite to tenure and is not analogous to the time period during which employees accrue different types of seniority rights. The University’s policies show tenure is more than a recognition of satisfactory work. Rather, the decision to grant or deny tenure depends on a myriad of qualitative factors and calls for an evaluation of each candidate’s capacity for research, teaching, and contributing to knowledge. Moreover, the University’s policy specifically imposes certain “Non-Merit Considerations,” such as financial resources, personnel needs, and curriculum demands. These latter criteria may depend not on the individual professor’s role at the University, but on extrinsic forces. Accordingly, the grant or denial of tenure cannot be viewed strictly as an evaluation of whether a professor has performed adequately during employment, as is the case with the accrual of

93. *Id.*

94. *Id.* at 175 (Scirica, J., dissenting) (citing *North Dakota State Univ. v. United States*, 255 F.3d 599 (8th Cir. 2001)). In the dissent, Justice Scirica notes the contrast between the two possible concepts of faculty tenure at the University.

Is tenure, as the Government contends, analogous to seniority rights and other benefits earned in the course of employment? Or, as the University argues, does tenure mark the beginning of a new employment relationship distinct from prior service? According to the first view, the payments at issue here were remuneration for employment and were subject to FICA tax. According to the second view, the payments were not remuneration for employment, because they were given primarily in exchange for the relinquishment of property rights the faculty received at the beginning of the tenured relationship.

Id.

seniority rights in other circumstances.⁹⁵

Based on the nature of the process by which tenure was granted at the University, the dissent found the rights to be property rights, not seniority rights. The dissent also distinguished the payments in the present case from those in *Appoloni*, “In cases like *Appoloni*, the teacher’s past satisfactory work during the probationary period may be seen as consideration for the tenure award, but not so here where the tenure decision is marked by such broad discretion and ‘Non-Merit Considerations.’”⁹⁶ Additionally, the dissent noted that tenure marked a new relationship, and thus a new contract with new rights, between the professor and the University and not merely a step in the evolvement of a continuing relationship with additional benefits. Thus, the payments for the relinquishment of these new rights were “more analogous to buy-outs of unexpired contract rights than to severance payments or payments for the relinquishment of rights of at-will employees.”⁹⁷

III. NORTH DAKOTA STATE UNIVERSITY

In *North Dakota State University v. United States*,⁹⁸ North Dakota State University (“NDSU”) offered a voluntary Early Retirement Program to tenured faculty and certain high-level administrators whose age and years of service totaled seventy.⁹⁹ “Under the Early Retirement Agreement, the employee agreed to give up any tenure, contract, and/or other employment rights, agreed not to seek employment with a North Dakota public university or college, and agreed to give up any claim against NDSU under [employment law].”¹⁰⁰ Once the employee agreed to enter into the Early Retirement Program, the employee and NDSU negotiated the payment amount, which was capped at one hundred percent of the employee’s most recent annual salary.¹⁰¹ However, the employee was not automatically entitled to one hundred percent of the employee’s most recent annual salary. “Various factors were considered in setting the retirement payment, including past performance, current salary, curriculum needs, and budget restraints. These were not the only factors considered during the negotiations; in fact, there was no restriction on the factors that could be considered.”¹⁰² In many ways, the Early Retirement Program served as a management tool to make personnel changes and “deal with budgetary

95. *Id.* at 177.

96. *Id.*

97. *Id.* at 178.

98. 255 F.3d 599 (8th Cir. 2001).

99. *Id.* at 601. During some periods of time, the sum of the age and years of service of the employee in question only had to total sixty-five. *Id.*

100. *Id.*

101. *Id.*

102. *Id.*

problems, curriculum needs, and . . . encourage individuals to terminate employment when there was insufficient cause for dismissal.”¹⁰³

