OFFICE OF
CHIEF COUNSEL

**DEPARTMENT OF THE TREASURY**
**INTERNAL REVENUE SERVICE**
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MEMORANDUM FOR STEVEN T. MILLER
DIRECTOR (T:EO )

FROM: Mary Oppenheimer
Assistant Chief Counsel (CC:TEGE:EOEG)

SUBJECT: Medical Resident FICA Refund Claims

This memorandum supplements our memorandum to you dated April 19, 2000, in which we discussed the handling of Federal Insurance Contributions Act ("FICA") refund claims that have been filed nation-wide involving medical residents. Because this advice will be distributed to the field offices, it constitutes conduit Chief Counsel Advice subject to disclosure under § 6110 of the Internal Revenue Code.

You have asked for our advice on whether a hospital that is a sponsoring or participating institution in a graduate medical education (GME) program (a "teaching hospital") is a school, college or university ("S/C/U") for purposes of the student FICA exception under § 3121(b)(10) of the Code.

The Accreditation Council for Graduate Medical Education (ACGME) currently recognizes approximately 1,700 institutions as "teaching institutions."[1] The Centers for Medicare and Medicaid (CMS) (formerly the Health Care Financing Administration) provides graduate medical education cost reimbursement to approximately 1,300 institutions which it describes as "teaching hospitals." CMS reimburses teaching hospitals approximately $2.5 billion per year for GME costs. These teaching institutions vary greatly in their involvement in GME. Some teaching institutions sponsor residency programs in many different specialities and employ many residents. Others sponsor or merely participate in residency programs employing only a handful of residents. Some teaching hospitals are closely affiliated with a university medical school, whereas other teaching hospitals are more loosely affiliated with a medical school or may not be affiliated at all with a

[1]American Medical Association's, Graduate Medical Education Directory (2000/2001), page 9 (commonly referred to as the "Green Book").

medical school. Institutions that are closely associated with a university are commonly referred to as "academic health centers."

Under § 3121(b)(10), the Student FICA exception is available only with respect to services performed in the employ of a S/C/U or a related § 509(a)(3) organization. Section 31.3121(b)(10)-2(d) of the Employment Tax Regulations provides that the term "S/C/U" for purposes of the student FICA exception is to be construed in its "commonly or generally accepted sense." A medical school clearly qualifies as a S/C/U. However, if a hospital where services are performed is the common law employer, but is not part of a medical school, the question arises whether the hospital qualifies as a S/C/U or a related § 509(a)(3) organization with respect to a S/C/U.[2]

The following discusses the existing guidance on whether an institution is a S/C/U within the meaning of § 3121(b)(10) of the Code. Next, this memo looks to Code sections other than § 3121(b)(10) for assistance in determining the meaning of the term "S/C/U" for purposes of the student FICA exception. Although these provisions do not deal with the employment taxes directly, we believe these definitions are instructive in determining the commonly or generally accepted meaning of the term "S/C/U" for purposes of the student FICA exception. Specifically, we believe that authorities interpreting the terms "educational organization" or "educational institution" under sections 151, 170, 117, 119 and 221 are helpful in defining the appropriate boundaries in interpreting the term "S/C/U." We believe authorities under these sections are instructive because they demonstrate the distinction between an institution that is a school versus an institution that merely engages in educational activities such as on the job training. This memo next addresses whether a division or segment of a teaching hospital could qualify as a S/C/U. Finally, this memo then discusses the legislative history to the Social Security Amendments of 1939, which suggests that Congress did not contemplate that institutions providing on the job training would be considered schools.

**Revenue Procedure 98-16**

Revenue Procedure 98-16, 1998-5 I.R.B. 19, sets forth generally applicable standards for determining whether services performed by students in the employ of certain institutions of higher education qualify for the exception from FICA tax provided under § 3121(b)(10). For purposes of Rev. Proc. 98-16, the term "institution of higher education" includes any public or private nonprofit school,

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[2]In our advice to you dated April 19, 2000, we advised that a hospital that is part of the same legal entity as a university meets the S/C/U requirement. That memo also provides a discussion on determining whether a hospital is a related § 509(a)(3) organization to a S/C/U.

college, university, or affiliated organization described in § 509(a)(3) of the Code that meets the requirements set forth in Department of Education (DOE) regulations at 34 C.F.R. § 600.4. These regulations define an institution of higher education, in relevant part, as an institution that (1) is in a state, (2) admits only high school graduates, (3) is authorized by the state to provide a post-secondary educational program, and (4) is accredited or preaccredited by a "nationally recognized accrediting agency" as defined in the DOE regulations at 34 C.F.R. § 600.2.

The revenue procedure at § 2.02 provides that the standards contained in it do not apply to the treatment of postdoctoral students, postdoctoral fellows, medical residents, or medical interns because services performed by these employees cannot be presumed to be for the purpose of pursuing a course of study. Thus, whether a hospital is a S/C/U for medical residents or fellows must be considered in light of the "commonly or generally accepted sense" test set forth in the regulations. While the tests under the DOE regulations may be helpful in determining whether a hospital is a S/C/U for purposes of § 3121(b)(10), they are not the controlling standard in the case of a teaching hospital employing medical residents.[3]

The dictionary is logical starting place to look in determining the meaning of the term "school." Unfortunately, it provides little help. According to dictionaries, the term "school" can cover a broad range of organizations. Webster's defines the word "school" broadly as, "Any place or means of learning or discipline; as the school of experience." But it also defines the term more narrowly as, "A faculty or institution for specialized higher education, usually with a university; as, a medical school or law school."[4] Similarly, the Random House College Dictionary defines "school" as "any place, situation, etc. that instructs or indoctrinates," but also defines the term as an "institution or academic department for teaching in a particular field."[5] Thus, based upon dictionary definitions the term "school" could be construed so broadly as to encompass virtually any organization where educational activities are carried on. For example, any employer that provides on the job training, or even continuing education for its employees, might be considered a school under the term's broadest dictionary definition. Indeed, an employer that provides no training would qualify as Webster's "school of experience." However, we believe that such a broad definition conflicts with the legislative history to

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[3]We note that the ACGME is not a "nationally recognized accrediting agency" within the meaning of the regulations at 34 CFR § 600.2. It is our understanding, however, that the ACGME has not sought recognition by the DOE as a nationally recognized accrediting agency.

