

Notice of Proposed Rulemaking and Notice of Public Hearing

Student FICA Exception

REG-156421-03

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that provide guidance regarding the meaning of “school, college, or university” and “student” for purposes of the student FICA exception under sections 3121(b)(10) and 3306(c)(10)(B) of the Internal Revenue Code (Code). In addition, this document contains proposed regulations that provide guidance on the meaning of “school, college, or university” for purposes of the FICA exception under section 3121(b)(2) for domestic service performed in a local college club, or local chapter of a college fraternity or sorority by a student. This document also provides a notice of public hearing on these proposed regulations.

DATES: Written and electronic comments must be received by May 25, 2004. Outlines of topics to be discussed at the public hearing scheduled for June 16, 2004, must be received by May 25, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-156421-03), room 5703, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-156421-03),

is enrolled and regularly attending classes at that SCU. Section 3306(c)(10)(B) contains a similar student exception. Thus, the student FICA exception applies to services only if both the “SCU status” and “student status” requirements are met. This regulation deals with both the SCU status and student status requirements.

To satisfy the SCU status requirement, the employer for whom the employee performs services (the common law employer) must be either a SCU or a related section 509(a)(3) organization. If a student is not employed by a SCU or a related section 509(a)(3) organization, then the student FICA exception is not available. See *e.g.*, Rev. Rul. 69–519, 1969–2 C.B. 185 (holding that students attending an apprenticeship school established pursuant to an agreement between a union and a contractors’ association were employees of the participating contractors to whom the students were assigned.) Section 31.3121(b)(10)–2(d) of the Employment Tax Regulations provides that the term “SCU” for purposes of the student FICA exception is to be construed in its “commonly or generally accepted sense.”

To satisfy the student status requirement, the employee must meet three requirements. First, under section 3121(b)(10), the employee must be a student enrolled and regularly attending classes at the SCU employing the student. Second, the employee must be pursuing a course of study at the SCU employing the student. Third, the employee must be “[a]n employee who performs services in the employ of a [SCU] as an incident to and for the purpose of pursuing a course of study at such [SCU]” Reg. §31.3121(b)(10)–2(c). The IRS’s position has been that whether services are incident to and for the purpose of pursuing a course of study depends on two factors: the employee’s course workload and the nature of the employee’s employment relationship with the employer. See *e.g.*, Rev. Proc. 98–16, 1998–1 C.B. 403; Rev. Rul. 78–17, 1978–1 C.B. 306.

B. Need for Regulations

Treasury and IRS have determined that it is necessary to provide additional clarification of the terms “SCU” and “stu-

dent who is enrolled and regularly attending classes” as they are used in section 3121(b)(10). In recent years the question has arisen whether the performance of certain services that are in the nature of on the job training are excepted from employment under the student FICA exception. This issue was presented with respect to medical residents and interns in *State of Minnesota v. Apfel*, 151 F.3d 742 (8th Cir. 1998), which concluded that services performed by medical residents and interns are not employment for social security purposes. The question also applies to services performed by employees in other fields, particularly regulated fields, where on the job training is often required to gain licensure. Guidance is needed to address situations where the performance of services and pursuit of the course of study are not separate and distinct activities, but instead are to some extent intermingled.

Section 3121(a) defines “wages” as “all remuneration for employment” Under section 3121(b), “employment” means “any service . . . performed . . . by an employee for the person employing him.” The Social Security Act provides nearly identical definitions of “wages” and “employment.” 42 U.S.C. sections 409(a)(1)(I); 410(a). “The very words ‘any service . . . performed . . . for his employer,’ with the purpose of the Social Security Act in mind, import a breadth of coverage.” *Social Security Board v. Nierotko*, 327 U.S. 358, 365 (1946). The courts have generally found that the terms “wages” and “employment” as used in both the social security benefits and FICA tax provisions are to be interpreted broadly. *State of New Mexico v. Weinberger*, 517 F.2d 989, 993 (10th Cir. 1995); *Mayberry v. United States*, 151 F.3d 855, 860 (8th Cir. 1998); *Moorhead v. United States*, 774 F.2d 936, 941 (9th Cir. 1985); *Abrahamsen v. United States*, 228 F.3d 1360, 1364 (Fed. Cir. 2000). The broad interpretation of these terms results from the underlying purpose of the Social Security Act, namely, “to provide funds through contributions by employer and employee for the decent support of elderly workmen who have ceased to labor.” *Nierotko*, 327 U.S. at 364. See also *St. Luke’s Hospital v. United States*, 333 F.2d 157, 164 (6th Cir. 1964) (“[I]n dealing

with the beneficent purposes of the Social Security Act, this court generally favors that interpretation of statutory provisions which calls for coverage rather than exclusion.”).

Wage and employment questions affect both social security benefits entitlement and FICA taxes which fund the social security trust fund. Except in unusual circumstances, the Social Security Act, and the Internal Revenue FICA provisions, are to be read in *pari materia*. *United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200, 213 (2001). Thus, whether certain service is employment affects not just FICA taxation, but also social security benefits eligibility and level of benefits. Moreover, the integrity of the social security system requires symmetry between service that is considered employment for social security benefits purposes and employment for FICA taxation purposes.

Resolution of this issue has significant social security benefits and FICA tax implications. The case of medical residents illustrates the possible effect on individuals and the social security system as a whole of excepting service in the nature of on the job training from employment for social security benefits and FICA tax purposes. The Social Security Administration (SSA) 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 reported 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 (2001 through 2010).¹

This regulation addresses two issues: (1) whether an organization carrying on educational activities in connection with the performance of services is a SCU within the meaning of section 3121(b)(10), and (2) whether certain employees performing services in the nature of on the job training have the status of a student who is enrolled and regularly attending classes for purposes of section 3121(b)(10).