At NDSU, tenure was granted to a faculty member upon recommendation by the North Dakota Board of Higher Education.¹⁰⁴ Although NDSU used a six-year tenure track, tenure was occasionally granted earlier, with some employees receiving tenure upon hire, and the probationary period could be waived in certain circumstances, such as the faculty member having tenure at another college or university.¹⁰⁵ Various factors were considered in granting tenure, including “scholarship in teaching, contribution to a discipline or profession through research, other scholarly or professional activities, and service to the institution and society.”¹⁰⁶ Once tenure was granted, the professor was granted certain rights, including the right to continuous academic year employment in the professor’s specific area.¹⁰⁷ The professor’s annual employment contract was automatically renewed each year unless the professor was terminated pursuant to the termination conditions specified in the policies under the tenure program.¹⁰⁸ A tenured faculty member could be terminated “based upon various fiscal reasons, including a demonstrably bona fide financial exigency, loss of legislative appropriations, loss of institutional or program enrollment, consolidation of academic units or program areas, or elimination of courses.”¹⁰⁹ In addition to termination of a faculty member due to the financial constraints imposed on NDSU, a tenured faculty member could be terminated for adequate cause, such as “incompetence or dishonesty in teaching, research, or other professional activities; continued or repeated unsatisfactory performance evaluations; substantial and manifest neglect of duty; conduct which substantially impaired fulfillment of responsibilities; physical or mental inabilities to perform duties; and continued violation of NDSU or [North Dakota Board of Higher Education] policies.”¹¹⁰ In addition to tenured faculty members, certain high-level administrators were eligible to participate in the Early Retirement Program. These high-level administrators also had certain employment rights, including a right to extended notice before being dismissed, the period of extended notice being determined based on the employee’s years of service.¹¹¹

103. Jon J. Jensen, *Reducing the Employment Tax Burden on Tenure Buyouts*, 80 N.D. L. REV. 11, 13 (2004).

104. *N.D. State Univ.*, 255 F.3d at 601.

105. *Id.*

106. *Id.*

107. *Id.*

108. *Id.*

109. *Id.*

110. *Id.*

111. *Id.* at 602.

While NDSU initially withheld FICA taxes from payments made under the Early Retirement Program, NDSU posed a question to the Social Security Administration as to whether payments under NDSU's Early Retirement Program constitute wages for FICA purposes. The Social Security Administration responded, stating that as described by NDSU, the program was “‘in effect, a payment to secure the release of an unexpired contract of employment,’ and as such, under the Social Security Procedure Operations Manuals, was not considered wages for purposes of determining benefit amounts or for deduction of benefits purposes.”¹¹² Based on this letter, NDSU stopped both withholding and paying FICA taxes on Early Retirement Program payments.¹¹³

The court in *North Dakota State University* addressed the very question posed to the Social Security Administration—whether the payments were subject to employment tax withholding, first asserting that tenure rights are rights which are valuable to the faculty member to whom tenure has been granted, even without a market in which to sell those rights.¹¹⁴ Next, the court addressed many of the arguments offered by the government as to why the payments should be subject to employment taxes.¹¹⁵ In distinguishing Revenue Ruling 75-44, the court noted that the tenure rights given at NDSU were not awarded simply based on years of service which would make them analogous to seniority rights.¹¹⁶

Importantly, tenure was not automatic upon completing service for a specified time period, which is a hallmark of ordinary seniority rights. Prior to an award of tenure, a professor was employed pursuant to one-year contracts for a period of time, generally six years at NDSU.¹¹⁷ The six years during which a professor taught before being granted tenure was not consideration for the grant of tenure. Rather, it was ordinarily a

112. *Id.* (citations omitted).

113. NDSU did not seek further guidance from either the Social Security Administration or the Internal Revenue Service. *Id.* at 602.

114. *Id.* at 605.

Despite the fact that tenure at a state institution is a constitutionally protected property interest and that the tenured faculty had clear contractual rights not to be terminated absent specific circumstances, the government argues that tenure rights are not contract rights that can be relinquished because the tenure rights have no economic value that can be bought and sold. We are unpersuaded by this argument. Rarely would we expect to find an employment contract that would have recognizable economic value to anyone other than the employee. Lack of a market in which to sell tenure rights does not prevent those rights from having value to the faculty member to whom tenure has been granted.

Id.

115. See *infra* Part II for a discussion of these arguments in support of finding payments to be subject to employment taxes.

116. *N.D. State Univ.*, 255 F.3d at 605–06.

117. *Id.* at 601.

prerequisite for tenure and served as a probationary period during which the University evaluated the professor to determine whether he or she had the qualities necessary to be worthy of tenure.¹¹⁸ After serving the probationary period, the professor still had to qualify for tenure through his or her scholarship, research, and service to the University and society, as “[t]he decision to award tenure rest[ed] on criteria that reflect[ed] the potential long-term contribution of the faculty member to the purposes, priorities, and resources of the institution, unit, and program.”¹¹⁹ At the end of the probationary period, the professor’s contract was either not renewed and the professor discontinued teaching at the University, or the professor was granted tenure and a lifetime appointment, as long as the grounds for removal were not triggered.¹²⁰