[4]Webster's New International Dictionary, 2d Ed. (1935).

[5]The Random House College Dictionary 1st Ed. (1982).

§ 3121(b)(10), with the standards of interpretation prescribed by the Supreme Court, and with the commonly or generally accepted sense of the term "S/C/U."

**The Role of Statutory Context**

The Supreme Court has stated that the first criterion in legislative interpretation is "a natural reading of the full text." United State v. Wells, 519 U.S. 482, 490 (1997). The meaning of a term in a statutory provision is determined by carefully considering the context in which the term is used.[6] Norfolk Southern Corporation v. Commissioner, 140 F.3d 240, 244 (4th Cir. 1998). The statutory context in which the term "S/C/U" appears provides some assistance in narrowing the boundaries of the term "S/C/U" for purposes of the student FICA exception. Section 3121(b)(10) of the Code excepts from employment "service performed in the employ of a school, college, or university . . . if such service is performed by a student who is enrolled and regularly attending classes at such school, college, or university." Section 31.3121(b)(10)-2(c) of the regulations provides that "an employee who performs services in the employ of a [S/C/U] as an incident to and for the purpose of pursuing a course of study has the status of student." The language "enrolled and regularly attending classes" and "pursuing a course of study" suggest that something more formal than "the school of experience" or on the job training is required be a S/C/U for purposes of § 3121(b)(10).

**The Primary Purpose of an Institution Determines Its Character**

Section 170(b)(1)(A)(ii) of the Code provides that the deduction provided in § 170(a) shall be limited, inter alia, to charitable contributions to an "educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on."

Section 1.170A-9(b)(1) of the Income Tax Regulations provides that

> an organization is described in section 170(b)(1)(A)(ii) if its primary function is the presentation of formal instruction and it normally maintains a regular faculty and curriculum and normally has a regularly

[6]In construing a statute, courts generally seek the plain and literal meaning of its language. United States v. Locke, 471 U.S. 84, 93, 95-96 (1985). More specifically, words in a revenue act generally are interpreted in their " 'ordinary, everyday senses.' " Commissioner v. Soliman, 506 U.S. 168, 174 (1993) (quoting Malat v. Riddell, 382 U.S. 669, 571 (1966) (quoting Crane v. Commissioner 331 U.S. 1, 6 (1947))); see also Helvering v. Horst, 311 U.S. 112, 118 (1940) ("[c]ommon understanding and experience are the touchstones for the interpretation of revenue laws.").

> enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The term includes institutions such as primary, secondary, preparatory, or high schools, and colleges and universities. It includes Federal, State, and other public-supported schools which otherwise come within the definition. It does not include organizations engaged in both educational and noneducational activities unless the latter are merely incidental to the educational activities. A recognized university, for example, which incidentally operates a museum or sponsors concerts is an educational organization within the meaning of section 170(b)(1)(A)(ii). However, the operation of a school by a museum does not necessarily qualify the museum as an educational organization within the meaning of this subparagraph. Thus, in order to qualify as an educational organization under section 170(b)(1)(A)(ii), it is not enough that the organization carries on educational activities; instead, the organization's primary purpose must be to carry on educational activities.

Thus, for purposes of § 170(b)(1)(A)(ii) of the Code and regulations thereunder organizations are classified based upon their primary purpose. We note that the regulations use the terms "school," "college," and "university" in describing an educational organization. We believe that the primary purpose standard reaches a result consistent with the "commonly or generally accepted sense" standard and with a "natural reading of the full text" for purposes of determining whether a teaching hospital is a "S/C/U."

**The Primary Purpose of a Teaching Hospital is Patient Care**

Courts in several cases have considered whether a teaching hospital is an educational organization under the standard described in § 170(b)(1)(A)(ii). These cases have arisen in context of §§ 151 (dependency exemptions) and 117 (qualified scholarships). Both of these provisions incorporate the § 170(b)(1)(A)(ii) standard in determining whether an institution is an "educational organization."

**Section 151**

Section 151(e)(4)(A) of the Code, dealing with deductions for dependency exemptions, defines "educational organization." This section provides a dependency exemption for a taxpayer's child who is a full-time student at an educational organization described in § 170(b)(1)(A)(ii) of the Code, or pursuing a full-time course of institutional on-farm training under the supervision of an accredited agent of an educational organization described in § 170(b)(1)(A)(ii) of the Code or of a state or political subdivision of a state. Section 151(e)(4) was amended in 1976 to specifically incorporate the § 170(b)(1)(A)(ii) standard. Before

1976, this provision was in effect substantially the same.[7] Section 1.151-3(c) of the regulations (promulgated before 1976) provides that an educational institution is

> a school maintaining a regular faculty and established curriculum, and having an organized body of students in attendance. It includes primary and secondary schools, colleges and universities, normal schools, technical schools, mechanical schools, and similar organizations, but does not include noneducational institutions, on the job training, correspondence schools, night schools, and so forth.

This language is based upon the legislative history to § 151(e)(4), which states,

> An 'educational institution' is one which normally maintains a regular faculty and curriculum and normally has a regularly organized body of students in attendance at the place where its educational activities are carried on. This excludes correspondence schools, employee training courses, and similar institutions and programs.
> . . .
>
> The term "educational institution" means a school maintaining a regular faculty and established curriculum and having an organized body of students in attendance. It means primary and secondary schools, preparatory schools, colleges, universities, normal schools, technical and mechanical schools and the like, but does not include noneducational institutions, on the job training, night schools and the like.