¹ GAO Report B–284947, Health, Education, and Human Services Division, *Social Security: Coverage For Medical Residents* (August 31, 2000).

C. Whether an Organization Carrying On Educational Activities Is a SCU

Organizations providing on the job training typically carry on both noneducational and educational activities. The issue is whether organizations carrying on both noneducational and educational activities are SCUs within the meaning of section 3121(b)(10). For example, organizations such as hospitals typically carry on both educational and noneducational activities. In *United States v. Mayo Foundation*, 282 F. Supp. 2d 997 (D. Minn. 2003), the United States argued, consistent with the position it has maintained administratively, that the primary purpose of an organization determines whether the organization is a SCU for purposes of the student FICA exception. The court rejected this argument, finding it inconsistent with the common sense standard. The court stated, “If the [IRS] had intended the term ‘SCU’ in §3121(b)(10) to have the same scope and meaning as ‘educational institution’ (found in §170(b)(1)(A)(ii) . . .), it could have clearly and explicitly given the phrase such scope and meaning by cross-referencing those Code provisions and their implementing regulations.” Although Treasury and IRS disagree with the interpretation of the district court, the Secretary understands and is responding to the court’s view by more clearly incorporating the primary purpose standard in regulations.

This regulation provides that the character of an organization as a SCU or not as a SCU is determined by its primary function. The primary function standard is consistent with the language of section 3121(b)(10) and the existing regulations thereunder, and is consistent with the intended scope of the student FICA exception as reflected in the legislative history accompanying the Social Security Amendments of 1939 and 1950.

Section 170(b)(1)(A) of the Code defines various classes of organizations for charitable deduction purposes. All of the organizations have some combination of charitable, educational, religious and/or cultural purposes. The definitions distinguish them into categories based on various criteria. One such class defined in section 170(b)(1)(A)(ii) is for any “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:

An educational 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 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 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 function must be to carry on educational activities.

The section 170(b)(1)(A)(ii) standard applies to the organization as a whole, an approach that is consistent with §31.3121(b)(10)-2(b) of the regulations, which provides that one of “[t]he statutory tests [is] the character of the *organization* in the employ of which the services are performed as a [SCU]” Thus, the character of the organization determines whether it is a SCU, not merely whether the organization carries on some educational activities. Further, section 3121(b) provides that “the term ‘employment’ means any service . . . performed . . . by an employee for the *person* employing him,” and §31.3121(d)-2 of the regulations provides that “every *person* is an

employer if he employs one or more employees.” Under section 7701(a)(1), the term “person” means any individual, trust, estate, association, or corporation. Thus, the character of the *person* employing the employee—the legal entity recognized for federal tax purposes—determines whether the SCU status requirement is met, not merely the character of a division or function of the employer.

In addition, the primary function standard reaches a result consistent with the “commonly or generally accepted sense” standard of the existing regulation (§31.3121(b)(10)-2(d)). In common parlance, the term “hospital” is used to describe an organization with the primary function of caring for patients. The term “museum” is used to describe an organization with the primary function of maintaining a collection and displaying it to the public in a way that will educate them about the collection and related concepts. A hospital or a museum may conduct educational activities, even classes or possibly even certificate or degree programs, but the activities which define them in the public mind are patient care and maintenance and display of a collection. An organization bears the label “school” when its primary function is the conduct of classes for an identified set of students leading to the awarding of a credential demonstrating mastery of some subject matter.

Finally, defining the term “SCU” to include institutions whose primary function is other than to carry on educational activities could lead to expansion of the student FICA exception beyond what Congress intended. When Congress enacted the student FICA exception in 1939, and amended it in 1950, it contemplated that the exception would be limited in scope. The House Report to the Social Security Amendments of 1939 states the following in describing the purpose of the student FICA and other exceptions:

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 amendment 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 and a nuisance. The benefit rights 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 develop 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. 19 (1939), 1939-2 C.B. 565, 570.

The House Report to the Social Security Amendments of 1950 continued to describe the exception as a matter of administrative convenience not meaningfully affecting social security benefits:

The bill would continue to exclude service performed for nominal amounts in the employ of tax-exempt nonprofit organizations,² service performed by student nurses and internes [sic],³ and service performed by students in the employ of colleges and universities. These exclusions simplify administration without depriving any significant number of people of needed protection.

H. R. Rep. No. 1300, 81st Cong. 1st Sess. 12 (1949). The Senate Report contains similar language. S. Rep. No. 1669, 81st Cong. 2d Sess. 15 (1950). Defining “SCU” to include organizations whose primary purpose is not to carry on educational activities would create a broad exception contrary to what Congress intended. Accordingly, the term “SCU” should not be interpreted so broadly as to include organizations whose primary function is other than to carry on educational activities.

D. Whether Certain Employees Are Students

This regulation clarifies who is a student enrolled and regularly attending classes for purposes of section

3121(b)(10). The existing regulations at §31.3121(b)(10)-2(c) provide that an employee will have the status of student only if the services are performed “as an incident to and for the purpose of pursuing a course of study” at the SCU. Thus, to qualify for the exception, the individual’s predominant relationship with the SCU must be as a student, and only secondarily or incidentally as an employee.

Where an individual’s employment and educational activities are separate and distinct, the extent and nature of the respective activities determine whether the employment or student aspect of the relationship with the SCU is predominant. See Rev. Proc. 98-16. In the vast majority of cases the service and the course of study are separate and distinct activities; for example, the biology major’s service in the cafeteria is unrelated to his course of study. By contrast, some employees’ services are arguably part of a course of study; for example, the services of a medical resident are necessary to receive a certificate in a medical specialty. The standards in Rev. Proc. 98-16—whether the employee has at least a half-time course workload, and whether the employee is eligible to receive certain employee benefits—are inadequate to determine student status in such circumstances. Where the services performed by the individual for the SCU are also earning the individual credit toward an educational credential, the determination of whether the employment relationship is the predominant relationship with the SCU must be based on other factors. This regulation is intended to provide standards to determine student status in such cases.

