

THE SIXTH CIRCUIT SPLITS FROM THE EIGHTH CIRCUIT ON TAXABILITY OF EARLY RETIREMENT PAYMENTS

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The Court of Appeals for the Sixth Circuit recently decided a case involving the tax treatment of payments made to tenured faculty for the purpose of early retirement. Specifically at issue was whether such payments constitute “wages” for purposes of the Federal Insurance Contributions Act (FICA). Although a case of first impression for the Sixth Circuit, a similar issue came before the Eighth Circuit Court of Appeals in 2001, which held that the payments were not wages and therefore not subject to FICA.¹ However, in a departure from the Eighth Circuit, the Sixth Circuit held the payments were wages subject to FICA.

CASE HISTORY

Appoloni v. U.S. involved two similar cases which were consolidated on appeal.² Both cases involved three taxpayers bringing suit on behalf of a class consisting of all former employees of Michigan school districts and public post-secondary schools. The cases were factually similar – public school teachers were offered monetary incentives to retire early and upon payment, the school districts withheld FICA taxes. The sole issue in both cases was whether FICA was properly withheld by the employer. The key issue in these cases was whether the payments received by the plaintiffs for the relinquishment of their tenure rights were “wages” for purposes of FICA. If the payments were not considered wages, then FICA should not have been withheld by the school districts and the plaintiffs would have been entitled to a refund. If, however, the payments did constitute wages, the school districts properly withheld FICA taxes and the plaintiffs were not entitled to a refund. Although the cases were factually similar and had an identical issue, the results at the trial court level were different.

Appoloni v. U.S.

Appoloni v. U.S. involved three public school teachers, each with tenure granted by the Dowagiac Union Public School District (school district).³ Donald F. Appoloni, Russell C. Bergemann, and Sandra Engel (together, the Appoloni plaintiffs) had been granted tenure in 1990, 1970 and 1975, respectively. Tenure was granted pursuant to the Michigan Teachers' Tenure Act (the Tenure Act) after each teacher completed a four-year probationary period with the school district. The Tenure Act guarantees that, once tenured, teachers cannot be discharged or demoted without reasonable cause.⁴

During the 2000-2001 academic year, the school district offered an early Employee Severance Plan (ESP) to certain teachers. The stated purpose of the ESP was to lessen the “economic responsibility” of the school district and “prevent teacher layoffs.” Accordingly, the ESP was available to all tenured teachers at the high end of the pay scale with at least ten years of service. The ESP would provide the equivalent of

one year's salary (based on the participant's 1999-2000 annual salary) to be paid in 60 monthly installments over five years. In exchange, the participant would be required to waive all employment rights against the school district, including "claims that the employee was improperly forced to resign, claims or grievances based upon breach of the [employment contract], age discrimination claims, claims under state and federal civil rights law, and claims under the Tenure Act."⁵ As eligible employees, Appoloni, Bergemann and Engel voluntarily participated in the plan by resigning as of June 30, 2001, entitling each of them to 60 payments under the ESP. When the school district withheld FICA taxes from the payments, the three teachers filed claims for refunds with the Internal Revenue Service (IRS). Following denial of their refund claims, they filed a class action suit against the government in the federal district court for the Western District of Michigan. The parties filed cross motions for summary judgment.⁶ The Appoloni plaintiffs claimed that payments made pursuant to the ESP were not wages, but rather payments in exchange for property rights (*i.e.*, tenure rights), and therefore should not be subject to FICA. The government argued, however, that the payments arose out of an employment relationship and therefore constitute wages subject to FICA. The trial court agreed with the government and granted summary judgment in its favor, denying the teachers' claims for refund of FICA taxes withheld. The Appoloni plaintiffs then appealed to the Sixth Circuit.

Klender v. U.S.

Similar facts were developing on the eastern side of Michigan which led to the class action in *Klender v. U.S.*⁷ *Klender* also involved three Michigan public school teachers – Phyllis Klender, Roger Petri, and William Rase (together, the Klender plaintiffs) – who were granted tenure pursuant to the Tenure Act. The Klender plaintiffs worked in two different districts and were offered different types of ESPs as described below.