S. Rep. No. 1622, 83rd Cong., 2d Sess. pp. 20, 93 (1954). (Emphasis added).

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[7]The definitions of "educational institution" under §§ 151 and 117 (discussed infra) before amendment and "educational organization" under § 170(b)(1)(A)(ii) are in substance nearly identical. Before amendment, § 151(e)(4) provided, "For purposes of this paragraph, the term 'educational institution' means only an educational institution which normally maintains a regular faculty and curriculum and normally has an organized body of students in attendance at the place where its educational activities are carried on" and § 117 merely cross-referenced § 151(e)(4). Similarly, § 170(b)(1)(A)(ii) defines "educational organization" as an "educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on." There is little legislative history to the amendments to §§ 151 and 117 because Congress included these changes in the "deadwood" provisions of P.L. No. 99-455, § 1901(a)(23). This suggests that Congress did not view these changes as substantive changes. The Service views these changes as nonsubstantive. See the discussion of Rev. Rul. 81-79, 1981- C.B. 605, infra under the heading "Can a Division or Segment of a Hospital be a School?".

The Tax Court considered whether a teaching hospital is an "educational institution" within the meaning of § 151(e)(4) in Bayley v. Commissioner, 35 T.C. 288 (1960). In Bayley, the issue was whether the petitioner's son was a dependent under § 151(e). Petitioner's son was a medical student at the University of Tennessee during the first four months of 1954, and an intern at Jackson Memorial Hospital (Hospital) in Miami, Florida, from July 1, 1954 through July 1, 1955.[8] Since October 1, 1954, the Hospital had been a teaching hospital of the University of Miami School of Medicine. The faculty of the medical school was responsible for training the interns. The court noted that the interns were appointed and employed by the Hospital. The court found that there was no question that the son was a student at an educational institution during the first four months of 1954 when he was a medical school student. The question was thus narrowed to whether the son was a full time student at an educational institution when he was an intern at the Hospital.

The court concluded that the Hospital was not an "educational institution," and, moreover, the son was not a "student at an educational institution" while working at the hospital. The court emphasized the legislative history to § 151(e)(4) which excludes "employee training courses" and "on the job training" from the definition of educational institution. The court held that the Hospital's status as a teaching hospital did not mean it was an educational institution. Even though the faculty of the medical school became responsible for the " 'training' " of the residents, there was no evidence of the effect this had on the duties or services incident to the son's employment. In addition, the court found there to be no evidence that the hospital maintained a regular faculty and curriculum; normally had a body of students in attendance; or carried on educational activities for any such regularly organized body of students. Id. at 292-94.

Several revenue rulings applying the standards set forth under §§ 151(e)(4) and 170(b)(1)(A)(ii) have also concluded that teaching hospitals are not educational institutions. Revenue Ruling 68-604, 1968-2 C.B. 63, considers whether a hospital that provides training programs for medical students, interns, and residents qualifies as an educational institution for purposes of § 151(e)(4). The hospital at issue has a bed capacity of approximately 1,000 and is primarily concerned and charged with medical care for the indigent of the county that it serves. It operates both in-patient and out-patient facilities normally associated with a large hospital in a metropolitan area. The hospital is actively engaged in graduate medical education for physicians and dentists through its fully accredited programs for internships and residencies and is one of the undergraduate teaching hospitals of an adjacent medical school. The hospital has a full time director of medical

[8]University of Miami-Jackson Memorial Medical Center is considered a teaching institution by the ACGME.

education and a staff of 64 physicians who spend a large portion of their time teaching interns and residents.

Under the ruling's facts, interns and residents spend about 12 and 14 hours per week respectively in class discussion, lectures and laboratories, in addition to their supervised clinical training in wards and clinics. Third and fourth year medical students spend their full time in pursuit of their clinical clerkship and attend at least one class daily. The clinical clerkships consist of training in development of patient history, examination and diagnosis. Second year medical students devote three hours per week to instruction in physical diagnosis and one hour per week to instruction in gross pathology.

The ruling cites the legislative history which provides that the term "educational institution" means "primary and secondary schools, preparatory schools, colleges and universities, normal schools, technical and mechanical schools and the like, but does not include noneducational institutions, correspondence schools, on the job training, night schools and the like." S. Rep. No. 1622, p. 193. The ruling concludes that because the primary purpose of the hospital is to provide medical care for the sick and injured, it does not qualify as an educational institution under § 151(e)(4). However, the ruling states that a division or segment of a hospital could be an educational institution if it normally maintains a regular faculty and curriculum and has an organized body of students who regularly attend classes, provided the division or segment does not engage in on the job training.[9]

Revenue Ruling 77-175, 1973-1 C.B. 630, considers whether a teaching hospital is an "educational institution" for purposes of the United States-Japan Income Tax Convention. In general, the Convention exempts from federal income tax compensation that a resident of Japan receives for teaching or research at an American educational institution when the resident is temporarily present in the United States at the invitation of the United States Government or of a university or other accredited educational institution. The Convention provides that the term educational institution will be interpreted to have the meaning given this term under § 151(e)(4) of the Code.

Under the ruling's facts, a Japan resident is employed as a research fellow by a university hospital. The university hospital has many administrative and functional ties to the university but is a separate corporation controlled by its own board of trustees. The hospital serves as one of the principal teaching hospitals for the university's school of medicine. Most members of the hospital's staff are members of the medical school faculty. In addition, some medical school classes are taught

[9]See the discussion infra under the heading "Can a Division or Segment of a Hospital be a School?"

at the hospital. However, the hospital does not maintain a regular faculty nor does it have a regularly organized body of students.