This regulation is intended to further Congress’s intent regarding those eligible for the student FICA exception as reflected by the legislative history to the Social Security Amendments of 1939. Consistent with Congress’s intent, the student FICA exception covers individuals earning small amounts who are expected to accumulate social security benefits through future employment that will follow the completion of their education. Thus, in the typical case, a student will earn a modest amount while devoting his primary time and attention to classes and study.

This regulation provides clarification in three respects. First, it describes what the individual must be doing to be considered enrolled and regularly attending classes. In order to be a class, the activity must be more than an activity that gives the individual an opportunity to acquire new skills and knowledge. It must involve instructional activities, and be led by a knowledgeable faculty member following an established curriculum for identified students. Classes can include much more than traditional classroom-based instruction, but the faculty leadership, the set curriculum, and the prescribed time frame are essential.

Second, this regulation provides standards for determining whether an employee is pursuing a course of study. The regulation provides that one or more courses conducted by a SCU the completion of which fulfills the requirements to receive an educational credential granted by the SCU is a course of study.

Third, this regulation provides standards for determining whether an employee’s services are incident to and for the purpose of pursuing a course of study. The regulation provides in general that whether the employee’s services are incident to and for the purpose of pursuing a course of study depends on all the facts and circumstances. This determination is made by comparing the educational aspect of the relationship between the employer and the employee with the service aspect of the relationship. The regulation provides that the employee’s course workload is used to measure the scope of the educational aspect of the relationship. A relevant factor is the employee’s course workload relative to a full-time course workload. The regulation further provides that where an employee has the status of a career employee, the services performed by the employee are not incident to and for the purpose of pursuing a course of study.

This regulation specifies various aspects of an individual’s employment relationship with the SCU which cause conclusively the individual to have the status of a “career employee.”

This regulation provides that the criteria used to identify an employee as having the status of a career employee are (1) the

² The general exception from employment for services performed for non-profit organizations was repealed in 1983 by Public Law 98-21, section 102(b).

³ The Social Security Amendments of 1965 repealed the student intern exception under §3121(b)(13). See discussion *infra*.

employee's hours worked, (2) whether the employee is a "professional employee," (3) the employee's terms of employment, and (4) whether the employee is required to be licensed in the field in which the employee is performing services. The hours worked criteria reflects Congressional intent to limit the student FICA exception to services performed by those individuals who are predominantly students. Employees who are working enough hours to be considered full-time employees (40 hours or more per week) have filled the conventional measure of available time with work, and not study. Even if they are capable of balancing a full-time job with a heavy course load, they are earning wages at a level that exceeds Congress's intended scope for the student FICA exception. The IRS's long-standing position is that hours worked is a relevant factor in determining whether an employee has student status. Rev. Rul. 78-17, 1978-1 C.B. 306 (holding that whether an employee has student status is determined by hours worked relative to credits taken); Rev. Rul. 66-285, 1966-2 C.B. 455 (holding that services of an employee employed full-time are not incident to and for the purpose of pursuing a course of study). Rev. Rul. 85-74, 1985-1 C.B. 331, dealing with the student nurse exception, uses an hours worked standard. The student nurse exception and the student FICA exception share the same legislative history. The IRS's use of an hours worked standard was found to be a reasonable interpretation of the legislative history in *Johnson City Medical Center v. United States*, 999 F.2d 973 (6th Cir. 1993).

The regulation provides that a "professional employee" has the status of a career employee, and thus his services are not incident to a course of study. The standards defining a professional employee for purposes of this regulation closely follow existing Department of Labor standards defining certain professional employees. See 29 U.S.C. 213(a); and 29 CFR 541.3(a)(1), (b), (c), (d). Section 213(a) and the regulations thereunder provide that certain employees are exempt from the minimum wage and overtime laws. This regulation provides that a professional employee for purposes of the student FICA exception is an employee whose primary duty consists of the performance of services requiring knowledge of

an advanced type in a field of science or learning, whose work requires the consistent exercise of discretion and judgment in its performance, and whose work is predominantly intellectual and varied in character. The services of employees exhibiting these characteristics are not incident to a course of study.

This regulation provides that an employee's terms of employment may also cause an employee to have the status of a career employee. A list of terms is provided, any one of which causes the employee to have the status of a career employee. On the list are terms of employment that provide for eligibility to receive certain employee benefits typically associated with career employment, such as eligibility to participate in certain types of retirement plans or tuition reduction arrangements. The notion of a career employee standard based on eligibility to receive certain fringe benefits was recommended by the higher education community for purposes of guidance that was issued in Rev. Proc. 98-16, and Treasury and IRS believe it is an appropriate standard to use for purposes of identifying employees whose services are not incident to and for the purpose of pursuing a course of study. Rev. Proc. 98-16 provides that career employee status precludes application of the safe harbor standard, but leaves the possibility that the employee could have the status of a student based on all the facts and circumstances. In contrast, this regulation provides that an employee considered as having the status of a career employee based on eligibility to receive certain employee benefits does not have the status of a student for purposes of the student FICA exception.

Finally, this regulation provides that an employee who must be licensed by a government entity in order to perform a certain function has the status of a career employee. An employee who is required to be licensed to perform the services must have received sufficient prior instruction and demonstrated sufficient mastery of the activity to receive the license. Furthermore, licensed workers typically earn more than a modest amount for their work to reflect their expertise. As discussed, the legislative history indicates that the student FICA exception is intended to cover individuals earning a small amount of wages prior to entry into meaningful

post-education employment. The exception is not intended to cover an individual who has developed enough expertise to be working in a field where he or she is already licensed and has the capacity to earn substantial wages.

