

Court Orders FICA Refunds in Tenured Faculty Buy-out Cases

August 31, 2004

A recent decision from the United States District Court for the Eastern District of Michigan may be of interest to school districts, community colleges and state universities. The Court decided that federal employment taxes (FICA) do not apply to payments made by public school districts to tenured faculty, as an inducement to relinquish tenure rights in connection with early retirement programs.

The case, *Klender et al v U.S.*, authored by District Judge David M. Lawson, was issued on August 2, 2004. The Court granted a motion for summary judgment that had been filed on behalf of all individuals a) formerly employed by public school districts, public colleges or universities or community colleges; b) residing in the Eastern District of Michigan; c) who received from the school district, public colleges or universities or community colleges, a payment in exchange for a property right or the right to continued employment absent just cause for termination, pursuant to an Early Retirement Incentive Plan; d) who applied to the Internal Revenue Service for a refund of the portion of said payment that was withheld as taxes and other payroll deductions as if from wages pursuant to the Federal Insurance Contributions Act within two years from the time the tax was paid; and e) whose refund was refused by the Internal Revenue Service on or after March 27, 2000, or who filed a claim for a refund before September 27, 2001 that was not acted upon before March 27, 2002.

We do not know whether the U.S. intends to appeal the decision. However, since the *Klender* case followed (and expanded upon) the reasoning of a federal appellate decision in the Eighth Circuit (*N. Dakota State Univ. v U.S.*, 255 F.3d 599), it appears there is a sound basis for a reporting position that payments made in exchange for release of tenure rights are not subject to employer or employee employment taxes assessed to fund Social Security and Medicare (i.e. "FICA" contributions). If FICA is not paid or withheld, however, there is a risk if the U.S. wins on appeal. In that case, the employer may face claims for failure to remit the employer share and to withhold and remit the employee share. As a result, employers may wish to ask retiring employees to enter into repayment agreements covering the "loss on appeal" contingency. These cases also provide a basis for refund claims with respect to FICA taxes paid during the two-year period prior to the refund claim being filed.

In *Klender*, the named teacher-plaintiffs had participated in severance plans which required the teacher to relinquish his or her right to continued employment as a tenured teacher under Michigan's Teachers' Tenure Act and some of the plans limited the rights of the teachers to seek re-employment with the school district. After they severed their employment each teacher began to receive installment payments. The respective school districts withheld from each payment an amount for taxes under FICA. The teachers contended that the payments under the incentive programs did not constitute "wages" within the meaning of FICA, and they each sought a refund from the Internal Revenue Service (IRS). When the refunds were refused, the lawsuit was commenced.

The plaintiffs argued that the installment payments they received under their buyout plans were not subject to the tax, claiming that the payments were made by the school district in exchange for property rights - that is, their rights as tenured teachers to continued employment absent just cause for termination - and therefore the payments were not for wages. The Federal Insurance Contributions Act imposes on the income of every individual a 7.65% tax on all "wages"

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received "with respect to employment." The government argued that applicable federal law in the Sixth Circuit requires that the phrase "remuneration for employment" "should be interpreted broadly" and must include certain compensation in the employer-employee relationship for which no actual services were performed.

Judge Lawson observed that courts in Michigan consider tenure for public school teachers to be a property right. Accordingly, the Judge held:

"The rights granted by statute are the rights the plaintiffs relinquished in exchange for the payments at issue in this case. The illegal deprivation of those rights would have given rise to a cause of action for damages, and those damages recovered would not be taxable under the Sixth Circuit's reasoning in [the] Gerbec [case]. Likewise, the payments made for the sale of those rights would not constitute remuneration for employment. ... The Court finds, therefore, that the payments made to the public school teachers in exchange for their tenure rights, that is, the right to continued employment absent just cause for termination, pursuant to the early retirement incentive plans outlined earlier, were not "wages" within the meaning of FICA ... [and the] tax should not have been assessed on those payments, and the plaintiff's claim for a refund should have been allowed."

See 2004 WL 1768252 (E.D. Mich.) If you need assistance with revision of this or any other school policy, or with other questions related to school law, please contact our Labor Group. This message is for general information only and should not be used as a basis for specific action without obtaining further legal advice.