The ruling cites the regulations at § 1.151-3(c), which provide that the term "educational institution" does not include "noneducational institutions, on the job training, correspondence schools, night schools, and so forth." Since the hospital is a separate legal entity, the ruling holds that the hospital must qualify on its own as an educational institution; it cannot rely on the medical school's status. The Service concluded that the hospital's basic objective, as a member of the medical center, is to provide an integrated program of education, research, and health services for the primary purpose of providing better health care, and thus is not an educational institution. Finally, the ruling holds that the result is the same after the amendment to § 151(e)(4) by the Tax Reform Act of 1976 because the definition under § 170(b)(1)(A)(ii) is very similar to the definition under the regulations at § 1.151-3(c) in that both require a regular faculty and curriculum and a regularly enrolled body of students in attendance at the place where educational activities are regularly carried on.

Revenue Ruling 74-484, 1974-2 C.B. 342, performs a similar analysis in holding that a Veterans Administration hospital is not an educational institution. The Service found that the hospital has as its primary function the care and service of patients admitted therein. In addition, although the hospital has substantial activity in the area of education and maintains an association with a state university, and is responsible for the teaching of interns an residents in postgraduate training and medical students enrolled at the university, it does not maintain a regular faculty or curriculum or have a regularly organized student body. The Service therefore concludes that the VA hospital is not an educational institution.

**Section 117**

Authorities interpreting the § 117 exclusion provision are also helpful in determining the meaning of the term "school" for purposes of the student FICA exception. Section 117(a) provides that "[g]ross income does not include any amount received as a qualified scholarship by an individual who is a candidate for a degree at an educational organization described in section 170(b)(1)(A)(ii)." Before the TRA of 1976, this section excluded qualified scholarships at an "educational institution (as defined in section 151(e)(4))." The regulations at section 1.117-3(b) cross-reference the regulations under § 151(e)(4). The legislative history to the Tax Reform Act of 1986 describes an educational organization for purposes of § 117 as follows:

> An educational institution is described in section 170(b)(1)(A)(ii) if it normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place

> where its educational activities are regularly carried on. This definition encompasses primary and secondary schools, colleges and universities, and technical schools, mechanical schools, and similar institutions, but not noneducational institutions, on-the-job training, correspondence schools, night schools and so forth (Reg. secs. 1.117-3(b), 1.151-3(c)).

H. Conf. Rep. No. 99-841, 99th Cong., 2d. Sess. II-15 (1986). Thus, Congress did not consider an institution providing on the job training to be an educational organization described under § 170(b)(1)(A)(ii).

Several Tax Court cases interpreting the exclusion provision under § 117 have also concluded that teaching hospitals are not educational organizations. In Proskey v. Commissioner, 51 T.C. 918 (1969), the Tax Court considered whether stipends received by a resident at University Hospital, University of Michigan, constituted a fellowship grant excludable under § 117.[10] In order to determine whether University Hospital was an educational organization, the court considered whether the hospital's primary purpose was education or whether it was patient care. The court noted that in 1965 approximately 22,000 patients were hospitalized at University Hospital annually for 290,000 patient days. In addition, the court noted there were approximately 335 permanent staff physicians at the hospital, all of whom were faculty members at the University of Michigan Medical School, and the hospital employed 414 residents during that year. The court noted the formal educational program carried on by the hospital. The court concluded that the primary purpose of the University Hospital was not teaching and research but instead was the care and treatment of its patients. In so concluding, the court noted the level of patient care activity at the hospital. In addition, the court found that a more important indicator that the taxpayer's activities were not for the purpose of study but rather to fulfill the operational needs of the University Hospital was the broad scope of the services he was required to perform. The court noted that the resident handbook required many day to day activities serving the operational needs of the hospital, not the educational pursuits of the taxpayer. Id. at 923. In response to the taxpayer's argument that his principal objective was to obtain training in his profession, the court stated,

> [V]irtually all work as an apprentice, whether in medicine or law, carpentry or masonry, provides valuable training. Nothing in section 117 requires that an amount paid as compensation for services rendered be treated as a non-taxable fellowship grant, merely because the recipient is learning a trade, business or profession. Whatever training petitioner received during the years of his residency – and we

[10]The University of Michigan Hospitals are considered teaching institutions by the ACGME.

> do not doubt that it was substantial – was merely incidental to and for the purpose of facilitating the raison d'etre of the Hospital, namely, the care of its patients.

Id. at 924-25.

In Bharmota v. Commissioner, T.C. Memo 1979-28, the Tax Court considered whether compensation received by the taxpayer as a medical resident during the years 1973 and 1974 was excludable from gross income under section 117. During part of 1972 and 1973, the taxpayer was an intern at Harper Hospital in Detroit, Michigan. The taxpayer was thereafter appointed to the residency program in pathology sponsored by the Wayne State University School of Medicine and Affiliated Hospitals.[11] The taxpayer rotated through four hospitals over the two year period. The taxpayer spent about five hours per week in didactic instruction and conferences.

The court considered whether the hospitals were "educational institutions." The court referred to § 151(e)(4), which defined an educational institution as being "only an educational institution which normally maintains a regular faculty and curriculum and normally has a regularly organized body of students in the place where educational activities are carried on." The court held that none of the institutions were educational institutions. The court found that evidenced showed that the hospitals were "working hospitals whose primary purpose was to heal and care for the sick--not educate students." The court noted that the taxpayer was not a degree candidate. The court distinguished the candidates for a Masters Degree in Pathology offered by the medical school by noting that they were released from their regularly scheduled duties to attend classes. The court held that although the taxpayer may have received five hours pers week in didactic instruction and conferences, "these conferences cannot render a hospital into something that it is not, namely, an educational institution."