The IRS requests comments on the criteria used to identify an employee as having the status of a career employee. In particular, the IRS requests comments on the licensure criterion and whether this criterion should be further refined or clarified.

IRS and Treasury believe that Congress has shown the specific intent to provide social security coverage to individuals who work long hours, serve as highly skilled professionals, and typically share some or all of the terms of employment of career employees, particularly medical residents and interns. The Social Security Amendments of 1939 added section 1426(b)(13) to the Code (later redesignated section 3121(b)(13)), which provided an exception from social security coverage for "service performed as an intern in the employ of a hospital by an individual who has completed a 4 years' course in a medical school chartered or approved pursuant to State law." The House Report accompanying the legislation provides:

Paragraph 13 excepts service performed as a student nurse in the employ of a hospital or a nurse's training school by an individual who is enrolled and is regularly attending classes . . . ; and service performed as an interne [sic] (*as distinguished from a resident doctor*) in the employ of a hospital by an individual who has completed a four years' course in a medical school chartered or approved pursuant to State law.

H. R. Rep. No. 728, 76th Cong. 1st Sess. 49 (1939), 1939-2 C.B. 538, 550-51 (emphasis added); see also S. Rep. No. 734, 76th Cong. 1st Sess. 58, 1939-2 C.B. 565, 578. Thus, the services of medical interns were excepted from FICA, but the services of resident doctors were not.

Twenty-five years later, in *St. Luke's Hospital v. United States*, 333 F.2d 157 (6th Cir. 1964), the Sixth Circuit confirmed that section 3121(b)(13) of the Code applied to medical interns, but that medical residents were not specifically excepted from social security coverage. *St. Luke's* claimed a refund of FICA taxes for the years 1953 through 1958 based on the student intern exception under sec-

tion 3121(b)(13). The refund claims were computed based upon the remuneration paid to medical school graduates in their second or subsequent year of clinical training. The court held that the services of medical residents were not excluded under the medical intern exception.

In 1965, one year after the *St. Luke's* decision, Congress amended the Code to repeal the special exemption for medical interns. The legislative history underlying the Social Security Amendments of 1965 (Public Law 89-97) suggests that Congress intended that medical interns be covered by FICA just as medical residents already were. The House Report states:

Coverage would also be extended to services performed by medical and dental interns. The coverage of services as an intern would give young doctors an earlier start in building up social security protection and would help many of them to become insured under the program at the time when they need the family survivor and disability protection it provides. This protection is important for doctors of medicine who, like members of other professions, in the early years of their practice, may not otherwise have the means to provide adequate survivorship and disability protection for themselves and their families. Interns would be covered on the same basis as other employees working for the same employers, beginning on January 1, 1966.

H. R. Rep. No. 213, 89th Cong. 1st Sess. 95 (1965).

The Senate Report states:

Section 3121(b)(13) of the Internal Revenue Code of 1954 excludes from the term 'employment,' and thus from coverage under the [FICA], services performed as an intern in the employ of a hospital by an individual who has completed a 4-year course in a medical school Section 311(b)(5) of the bill amends section 3121(b)(13) so as to remove this exclusion. The effect of this amendment is to extend coverage under the [FICA] to such interns unless their services are excluded under provisions other than section 3121(b)(13). Thus, the services of an intern are covered if he is employed by a hospital which is not exempt from income tax

as an organization described in section 501(c)(3) of the Code.

S. Rep. No. 404, 89th Cong. 1st Sess. 237-38 (1965). The last sentence makes indirect reference to the exclusion from FICA for services performed for exempt organizations under section 3121(b)(8)(B) of the 1954 Code. That exclusion was repealed by the Social Security Amendments of 1983 (Public Law 98-21). Nothing in the legislative history indicates that Congress believed interns (or residents, who were even further along in their medical careers than interns) were eligible for the student FICA exception.

In addition to revoking the medical intern exception, section 311 of the Social Security Amendments of 1965, entitled, "Coverage for Doctors of Medicine," changed the law in two other ways affecting medical doctors. First, section 1402(c)(5) of the 1954 Code was amended to eliminate the exception for physician services from the definition of "trade or business," thus subjecting these services to self-employment tax. Second, section 3121(b)(6)(C)(iv) of the 1954 Code, which provided an exception from the definition of employment for "service performed in the employ of the United States if the service is performed by any individual as an employee included under § 5351(2) of title 5, [U.S.C.], (relating to certain interns, student nurses, and other student employees of hospitals of the Federal Government)," was amended by adding, "other than as a medical or dental intern or a medical or dental resident in training." These provisions, taken together, indicate Congress's intent to create a scheme under which all medical doctors are covered under the social security system, whether or not they are still in training, whether or not they are self-employed, or whether or not they work for the federal government.

E. Effect on Rev. Proc. 98-16

Several years ago, representatives of higher education asked the IRS and Treasury for guidance on the application of the student FICA exception. Colleges and universities were particularly interested in guidance relating to students who had on-campus jobs that were completely separate and distinct from their course work. In response, the IRS issued Rev. Proc.

98-16, which sets forth 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 section 3121(b)(10). The revenue procedure provided answers to many long-standing questions.