Based on the process of granting tenure as described by NDSU, the court found that a tenured professor experiences two successive, yet distinct, employment relationships with NDSU: the first being an at-will relationship during the probationary period and the second being the tenure relationship with NDSU.¹²¹ Thus, the rights earned under tenure were not earned from past service to University but instead represented rights established at the outset of the new employment relationship—the tenured relationship. With the granting of tenure came new rights and the protection of academic freedom. Tenure provided “a secure forum for the germination, cultivation, and exchange of ideas without fear that expression of viewpoints will result in retribution.”¹²² The value of the property rights in tenure emerged from this academic freedom. “It is this unique relationship and its accompanying rights, formed only when and if tenure is granted, that give tenure its significance and value.”¹²³ When rights were granted at the outset of the employment relationship, the rights appeared less like rights given for past services to the employer.¹²⁴

In addition to the nature of tenure as property rights given at the time the contract is negotiated, the court also looked to the manner in which payments under the early retirement plan were calculated, “Past

118. *Id.*

119. *Id.* at 606 (internal quotations omitted).

120. *Id.* at 605–06. The dissent in the *University of Pittsburgh* case addresses this same point. See *supra* note 94 and accompanying text.

121. See also *Mayberry v. Dees*, 663 F.2d 502, 516 (4th Cir. 1981) (holding that the tenure position is “a significantly different status—effectively a new job”).

122. *N.D. State Univ.*, 255 F.3d at 606.

123. *Id.*

124. Compare Rev. Rul. 75-44, 1975-1 C.B. 15, with Rev. Rul. 58-301, 1958-1 C.B. 23. It is important to note in I.R.S. General Counsel Memorandum 38,534, the IRS stated that the distinction between the two revenue rulings is viable but is one that is hard to recognize and implement. See I.R.S. Gen. Couns. Mem. 38,534 (Oct. 7, 1980); see also Mary B. Hevener & Anne G. Batter, *When Are Payments from an Employer to an Employee Not “Wages” Subject to Employment Taxes?*, 95 J. TAX’N 349, 356–57 (2001).

performance and current salary were not the only factors considered in determining the amount of the early retirement payments; in fact, there was no limit on what factors could be considered.”¹²⁵ In this sense, the payments under the early retirement plans appeared less like payments for past services or a relinquishment of seniority rights like in *University of Pittsburgh*. While the manner in which payments were calculated was not dispositive, the court “[did] not deem the inclusion of past performance and current salary as some of the factors in the decisional mix here to be controlling.”¹²⁶ This idea is further supported by the court in *Appoloni*:¹²⁷ “We have consistently held that where a payment arises out of the employment relationship, and is conditioned on a minimum number of years of service, such a payment constitutes FICA wages.”¹²⁸

Payments negotiated by faculty members under the early retirement plans were given in exchange for the relinquishment of tenure rights. Unlike the dismissal payments at issue in Revenue Ruling 74-252, the faculty members were not paid what was due to them under the terms of a previously negotiated employment contract. “They did not receive what they were entitled to under their contracts, which was continued employment absent fiscal constraints or adequate cause for termination. Rather they gave up those rights.”¹²⁹ In this sense, the payments were made in consideration for the relinquishment of valuable property rights and were thus not subject to employment taxes.

After the decision was issued by the Eighth Circuit in 2001, the IRS issued a notice stating that the Commissioner did not acquiesce in the decision.¹³⁰ This nonacquiescence was specifically “relating to whether early retirement payments that the taxpayer made to tenured faculty members are wages subject to [FICA] taxes.”¹³¹ The Action on Decision published by the IRS has specific precedential value for taxpayers, and the IRS offers the following guidance as to the meaning of nonacquiescence:

“Nonacquiescence” signifies that, although no further review was sought, the Service does not agree with the holding of the court and, generally, will not follow the decision in disposing of cases involving other taxpayers. In reference to an opinion of a circuit court of appeals, a “nonacquiescence” indicates that the Service will not follow the holding on a nationwide basis. However, the

125. *N.D. State Univ.*, 255 F.3d at 607.

126. *Id.*

127. 450 F.3d 185 (6th Cir. 2006). In this case, the court addressed the application of employment taxes to payments made to public school teachers who relinquished statutory tenure rights in exchange for early retirement incentive payments.

128. *Id.* at 191; *see also supra* note 71.

129. *N.D. State Univ.*, 255 F.3d at 607.

130. *Id.*, *nonacq.*, 2001-2 C.B. xv.