The Tax Court also considered whether a teaching hospital was an educational institution in Hanson v. Commissioner, T.C. Memo 1979-108. At issue in Hanson was whether compensation received by the taxpayer, who was a medical resident during the years 1973, 1974 and 1975, was excludable from gross income under § 117. During the years 1973, 1974 and 1975, the taxpayer was a resident at the Doctors Hospital Family Practice Residency Program. The program was an approved program by the American Medical Association. The program was based at the Doctors Hospital in Seattle, Washington, and was affiliated with the University of Washington School of Medicine. The residents in the program were

[11]Harper Hospital and Wayne State University/Detroit Medical Center are considered teaching institutions by the ACGME.

also assigned to several other hospitals or clinics, including the University Hospital.[12] The court found that these hospitals were working hospitals whose primary purpose was to heal and care for the sick, not to educate students. The court concluded that none of the hospitals or clinics in which the taxpayer worked qualify as a educational institution.

The Tax Court in Thakkar v. Commissioner, T.C. Memo 1975-292, Moffit v. Commissioner, 1972-187, and Moore v. Commissioner, T.C. Memo 1971-314, found that the primary purpose of the teachings hospitals involved was the care and treatment of patients. See also Meek v. Commissioner, 608 F.2d 368, 373 (9th Cir. 1979) ("The hospital did not have as its primary purpose the teaching of interns."); Woddail v. Commissioner, 321 F.2d 721, 724 (10th Cir. 1963) ("[T]he Tax Court expressly found that the adoption of the resident trainee program and the appointment of persons such as [the taxpayer] to the [residencies] was for the purpose of facilitating [the] care and treatment [of patients]. In other words, the instruction and training was primarily for the benefit of the VA in operating the hospital.").[13]

In cases considering whether residents' stipends are excludable under § 117, the courts have nearly uniformly concluded that medical residents are compensated for the valuable services they provide to teaching hospitals. See, for example, Meek, supra, at 373 (9th Cir. 1979) ("Although the hospital evidently could continue to provide medical care without the services of interns, the interns did perform valuable services which, if the interns were excused from performance, would have to be performed by others."); Hales v. Commissioner, T.C. Memo 1978-221 ("[Y]oung physicians are continually seeking 'scholarship' exclusions for their salaries, and press in case after case identical contentions upon this court – all to no avail. . . . [O]ne fact which has always been fatal to a taxpayer's claim for 'scholarship' treatment – the providing of extensive valuable services which materially benefit the grantor – is once again present in the instant case.").

**The Primary Purpose of Teaching Hospitals is Patient Care**

Thus, §§ 170, 151 and 117 each incorporate the same standard for determining what is an "educational institution." The courts and the Service in its rulings have consistently held that the primary purpose of a teaching hospital is patient care. These authorities conclude that teaching hospitals do not normally maintain a

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[12]The University of Washington Medical Center is considered a teaching institution by the ACGME.

[13]The teaching hospitals involved in these cases were the Allegheny General Hospital, Pittsburgh Pennsylvania; Jackson Memorial Hospital, Miami Florida; The University Hospital in Birmingham, Alabama (part of the Medical Center of the University of Alabama in Birmingham; and the VA Hospital in Topeka, Kansas. The ACGME considers each of these institutions to be teaching institutions.

regular faculty and curriculum and normally do not have a regularly enrolled body of pupils. The authorities consistently found GME programs to be akin to on the job training or apprenticeship programs. In addition, the authorities have concluded that an affiliation agreement with a medical school does not mean a teaching hospital has the status of a school; rather, the teaching hospital itself must qualify as a school. Moreover, the fact that hospital staff have faculty appointments at a medical school does not mean the hospital is a school. Although the authorities cited are several years old, respected writers on graduate medical education have suggested that in the era of managed care teaching hospitals in general have become less education-oriented.[14]

Support for this position is found in other quarters as well. For example, implicit in Medicare's reimbursement of GME costs is Congress' belief that GME enhances the quality of patient care in a teaching hospital. The legislative history to the Social Security Amendments of 1965 states that "educational activities enhance the quality of patient care in an institution," and therefore it is appropriate for Medicare to reimburse the GME costs of teaching hospitals. S. Rep. No. 404, part I, 85th Cong., 1st Sess. 36 (1965).[15] On a broader level, the ACGME states that its "mission . . . is to improve the quality of health in the United States by ensuring and improving the quality of graduate medical education experience for physicians in training."[16]

Not only is the primary purpose of teaching hospitals medical care, not education, there is also evidence that suggests that GME programs allow teaching hospitals to provide patient care at a lower cost than if residents' services were performed by other health care professionals. This fact at least suggests another incentive for GME other that the desire to train young doctors. Academics have estimated the substantial costs a teaching hospital would incur in replacing the services of medical residents. A 1989 study concluded that the services of up to 4,000 additional health care professionals at a cost of $220 to $270 million annually would be required to replace the lost patient care services by medical residents in New

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[14]See Kenneth M. Ludmerer, M.D., Time to Heal, American Medical Education from the Turn of the Century to the Era of Managed Care, p. 350 (1999) (As a result of the era of managed care, "[a]s the end of the century approached, academic health centers were rapidly losing their academic qualities–even as many medical educators proudly congratulated themselves on their 'proactive' behavior in the changed marketplace.")

[15]Under general Medicare reimbursement principles, costs incurred by a hospital must be related to patient care in order to be reimbursed by Medicare. See 42 CFR § 413.9. Teaching hospitals receive approximately $2.5 billion per year in reimbursement for the costs associated with graduate medical education including residents' stipends.

[16]2000-2001 Green Book at page 11.

York due to the reforms implemented in the wake of the Libby Zion incident.[17] Recently testimony was received by the District of Columbia City Council Subcommittee on Health and Human Services that the cost of replacing resident physicians at D.C. General Hospital would be in excess of $17 million annually.[18] We believe these findings support our contention that the primary purpose of teaching hospitals is patient care and GME programs are a means by which teaching hospitals can more economically carry out that mission.