The revenue procedure addresses different circumstances than those prompting the need for the clarifications provided in this proposed regulation. It provides a safe harbor that applies where the student's course work and the student's employment are separate activities, and are not intermingled. In clarifying the regulations interpreting section 3121(b)(10), the IRS and Treasury fully intend to retain the safe harbor in the revenue procedure. However, several discrete aspects of the safe harbor need to be updated to align with the proposed regulations. Thus, in conjunction with this notice of proposed rulemaking, the IRS is suspending Rev. Proc. 98-16 and proposing to replace it with a new revenue procedure that is revised in limited ways to align with the proposed regulations. See Notice 2004-12, to be published in I.R.B. 2004-10 (March 8, 2004). Taxpayers may rely on the proposed revenue procedure until final regulations and a final revenue procedure are issued. Also, the public is invited to comment on the proposed revenue procedure.

F. Related Proposed Amendments

Section 3306(c)(10)(B) of the Code exempts from "employment" for FUTA tax purposes services performed by a student who is enrolled and regularly attending classes at a SCU. This regulation provides that the standards that apply in determining whether an employer is a SCU and whether an employee is a student for purposes of section 3121(b)(10) also apply for purposes of section 3306(c)(10)(B). In addition, this regulation provides that the standards that apply for purposes of determining whether an employer is a SCU for purposes of section 3121(b)(10) also apply for purposes of section 3121(b)(2) (excluding from employment for FICA purposes domestic services performed for local college clubs, fraternities, and sororities by students who are enrolled and regularly attending classes).

G. Proposed Effective Date

It is proposed that these regulations apply to services performed on or after February 25, 2004.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. In addition, because no collection of information is imposed on small entities, the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on the impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on all aspects of the proposed regulations and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing is scheduled for June 16, 2004, beginning at 10 a.m. in room 2615 of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. All visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to

present oral comments at the hearing must submit electronic or written comments by May 25, 2004, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies). A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is John Richards of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 31 is proposed to be amended as follows:

PART 31—EMPLOYMENT TAXES

Paragraph 1. The authority citation for part 31 continues to read in part, as follows:

Authority 26 U.S.C. 7805 * * *

Par. 2. In §31.3121(b)(2)–1, paragraph (d) is revised to read as follows:

§31.3121(b)(2)–1 Domestic service performed by students for certain college organizations.

* * * * *

(d) *A school, college, or university is described in section 3121(b)(2) if its primary function is the presentation of formal instruction, it normally maintains a regular faculty and curriculum, and it normally has a regularly enrolled body of students in attendance at the place where its educational activities are regularly carried on. See section 170(b)(1)(A)(ii) and the regulations thereunder.*

* * * * *

Par. 3. Section 31.3121(b)(10)–2 is amended by:

1. Adding headings for paragraphs (a), (b).

2. Revising paragraphs (c) and (d).
3. Redesignating paragraph (e) as (g).
4. Adding paragraphs (e) and (f).

The revisions and additions read as follows:

§31.3121(b)(10)–2 Services performed by certain students in the employ of a school, college, or university, or of a nonprofit organization auxiliary to a school, college, or university.

(a) *General rule.* (1)* * *

(b) *Statutory tests.* * * *

(c) *School, College, or University.* A school, college, or university is described in section 3121(b)(10) if its primary function is the presentation of formal instruction, it normally maintains a regular faculty and curriculum, and it normally has a regularly enrolled body of students in attendance at the place where its educational activities are regularly carried on. See section 170(b)(1)(A)(ii) and the regulations thereunder.

(d) *Student Status—general rule.* Whether an employee has the status of a student performing the services shall be determined based on the relationship of the employee with the organization for which the services are performed. In order to have the status of a student, the employee must perform services in the employ of a school, college, or university described in paragraph (c) of this section at which the employee is enrolled and regularly attending classes in pursuit of a course of study within the meaning of paragraphs (d)(1) and (2) of this section. In addition, the employee's services must be incident to and for the purpose of pursuing a course of study within the meaning of paragraph (d)(3) of this section at such school, college, or university. An employee who performs services in the employ of an affiliated organization described in paragraph (a)(2) of this section must be enrolled and regularly attending classes at the affiliated school, college, or university within the meaning of paragraph (c) of this section in pursuit of a course of study within the meaning of paragraphs (d)(1) and (2) of this section. In addition, the employee's services must be incident to and for the purpose of pursuing a course of study within the meaning of paragraph (d)(3) of this section at such school, college, or university.

(1) *Enrolled and regularly attending classes.* An employee must be enrolled and regularly attending classes at a school, college, or university within the meaning of paragraph (c) of this section at which the employee is employed to have the status of a student within the meaning of section 3121(b)(10). An employee is enrolled within the meaning of section 3121(b)(10) if the employee is registered for a course or courses creditable toward an educational credential described in paragraph (d)(2) of this section. In addition, the employee must be regularly attending classes to have the status of a student. For purposes of this paragraph (d)(1), a class is an instructional activity led by a knowledgeable faculty member for identified students following an established curriculum. Traditional classroom activities are not the sole means of satisfying this requirement. For example, research activities under the supervision of a faculty advisor necessary to complete the requirements for a Ph.D. degree may constitute classes within the meaning of section 3121(b)(10). The frequency of events such as these determines whether the employee may be considered to be regularly attending classes.

(2) *Course of study.* An employee must be pursuing a course of study in order to have the status of a student. A course of study is one or more courses the completion of which fulfills the requirements necessary to receive an educational credential granted by a school, college, or university within the meaning of paragraph (c) of this section. For purposes of this paragraph, an educational credential is a degree, certificate, or other recognized educational credential granted by an organization described in paragraph (c) of this section. In addition, a course of study is one or more courses at a school, college or university within the meaning of paragraph (c) of this section the completion of which fulfills the requirements necessary for the employee to sit for an examination required to receive certification by a recognized organization in a field.