131. *Id.*

Service will recognize the precedential impact of the opinion on cases arising within the venue of the deciding circuit.¹³²

Thus, college and university administrators planning an early retirement program or any other voluntary termination program in the wake of *North Dakota State University* should be advised that the IRS will not follow the holding outside the Eighth Circuit. Relying on the holding in *North Dakota State University* will likely raise an audit flag to examiners at the IRS.¹³³

IV. ONE ADDITIONAL HURDLE

In 2007, Congress passed the Small Business and Work Opportunity Tax Act (the "Act") which amended the tax return preparer penalty provisions under § 6694 of the IRC.¹³⁴ Prior to the enactment of this legislation, the prepare penalties under § 6694 only applied to income tax returns. Section 8246 of the Act amended this provision to include preparers of all tax returns, amended returns, and claims for refund, including estate and gift tax returns, generation-skipping transfer tax returns, employment tax returns, and excise tax returns. Thus, if an individual prepares an employment tax return for a college or university after buying a professor out of tenure and does not properly report the payment, the individual could be subject to penalties under § 6694. The penalty under § 6694 is the greater of \$1,000 or 50% of the income derived with respect to each return or claim.¹³⁵

While the penalty may seem daunting, there is some good news for preparers of employment tax returns for colleges and universities. The standard under which the IRS will judge the conduct of the preparer is a reasonable belief standard.¹³⁶ In other words, the tax return preparer must reasonably believe that the tax treatment of a particular item noted on the return is more likely than not the proper tax treatment. A tax return preparer meets this standard if the preparer "analyzes the pertinent facts

132. *Id.*

133. Other academics commenting on the *North Dakota State University* decision have noted that the payments were more analogous to those in Rev. Rul. 75-44, arguing that the past performance requirement made the payments more like seniority rights in this revenue ruling as opposed to the contract rights in Revenue Ruling 58-301 which were more like property rights. Heather L. Turner, *Disparate Treatment of University Administrators' and Tenured Faculty Members' Early Retirement Payments for FICA Taxation: North Dakota State University v. United States*, 54 TAX LAW. 233, 238 (2000).

134. Small Business and Work Opportunity Tax Act of 2007, Pub. L. No. 110-28, 121 Stat. 190 (2007). The amendments made by the Act are effective for tax returns prepared after May 25, 2007.

135. I.R.C. § 6694(a)(1) (2006), amended by Act of Oct. 3, 2008, Pub. L. No. 110-343, Div. C, Title V, § 506(a), (122 Stat.) 3880. (West Supp. 2008).

136. I.R.S. Notice 2008-13, 2008-3 I.R.B. 282. This standard is in effect until further guidance is issued.

and authorities . . . and, in reliance upon that analysis, reasonably concludes in good faith that there is a greater than fifty percent likelihood that the tax treatment of the item will be upheld if challenged by the IRS.”¹³⁷ Preparers are allowed to rely upon information furnished by the taxpayer, without independent verification, provided this reliance is done in good faith. Also, a preparer may rely upon the advice or information furnished by another advisor, tax return preparer, or third party without independent verification, provided it is done in good faith.¹³⁸

Thus, a tax return preparer is not required to independently verify or review the items reported on tax returns, schedules or other third party documents to determine if the items meet the standard requiring a reasonable belief that the position would more likely than not be sustained on the merits.¹³⁹

However, the preparer cannot ignore any implications drawn from information known by or furnished to the taxpayer. Moreover, the preparer must make reasonable inquiries if information appears to be incorrect or incomplete.

In sum, while penalties now exist for preparers of employment tax returns, as long as college and university administrators exercise good faith and have a reasonable belief that the tax treatment of each item would likely be upheld, they will fall outside the parameters of § 6694.

V. CONCLUSION

For colleges or universities looking to offer an early retirement plan, or other voluntary termination program, to tenured faculty, the tax implications of that decision are likely to be found in the nature of the tenure policy at that particular academic institution and the nature and purpose of the payments given under the early retirement plan. While there is no clear and direct guidance issued by either the IRS or the Supreme Court in this area, looking to case law can give colleges and universities

137. *Id.* at 284.

138. *Id.* Good faith is defined in the following manner:

[A] tax return preparer will be found to have acted in good faith when the tax return preparer relied on the advice of a third party who is not in the same firm as the tax return preparer and who the tax return preparer had reason to believe was competent to render the advice.