We note that teaching hospitals may dispute these findings. ABC news recently reported on a petition filed by the Committee for Interns and Residents (CIR) and the American Medical Student Association (AMSA) with the Occupational Safety and Health Administration (OSHA) requesting that certain regulations be implemented to improve the working conditions of medical residents. In response to Peter Jenning's question on what role money plays in residents' long working hours, Doctor Timothy Johnson replied,

> That's probably the most complicated, controversial question. Hospitals get paid about a $100,000 a year by the federal government for each resident, but they only pay residents in salary about $30,000 a year. It looks like they're making a lot of money off cheap labor. They say, of course, they have to spend a lot of money on staff to supervise and train these residents, but if they were to replace residents with actual labor it would cost them a lot of money.[19]

Thus, whether the use of medical residents to fulfill the operational needs of a teaching hospital results in an economic net loss to a teaching hospital is a disputed question.

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[17]These regulations, set forth at § 405.4 of the New York Health Code (10 NYCRR 405.4), require that a hospital establish certain limits and monitor the working hours of medical residents to ensure that medical residents are not fatigued when performing patient care services. For example, the reforms limited residents work schedules to 80 hours per week. The additional patient care costs estimated in the 1989 study were in part due to those services necessary to make up for the patient care services that residents were providing during hours worked in excess of 80 hours per week! The study, entitled, A Revolution in Graduate Medical Education: The Implications of Regulatory Reform in New York State, was conducted by Kenneth E. Thorpe, Director, Program on Health Care Financing, Harvard University School of Public Health, February 1989.

[18]The report, entitled D.C. General Hospital Should be Renewed, Not Closed or Converted (Sept. 18, 2000), was prepared by Alan Sager, Ph.D., Professor of Health Services, Boston University School of Public Health.

[19]Reported on ABC World News Tonight, April 30, 2001. Transcript available on LEXIS or from Burrelle's Information Services.

We believe the primary purpose standard that has been applied for purposes of §§ 170, 151 and 117 is the appropriate standard to apply in determining whether an institution is a "school" within the "commonly or generally accepted sense" of that term. Thus, there is a difference between an educational institution (a S/C/U) and an institution that merely carries on certain educational activities. Consistent with the authorities discussed supra, our position is that a teaching hospital's primary purpose is patient care. We believe that a teaching hospital's GME program is generally incidental to, and intended to further the hospital's primary purpose, namely, patient care. Although teaching hospitals undoubtedly engage in substantial educational activities, these activities do not change the nature of the institution;

We note, however, that this question is made somewhat more complex by § 170(b)(1)(A)(iii) of the Code. This section provides that a deduction under § 170 is limited to charitable contributions to "an organization the principal purpose or functions for which are the providing of medical or hospital care or medical education or medical research . . . ." Regulations § 1.170A-9(c) provides that an organization is described in § 170(b)(1)(A)(iii) if "[i]t is a hospital, and its principal purpose or function is the providing of medical or hospital care or medical education or medical research." This section further provides,

> An organization whose principal purpose or function is the providing of medical education or medical research will not be considered a "hospital" within the meaning of [this paragraph] unless it is also actively engaged in providing medical care or hospital care to patients on its premises or in its facilities . . . as an integral part of its medical education or medical research function.

The regulations provide that the existence of educational activities will not jeopardize an institution's status as a hospital under § 170(b)(1)(A)(iii). The regulations recognize that a significant activity of a teaching hospital might be GME, but the existence of educational activities will not transform a hospital providing patient care into an educational institution.

**Can a Division or Segment of a Hospital be a School?**

The issue arises whether S/C/U status is properly determined with reference to the character of the legal entity, or whether the character of a segment or division of a legal entity may be examined to determine whether the employer has the status of a S/C/U. Section 31.3121(d)-2 of the regulations provides that "every person is an employer if he employs one or more employees." Section 7701(a)(1) provides that the term "person" means any individual, trust, estate, association, corporation. Section 31.3121(b)(10)-2(b) of the regulations provides that "[t]he statutory tests are (1) the character of the organization in the employ of which the services are

performed as a [S/C/U] . . . ." Thus, the character of the legal entity, not the character of a division or segment of the employer, determines the character of the employer for purposes of the student FICA exception.

By contrast, for certain other purposes, the character of the taxpayer is determined at the functional level. Prior to 1976, the Service had taken the position that for certain purposes whether an entity is an educational institution may be determined at the functional level. For example, Rev. Rul. 58-338, 1958-2 C.B. 54, holds that an accredited school of nursing maintained by a hospital and approved and registered by a state board for registration is an educational institution for purposes of § 117. Revenue Ruling 58-338 addressed whether room and board provided to student nurses at a hospital were excludable under § 117 as scholarships.

Similarly, for purposes of the "qualified tuition reduction" exception under § 117(d), an activity or function of a § 501(c)(3) organization may qualify as an educational organization for purposes of § 117(d) even though it is part of organization that is not a § 170(b)(1)(A)(ii) organization. For example, a church school that is not separately organized may qualify as an educational organization for purposes of § 117(d) even though § 117(d) incorporates the § 170(b)(1)(A)(ii) standard. The reasoning behind this position is that the 1976 amendment incorporating the § 170(b)(1)(A)(ii) standard was not intended by Congress to be a substantive change. See Rev. Rul. 81-79, 1981-1 C.B. 605 ("The 1976 amendment did not affect the definition of the term 'educational institution' developed under section 151(e)(4)(A) of the Code. Thus, a division or segment of an organization can be an educational institution . . . ." Note, however, that the activity would have the primary purpose of education were the activity separately organized.