(3) *Incident to and for the purpose of pursuing a course of study.* An employee's services must be incident to and for the purpose of pursuing a course of study in order for the employee to have the status of a student. Whether an employee's services are incident to and for the purpose of pursuing a course of study shall

be determined on the basis of the relationship of such employee with the organization for which such services are performed. The educational aspect of the relationship, as compared to the service aspect of the relationship, must be predominant in order for the employee's services to be incident to and for the purpose of pursuing a course of study. The educational aspect of the relationship between the employer and the employee is established by the employee's course workload. The service aspect of relationship is established by the facts and circumstances related to the employee's employment. In the case of an employee with the status of a career employee within the meaning of paragraph (d)(3)(ii) of this section, the service aspect of the relationship with the employer is predominant. Standards applicable in determining whether an employee's services are considered to be incident to and for the purpose of pursuing a course of study are provided in paragraphs (d)(3)(i) and (ii) of this section.

(i) *Course workload.* The educational aspect of an employee's relationship with the employer is evaluated based on the employee's course workload. Whether an employee's course workload is sufficient in order for the employee's employment to be incident to and for the purpose of pursuing a course of study generally depends on the particular facts and circumstances. A relevant factor in evaluating an employee's course workload is the employee's course workload relative to a full-time course workload at the school, college or university within the meaning of paragraph (c) of this section at which the employee is enrolled and regularly attending classes.

(ii) *Career employee status.* Services of an employee with the status of a career employee are not incident to and for the purpose of pursuing a course of study. An employee has the status of a career employee if the employee is described in paragraph (d)(3)(ii)(A), (B), (C) or (D) of this section.

(A) *Hours worked.* An employee has the status of a career employee if the employee regularly performs services 40 hours or more per week.

(B) *Professional employee.* An employee has the status of a career employee if the employee is a professional employee. A professional employee is an employee—

(1) Whose primary duty consists of the performance of work requiring knowledge of an advanced type in a field of science or learning customarily acquired by a prolonged course of specialized intellectual instruction and study, as distinguished from a general academic education, from an apprenticeship, and from training in the performance of routine mental, manual, or physical processes.

(2) Whose work requires the consistent exercise of discretion and judgment in its performance; and

(3) Whose work is predominantly intellectual and varied in character (as opposed to routine mental, manual, mechanical, or physical work) and is of such character that the output produced or the result accomplished cannot be standardized in relation to a given period of time.

(C) *Terms of employment.* An employee with the status of a career employee includes any employee who is—

(1) Eligible to receive vacation, sick leave, or paid holiday benefits;

(2) Eligible to participate in any retirement plan described in section 401(a) that is established or maintained by the employer, or would be eligible to participate if age and service requirements were met;

(3) Eligible to participate in an arrangement described in section 403(b), or would be eligible to participate if age and service requirements were met;

(4) Eligible to participate in a plan described under section 457(a), or would be eligible to participate if age and service requirements were met;

(5) Eligible for reduced tuition (other than qualified tuition reduction under section 117(d)(5) provided to a teaching or research assistant who is a graduate student) because of the individual's employment relationship with the institution;

(6) Eligible to receive employee benefits described under sections 79 (life insurance), 127 (qualified educational assistance), 129 (dependent care assistance programs), or 137 (adoption assistance); or

(7) Classified by the employer as a career employee.

(D) *Licensure status.* An employee is a career employee if the employee is required to be licensed under state or local law to work in the field in which the employee performs services.

(e) *Examples.* The following examples illustrate the principles of paragraphs (c) and (d) of this section:

Example 1. (i) Employee C is employed by State University T to provide services as a clerk in T's administrative offices, and is enrolled and regularly attending classes at T in pursuit of a B.S. degree in biology. C has a course workload which constitutes a full-time course workload at T. C performs services on average 20 hours per week, but from time to time works 40 hours or more during a week. C receives only hourly wages and no other pay or benefits. C is not required under state or local law to be licensed to perform the services for T.

(ii) In this *example*, C is employed by T, a school, college, or university within the meaning of paragraph (c) of this section. C is enrolled and regularly attending classes at T in pursuit of a course of study. C's hours worked do not cause C to have the status of a career employee, even though C may occasionally work 40 hours or more during a week. C's part-time employment relative to C's full-time course workload indicates that C's services are incident to and for the purpose of pursuing a course of study. C is not a professional employee, and C's terms of employment and licensure status do not cause C to have the status of a career employee within the meaning of paragraph (d)(3)(ii) of this section. Thus, C has the status of a student. Accordingly, C's services are excepted from employment under section 3121(b)(10).

Example 2. (i) Employee D is employed in the accounting department of University U, and is enrolled and regularly attending classes at U in pursuit of an M.B.A. degree. D has a course workload which constitutes a half-time course workload at U. D's work does not require the consistent exercise of discretion and judgment, and is not predominantly intellectual and varied in character. D regularly performs services full-time (40 hours per week), and is eligible to participate in a retirement plan described in section 401(a) maintained by U.

(ii) In this *example*, D is employed by U, a school, college, or university within the meaning of paragraph (c) of this section. In addition, D is enrolled and regularly attending classes at U in pursuit of a course of study. However, D has the status of a career employee because D regularly works 40 hours per week, and is eligible to participate in U's section 401(a) retirement plan. Because D has the status of a career employee within the meaning of paragraph (d)(3)(ii) of this section, D's services are not incident to and for the purpose of pursuing a course of study. Accordingly, D's services are not excepted from employment under section 3121(b)(10).