Id. at 285. A preparer is not considered to act in good faith if

(i) The advice is unreasonable on its face; (ii) The tax return preparer knew or should have known that the third party advisor was not aware of all relevant facts; or (iii) The tax return preparer knew or should have known (given the nature of the tax return preparer's practice), at the time the tax return or claim for refund was prepared, that the advice was no longer reliable due to developments in the law since the time the advice was given.

Id.

139. *Id.* at 284.

some guidance.

Retirement plans subject to employment taxes will be analogous to those in *University of Pittsburgh*, with the most notable characteristics being monthly payments based on the employee's salary at the time of retirement as well as the length of service to the college or university. In addition, eligibility should be based on past service to the college or university not on relinquishment of tenure.¹⁴⁰ Moreover, plans designed to reward service to a college or university are more likely to be taxed as wages. Finally, in establishing a tenure policy, a college or university should move away from an award of tenure contingent on past performance, similar to a promotion, towards an entirely new contract.¹⁴¹

Retirement plans, and more fundamentally tenure policies, similar to those adopted by the University of Pittsburgh will more likely lead to payments being characterized as wages. Payments not solely based on criteria limited to past performance and current salary but based on a variety of factors are less likely to be considered wages for employment tax purposes. Moreover, a college or university structuring its tenure policies should follow those policies akin to the policies adopted by North Dakota State University.¹⁴² Tenure plans which look less like a promotion based

140. *Univ. of Pittsburgh v. United States*, 507 F.3d 165, 171 (3d Cir. 2007).

[E]ligibility for the Plans, for *both* tenured and non-tenured Plan participants, was based on the employee's age and years of service. These requirements link the Plan payments to past services for the employer, not the specific rights being relinquished, and weigh heavily in favor of treating the payments as wages.

Id. at 172 (emphasis in original).

141. *Id.* at 173–74. Specific provisions in the University of Pittsburgh's policy on "Appointment and Tenure" give this impression:

Academic tenure is a status accorded *members of the University faculty who have demonstrated high ability and achievement* in their dedication to growth of human knowledge. Tenure is intended to assure the University that there will be *continuity in its experienced faculty and in the functions for which they are responsible*. Promotion to tenured rank constitutes recognition by the University that a person so identified is qualified by achievements and contributions to knowledge as to be ranked *among the most worthy of the members of the faculty engaged in scholarly endeavors*.

Id. (quoting Appeal at 193–94, *Univ. of Pittsburgh v. United States*, 507 F.3d 166 (3d Cir. 2007) (No. 06-1276)) (emphasis in original).

142. *North Dakota State Univ. v. United States*, 255 F.3d 599 (8th Cir. 2001). Specifically,

Tenure was granted to a faculty member upon recommendation by NDSU to the North Dakota Board of Higher Education (the Board), which made the final tenure decision. NDSU had a tenure track of six years, during which time faculty members were evaluated annually. The six-year track was not set in stone, however, and occasionally tenure was granted earlier, even upon hire. Under NDSU and Board policy, the six-year probationary period could be waived for faculty having tenure at another university or having a record of outstanding achievement. The Board considered various factors in making tenure decisions, including scholarship in teaching, contribution to a

on service and more like a new employment contract with distinct rights will lead to termination payments that are less likely to be characterized as wages subject to employment taxes because the rights being forfeited by the faculty member appear more akin to property rights. Also, for colleges and universities looking to implement early retirement programs or “Tenure Buy-Out Programs” submitting such programs for review by the Social Security Administration, as done by North Dakota State University, might allow for the discovery of problems that could be remedied early on.

For plans designed after January 12, 2005, the college or university should follow the guidance issued by the IRS in Revenue Ruling 2004-110 as the IRS will not classify those payments as wages for employment tax purposes, provided that they are made under facts and circumstances substantially the same as those in Revenue Rulings 55-520 and 58-301. It is worthwhile to note, however, that the ruling solely mentions employment contracts and does not specifically mention tenure. Thus, for many academic institutions, submitting the plan to the Social Security Administration or IRS for guidance as North Dakota State University did might enable the institution to act with more concrete guidance.

In the end, it often comes down to a facts and circumstances analysis—a situation which is difficult to plan for. For many college and university administrators, this leads to an inequitable treatment of similarly situated persons—inequitable treatment that could best be resolved by guidance from the Supreme Court.

discipline or profession through research, other scholarly or professional activities, and service to the institution and society.

Tenure was not a right that could be demanded by a professor. Once tenure was granted, however, tenure gave the professor the right to continuous academic year employment in the specific program area for which the tenure was granted.

Id. at 601.