The excise tax provisions under §§ 4041(g), 4221(d)(5) and 4253(j) also serve as an instructive contrast to the employment tax provisions. These provisions exempt from excise taxes sales of certain goods and services to nonprofit educational organizations. These sections define a "nonprofit educational organization" as an educational organization described in § 170(b)(1)(A)(ii). However, the definition of nonprofit educational institution for purposes of these sections is broadened to include a "school operated as an activity of an organization described in § 501(c)(3) . . . if such school normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where educational activities are regularly carried on." Thus, Congress recognized that the term "educational organization" for purposes of § 170(b)(1)(A)(ii) is based upon the character of the organization, and deemed it necessary to look beyond the entity level to the functional level for purposes of these excise tax provisions. Here too, we note that the activity in question is one that would have the primary purpose of education were it a separate organization.

In contrast, Congress has not provided that a division or segment of an employer can constitute a [S/C/U] for purposes of § 3121(b)(10). The employment tax regulations provide that whether an employer has the status of a S/C/U is determined by the character of the "organization." Moreover, the employment tax provisions are generally applied on an employer-by-employer basis. For example, the Service could not divide a legal entity into multiple divisions and apply a separate FICA wage base with respect to services performed by an employee for each segment. Conversely, multiple legal entities generally cannot be combined for purposes of applying a single wage base. Consistent with this position, our April 19, 2000 memo advises that a hospital that is part of the same legal entity as a university meets the S/C/U requirement.

Finally, even assuming for the sake of argument that a GME department of a teaching hospital could be considered a school, the S/C/U requirement still may not be met. Residents are compensated for the patient care services they provide (as numerous § 117 cases have held (see discussion supra)). Thus, even if a legal entity could be bifurcated for employment tax purposes, and the primary purpose of each separately examined, the Service could determine that residents are not employed by a GME program, but rather are employed by the remaining division whose primary purpose is patient care.

**Congress Has Not Expanded the Definition of "School" For Purposes of § 3121(b)(10)**

Congress has chosen, for purposes of certain Code provisions, to expand the definition of educational institution to include teaching hospitals and other employers engaged in on the job training. However, it has not expanded the definition of S/C/U for purposes of the student FICA exception.

For example, § 119(d) provides that qualified campus lodging is excluded from gross income. Qualified campus lodging is "lodging which is located on, or in the proximity of, a campus of the educational institution." The term "educational institution" means (1) an institution described in § 170(b)(1)(A)(ii) of the Code or (2) an academic health center. The former, of course, is a "S/C/U," and was so described by Congress in the legislative history to the in the legislative history to the Tax Reform Act of 1989 (TRA '86).[20] The term "academic health center," however,

[20]By way of background, before enactment of section 119(d), Congress, in the Deficit Reduction Act of 1984 (DEFRA '84), Pub. L. No, 98-369, § 531(g), established a moratorium on the issuance of Treasury regulations relating to the income tax treatment of qualified campus housing until January 1, 1986. Section 531(g)(2) of DEFRA '84 provided that "qualified campus housing" means lodging which is located on (or in close proximity to) a campus of an educational institution described in § 170(b)(1)(A)(ii) of the 1954 Code. In 1996, § 119(d) was enacted by the Tax Reform Act of 1986 (TRA of '86), Pub. L. No. 99-514, § 1164(a). Under the TRA of '86, Congress added section 119(d) to exclude from gross

means an entity which is described in § 170(b)(1)(A)(iii), that receives (during the calendar year in which the taxable year of the taxpayer begins) payments under subsection (d)(5)(B) or (h) of § 1886 of the Social Security Act (relating to graduate medical education),[21] and that has as one of its principal purposes or functions the providing and teaching of basic and clinical medical science and research with the entity's own faculty.

The second half of the definition was added by the Small Business Job Protection Act of 1996 (SBJPA '96), which enacted section 119(d)(4) to expand the definition of "educational institution" beyond organizations described in § 170(b)(1)(A)(ii). The Conference Report provides, "The Senate amendment treats as 'educational institutions' for purposes of section 119(d) certain medical research institutions ('academic health centers') that engage in basic and clinical research, have a regular faculty and teach a curriculum in basic and clinical research to students in attendance at the institution." H.R. Conf. Rep. No. 104-737, 104th Cong. 2d. Sess. 205. The Joint Committee on Taxation print provides,

> The [SBJPA] treats as educational institutions for purposes of Code section 119(d) certain medical research institutions (referred to as academic health centers that have as one of their principal purposes or functions the providing and teaching of basic and clinical medical science and research with the entity's own faculty (regardless of the

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income the value of qualified campus lodging at an educational institution. Consistent with the definition of "educational institution" used for purposes of the moratorium, § 119(d)(4) provided that "the term 'educational institution' means an institution described in section 170(b)(1)(A)(ii)." The conference report to TRA '86 described the moratorium as covering "lodging furnished by a school, college, or university to any of its employees." H.R. Conf. Rep. No. 99-841, 99th Cong. 2d Sess. II-544 (1986). (Emphasis added.) The Joint Committee on Taxation print summarizing the conference agreement provides that "for Federal tax purposes, the fair market value of the use . . . of qualified campus lodging furnished by, or on behalf of, a school, college, or university is to be treated as not greater than five percent of the appraised value . . . ." Joint Committee on Taxation Staff, Summary of Conf. Agreement on H.R. 3838, 99th Cong. 2d Sess. (JCS-16-86). (Emphasis added). Thus, Congress used the term "S/C/U" to describe an educational institution under § 170(b)(1)(A)(ii). Congress' use of the term "S/C/U" in referring to a § 170(b)(1)(A)(ii) educational organization provides some evidence that it views the term "S/C/U" in its commonly or generally accepted sense as being described by the standards under § 170(b)(1)(A)(ii).

[21]Medicare payments comprise two elements. First, under § 1886(h) of the Social Security Act, Medicare makes "direct" payments, which are determined based upon the number of residents employed by the hospital. See 42 CFR § 413.86. Second, under § 1886(d)(5)(B) of the Social Security Act, Medicare makes "indirect" payments in the form of increases to the teaching hospital's basic diagnostic related group (DRG) operating payments. See 42 CFR § 412.105. Medicare reimbursement payments are made only to accredited graduate medical education programs. Recognized accrediting bodies include the Accreditation Council for Graduate Medical Education and the American Osteopathic Association.