Example 3. (i) Employee E is employed by University V to provide patient care services at a teaching hospital that is an unincorporated division of V. These services are performed as part of a medical residency program in a medical specialty sponsored by V. The residency program in which E participates is accredited by the Accreditation Counsel for Graduate Medical Education. Upon completion of the program, E will receive a certificate of completion, and be eligible to sit for an examination required to be certified by a recognized organization in the medical specialty. E regularly performs services more than 40 hours per week. E's patient care services require knowledge of an advanced type in the field of medicine, and are pre-

dominantly intellectual and varied in character. Further, although E is subject to supervision, E's services require the consistent exercise of discretion and judgment regarding the treatment of patients. In addition, E receives vacation, sick leave, and paid holiday benefits; and salary deferral benefits under an arrangement described in section 403(b). E is a first-year resident, and thus is not eligible to be licensed to practice medicine under the laws of the state in which E performs services.

(ii) In this *example*, E is employed by V, a school, college, or university within the meaning of paragraph (c) of this section. However, because of E's hours worked, professional employee status, and employee benefits, E has the status of a career employee within the meaning of paragraph (d)(3)(ii) of this section. Thus, E's services are not incident to and for the purpose of pursuing a course of study. Accordingly, E's services are not excepted from employment under section 3121(b)(10).

Example 4. (i) Employee F is employed in the facilities management department of University W. F has a B.S. degree in engineering, and is completing the work experience required to sit for an examination to become a professional engineer eligible for licensure under state or local law. F is not attending classes at W in pursuit of a course of study leading to an educational credential. F regularly performs services 40 hours or more per week. F receives certain employee benefits including vacation, sick leave, and paid holiday benefits. F also receives retirement benefits under an arrangement described in section 457.

(ii) In this *example*, F is employed by W, a school, college, or university within the meaning of paragraph (c) of this section. However, F is not enrolled and regularly attending classes at W in pursuit of a course of study. F's work experience is not a course of study for purposes of paragraph (d)(2) of this section. In addition, because of F's hours worked and employment benefits, F has the status of a career employee within the meaning of paragraph (d)(3)(ii) of this section. Thus, F's services are not incident to and for the purpose of pursuing a course of study. Accordingly, F's services are not excepted from employment under section 3121(b)(10).

Example 5. (i) Employee G is employed by Employer X as an apprentice in a skilled trade. X is a subcontractor providing services in the field in which G wishes to specialize. G is pursuing a certificate in the skilled trade from Community College C. G is performing services for X pursuant to an internship program sponsored by C under which its students gain experience, and receive credit toward a certificate in the trade.

(ii) In this *example*, G is employed by X. X is not a school, college or university within the meaning of paragraph (c) of this section. Thus, the exception from employment under section 3121(b)(10) is not available with respect to G's services for X.

Example 6. (i) Employee H is employed by a cosmetology school Y at which H is enrolled and regularly attending classes in pursuit of a certificate of completion. Y's primary function is to carry on educational activities to prepare its students to work in the field of cosmetology. Prior to issuing a certificate, Y requires that its students gain experience in cosmetology services by performing services for the general public on Y's premises. H performs services

less than 40 hours per week. H's work does not require knowledge of an advanced type in a field of science or learning, nor is it predominantly intellectual and varied in character. H receives remuneration in the form of hourly compensation from Y for providing cosmetology services to clients of Y, and does not receive any other compensation or benefits. H is not required to be a licensed cosmetologist in the state in which H performs services while participating in the training program.

(ii) In this *example*, H is employed by Y, a school, college or university within the meaning of paragraph (c) of this section, and is enrolled and regularly attending classes at Y in pursuit of a course of study. In addition, because H works less than 40 hours per week, H is not a professional employee, and H's terms of employment, and licensure status do not indicate that H has the status of a career employee, H is not a career employee within the meaning of paragraph (d)(3)(ii) of this section. Thus, H's services are incident to and for the purpose of pursuing a course of study. Accordingly, H's services are excepted from employment under section 3121(b)(10).

Example 7. (i) Employee J is a teaching assistant at University Z. J is enrolled and regularly attending classes in pursuit of a graduate degree at Z. J has a course workload which constitutes a full-time course workload at Z. J performs services less than 40 hours per week. J's duties include grading quizzes, providing class and laboratory instruction pursuant to a lesson plan developed by the professor, and preparing laboratory equipment for demonstrations. J receives no employee benefits. J receives a cash stipend and a qualified tuition reduction within the meaning of section 117(d)(5) for the credits earned for being a teaching assistant. J is not required under state or local law to be licensed to perform the activities of a teaching assistant.

(ii) In this *example*, J is employed as a teaching assistant by Z, a school, college, or university within the meaning of paragraph (c), and is enrolled and regularly attending classes at Z in pursuit of a course of study. J's full-time course workload relative to J's employment workload indicates that J's services are incident to and for the purpose of pursuing a course of study. J is not a professional employee because J's work does not require the consistent exercise of discretion and judgment in its performance. In addition, J's terms of employment and licensure status do not cause J to have the status of a career employee within the meaning of paragraph (d)(3)(ii) of this section. Thus, J has the status of a student. Accordingly, J's services are excepted from employment under section 3121(b)(10).

(f) *Effective date.* Paragraphs (c), (d), and (e) of this section apply to services performed on or after February 25, 2004.

* * * * *

Par. 4. In §31.3306(c)(10)-2 is revised as follows:

1. Paragraph (c) is revised.
2. Paragraph (d) and (e) are added.

The revision and addition read as follows:

§31.3306(c)(10)–2 *Services of student in employ of a school, college, or university.*

* * * * *

(c) *General rule.* (1) For purposes of this section, the tests are the character of the organization in the employ of which the services are performed and the status of the employee as a student enrolled and regularly attending classes at the school, college, or university described in paragraph (c)(2) of this section, in the employ of which he performs the services. The type of services performed by the employee, the place where the services are performed, and the amount of remuneration for services performed by the employee are not material.

(2) *School, college, or university.* A school, college, or university is described in section 3306(c)(10)(B) if its primary function is the presentation of formal instruction, and it normally maintains a regular faculty and curriculum, and it normally has a regularly enrolled body of students in attendance at the place where its educational activities are regularly carried on. See section 170(b)(1)(A)(ii) and the regulations thereunder.