> fact that the students formally matriculate at another educational institution).

Joint Committee on Taxation Staff, General Explanation of Tax Legislation enacted in the 104th Congress, 104th Cong., 2d Sess. (JCS 12-96). Taken against the background that the qualified campus lodging rules already applied to § 170(b)(1)(A)(ii) S/C/Us, this separate inclusion indicates that academic health centers are not S/C/Us.

Similarly, Congress broadly defined "eligible education institution" for purposes of § 221(e) of the Code, which deals with the deductibility of interest on student loans, to include certain teaching hospitals. Section 221(e)(2) provides that the term "eligible educational institution" is defined generally by reference to § 25A(f)(2) of the Code, which in turn references § 481 of the Higher Education Act of 1965 (20 U.S.C. 1088) (higher education institutions and certain vocational institutions). This section goes on to provide, "except that such term shall also include an institution conducting an internship or residency program leading to a degree or certificate awarded by an institution of higher education, a hospital, or a health care facility which offers postgraduate training."

Thus, for purposes of certain Code sections, Congress has deemed it appropriate to define the terms "educational institution" or "educational organization" more broadly than under § 170(b)(1)(A)(ii) to include certain teaching hospitals. Congress has not specifically broadened the definition of S/C/U under § 3121(b)(10) to include certain teaching hospitals.

**Expansion of the Student FICA Exception to Include On The Job Training is Contrary to Congress' Intent**

When it enacted § 3121(b)(10) in 1939, Congress contemplated that the student FICA exception would be limited in scope. The House Report provides,

> In order to eliminate the nuisance of inconsequential tax payments the bill excludes certain services performed for fraternal benefit societies and other nonprofit institutions exempt from income tax and certain other groups. While the earnings of a substantial number of persons are excluded by this recommendation, the total amount of earnings involved is undoubtedly very small. . . . The intent of this exclusion is to exclude those persons and those organizations in which the employment is part-time or intermittent and the total amount of earnings is only nominal, and the payment of tax is inconsequential or a nuisance. The benefit rights that are built up are also inconsequential. Many of those affected, such as students and the secretaries of lodges, will have other employment which will enable

> them to build up insurance benefits. This amendment, therefore, should simplify the administration for the worker, the employer, and the government.

H.R. Rep. No. 728, 76th Cong. 1st Sess. (1939), 1939-2 C.B. 538, 543. The Senate Report uses similar language. S. Rep. No. 734, 76th Cong. 1st Sess. (1939), 1939-2 C.B. 565, 570. Expansion of the "S/C/U" language to include on the job training would have far greater effects than suggested by this legislative history. It would reach people earning meaningful wages for substantial periods, thus lowering both benefits and coverage.

The Social Security Administration (SSA) has reported to the General Accounting Office (GAO) that "[b]ecause many residents are married and have children and work as residents for up to 8 years, an exemption from Social Security coverage could have a very significant effect on their potential disability benefits or their family's survivor benefits." Moreover, SSA reports that if medical residents were determined to be students for purposes of the student FICA exception, 270,000 medical residents would lose some coverage over the next ten years, and the trust fund would lose $3.9 billion over the next ten years.[22] Thus, an expansive reading on the term "S/C/U" to include employers providing on the job training, such as teaching hospitals, would expand the student FICA exception beyond what Congress had intended.

Finally, interpreting the term "school" to include teaching hospitals would be contrary to the general rule that exceptions to social security coverage are narrowly construed. In Social Security Board v. Nierotko, 327 U.S. 358, 365 (1946), the Supreme Court stated, "The very words, 'any service . . . performed . . . for his employer,' with the purpose of the Social Security Act in mind, import a breadth of coverage." The Ninth Circuit has held that exceptions from employment under section 3121(b) should be narrowly construed. Moorhead v. United States, 774 F.2d 936, 941. Given the purpose of the Social Security Act, we do not believe that the term "S/C/U" should be interpreted more broadly for purposes of the student FICA exception than the term "educational organization" for purposes of §§ 170(b)(1)(A)(ii), 151, and 117.

In Nationwide Mutual Insurance Company v. Darden, 503 U.S. 318, 324-26 (1992), the Supreme Court has cautioned that the common meaning of terms should not be expanded without some Congressional direction. See also National Labor Relations Board v. Highland Park Mfg. Co., 341 U.S. 322, 324 (1951) ("If Congress intended [terms] . . . to have other than their ordinary accepted meaning, it would

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[22]GAO Report B-284947, Health, Education, and Human Services Division, Social Security: Coverage For Medical Residents (August 31, 2000).

and should have given them special meaning by definition.") Similarly, in Bayley, supra, at 294, the Tax Court considered whether the expansion of the term "educational organization" to cover certain on-farm training should by analogy be extended to other types of on the job training such as medical resident training. The Court stated, "We believe that if Congress had intended to extend the benefits of the statute to other types of on-the-job training, it would have specifically so provided." As Congress has not chosen to expand the definition of S/C/U for purposes of § 3121(b)(10) beyond what that term means in its common sense, it would be inappropriate for the Service to do so.[23]

**Conclusion**

Instead, we believe a "natural reading of the full text" suggests application of the primary purpose standard described in the regulations under section 170. Under this standard, the primary purpose of a teaching hospital generally is patient care, not education. Thus, teaching hospitals that are not part of medical schools should not be treated as S/C/Us for purposes of § 3121(b)(10).

[23]Indeed, we believe there is compelling evidence that Congress specifically intended to cover medical residents under social security. See the discussion of the Social Security Amendments of 1965 that was included as an appendix to our memorandum issued to you dated April 19, 2000.