(d) *Student Status—general rule.* Whether an employee has the status of a student within the meaning of section 3306(c)(10)(B) performing the services shall be determined based on the relationship of the employee with the organization for which the services are performed. In order to have the status of a student, the employee must perform services in the employ of a school, college, or university described in paragraph (c)(2) of this section at which the employee is enrolled and regularly attending classes in pursuit of a course of study within the meaning of paragraphs (d)(1) and (2) of this section. In addition, the employee's services must be incident to and for the purpose of pursuing a course of study at such school, college, or university within the meaning of paragraph (d)(3) of this section.

(1) *Enrolled and regularly attending classes.* An employee must be enrolled and regularly attending classes at a school, college, or university within the meaning of paragraph (c)(2) of this section at which the employee is employed to have the status of a student within the meaning of section 3306(c)(10)(B). An employee is enrolled within the meaning of sec-

tion 3306(c)(10)(B) if the employee is registered for a course or courses creditable toward an educational credential described in paragraph (d)(2) of this section. In addition, the employee must be regularly attending classes to have the status of a student. For purposes of this paragraph (d)(1), a class is a didactic activity in which a faculty member plays a leadership role in furthering the objectives of an established curriculum. Traditional classroom activities are not the sole means of satisfying this requirement. The frequency of events such as these determines whether the employee may be considered to be regularly attending classes.

(2) *Course of study.* An employee must be pursuing a course of study in order to have the status of a student within the meaning of section 3306(c)(10)(B). A course of study is one or more courses the completion of which fulfills the requirements necessary to receive an educational credential granted by a school, college, or university within the meaning of paragraph (c)(2) of this section. For purposes of this paragraph, an educational credential is a degree, certificate, or other recognized educational credential granted by an organization described in paragraph (c)(2) of this section. In addition, a course of study is one or more courses at a school, college, or university within the meaning of paragraph (c)(2) of this section the completion of which fulfills the requirements necessary for the employee to sit for an examination required to receive certification by a recognized organization in a field.

(3) *Incident to and for the purpose of pursuing a course of study.* An employee's services must be incident to and for the purpose of pursuing a course of study in order for the employee to have the status of a student within the meaning of section 3306(c)(10)(B). Whether an employee's services are incident to and for the purpose of pursuing a course of study shall be determined on the basis of the relationship of such employee with the organization for which such services are performed. The educational aspect of the relationship, as compared to the service aspect of the relationship, must be predominant in order for the employee's services to be incident to and for the purpose of pursuing a course of study. The educational aspect of the relationship between the employer and the employee is established by

the employee's course workload. The service aspect of relationship is established by the facts and circumstances related to the employee's employment. In the case of an employee with the status of a career employee, the service aspect of the relationship with the employer is predominant. Standards applicable in determining whether an employee's services are considered to be incident to and for the purpose of pursuing a course of study are provided in paragraphs (d)(3)(i) and (ii) of this section.

(i) *Course workload.* The educational aspect of an employee's relationship with the employer is evaluated based on the employee's course workload. Whether an employee's course workload is sufficient for the employee's employment to be incident to and for the purpose of pursuing a course of study generally depends on the particular facts and circumstances. A relevant factor in evaluating the employee's course workload is the employee's course workload relative to a full-time course workload at the school, college or university within the meaning of paragraph (c)(2) of this section at which the employee is enrolled and regularly attending classes.

(ii) *Career employee status.* Services of an employee with the status of a career employee are not incident to and for the purpose of pursuing a course of study. An employee has the status of a career employee if the employee is described in paragraph (d)(3)(ii)(A), (B), (C), or (D) of this section.

(A) *Hours worked.* An employee has the status of a career employee if the employee regularly performs services 40 hours or more per week.

(B) *Professional employee.* An employee has the status of a career employee if the employee is a professional employee. A professional employee is an employee—

(1) Whose primary duty consists of the performance of work requiring knowledge of an advanced type in a field of science or learning customarily acquired by a prolonged course of specialized intellectual instruction and study, as distinguished from a general academic education, from an apprenticeship, and from training in the performance of routine mental, manual, or physical processes.

(2) Whose work requires the consistent exercise of discretion and judgment in its performance; and

(3) Whose work is predominantly intellectual and varied in character (as opposed to routine mental, manual, mechanical, or physical work) and is of such character that the output produced or the result accomplished cannot be standardized in relation to a given period of time.

(C) *Terms of employment.* An employee with the status of a career employee includes any employee who is—

(1) Eligible to receive vacation, sick leave, or paid holiday benefits;

(2) Eligible to participate in any retirement plan described in section 401(a) that is established or maintained by the employer, or would be eligible to participate if age and service requirements were met;

(3) Eligible to participate in an arrangement described in section 403(b), or would be eligible to participate if age and service requirements were met;

(4) Eligible to participate in a plan described under section 457(a), or would be eligible to participate if age and service requirements were met;

(5) Eligible for reduced tuition (other than qualified tuition reduction under section 117(d)(5) provided to a teaching or research assistant who is a graduate student) because of the individual's employment relationship with the institution;

(6) Eligible to receive employee benefits described under sections 79 (life insurance), 127 (qualified educational assistance), 129 (dependent care assistance programs), or 137 (adoption assistance); or

(7) Classified by the employer as a career employee.

(D) *Licensure status.* An employee is a career employee if the employee is required to be licensed under state or local law to work in the field in which the employee performs services.

(e) *Effective date.* Paragraphs (c) and (d) of this section apply to services performed on or after February 25, 2004.

Mark E. Matthews,
*Deputy Commissioner for
Services and Enforcement.*