Phyllis Klender was a librarian in the Pinconning Area Schools district since 1968. She had been granted tenure in 1971 after completing the probationary period required by the Tenure Act. In 1999, Ms. Klender agreed to an offer of early retirement which would entitle her to receive \$46,800 over 72 months. As part of the ESP, she was required to execute a "Release and Waiver of Claims Agreement," which prevented her from raising claims against the school district in the future.⁸ The waived rights included, among others, the right to bring a cause of action or grievance against the school district, and any and all tenure rights and rights to reappointment.

Roger Petri was offered a similar ESP in 1996 by the same district. The plan was available to all teachers that worked with the district for at least ten years. The plan provided that eligible participants would receive a minimum of \$2,000 over a period of up to three years, with the possibility of receiving an additional \$35,000 if ten or more teachers participated. Having worked in the district since 1971 and being tenured since 1973, Mr. Petri was eligible to participate. He voluntarily accepted the ESP by notifying the district and signing the appropriate forms, including a release of his tenure rights.

William Rase was a teacher in the West Branch-Rose City School District since 1979 and had been granted tenure in 1981. In exchange for retiring early and relinquishing his tenure rights, Mr. Rase agreed in 2001 to an ESP available to tenured

teachers with at least twenty years of experience. Under the plan, he was entitled to receive \$30,000.

The school districts withheld FICA taxes from the payments made to the Klender plaintiffs. Similar to *Appoloni*, the Klender plaintiffs filed claims for refunds with the IRS and, when denied, filed suit in federal district court, however this time in the Eastern District of Michigan. Both parties filed motions for summary judgment. The Klender plaintiffs argued that the payments were not wages subject to FICA because the payments were received in exchange for the release of employment rights. Noting that tenure is considered to be a property right in Michigan, the trial court granted the Klender plaintiffs' summary judgment and ordered a refund of the FICA taxes withheld.

Appeal to the Sixth Circuit

Following the trial courts' decisions in *Appoloni*, the Appoloni plaintiffs appealed to the Sixth Circuit Court of Appeals. Following *Klender*, the government appealed to the same court, and the cases were consolidated on appeal.

RELEVANT LAW

FICA

Section 3101 of the Internal Revenue Code of 1986, as amended (Code) imposes FICA tax on the wages of employees received with respect to employment. An employer is required to withhold tax at a rate of 6.2% from the wages of its employees, and also to contribute an equal amount itself.⁹ The proceeds of this tax are used to support federal programs, such as Social Security benefits.

Section 3121(a) defines wages as "all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash." The term employment is defined in section 3121(b) as "any service, of whatever nature, performed . . . by an employee for the person employing him."

The regulations expand on the meaning of "remuneration for employment," noting that payments can be remuneration "even though at the time paid the relationship of employer and employee no longer exists between the person in whose employ the services were performed and the individual who performed them."¹⁰ Further, the name given to payments is immaterial, thus "salaries, fees, bonuses, and commissions . . . are wages if paid as compensation for employment."¹¹

The term "remuneration for employment" has been interpreted broadly by the courts. The Sixth Circuit addressed the definition of wages in *Gerbec v. U.S.* which involved a class action suit for violations of the Employment Retirement Income Security Act of 1974. The plaintiffs in *Gerbec* sued their former employer when they were discharged just prior to vesting in the employer's pension and health plans. The plaintiffs received settlement payments from their former employer as compensation for loss of dignity and loss in earnings capacity. With regard to the latter, the Sixth Circuit held that such payments were subject to FICA even though no services were performed for the payments they received. This was because the "awards representing a loss in wages, both

back wages and future wages, that otherwise would have been paid, reflect compensation paid to the employee because of the employer-employee relationship, regardless of whether the employee actually worked during the time period in question.”¹²

The holding of *Gerbec* was based on the United Supreme Court’s decision in *Soc. Sec. Bd. v. Nierotko*, in which an award of back pay was held to be wages.¹³ In so holding, the Supreme Court specifically noted that wages are not limited to payments resulting from productive activity, but rather includes “the entire employer-employee relationship for which compensation is paid to the employee by the employer.”¹⁴

Although a broad definition of “wages” applies, the Supreme Court has also noted that the term is narrower than “income.”¹⁵ Hence, it is possible for a payment to be income and subject to income tax, and yet not be considered wages for purposes of FICA.

Revenue Rulings

The IRS has addressed the treatment of similar types of payments in three revenue rulings. Although revenue rulings do not have the force of law, the courts do consider such pronouncements in interpreting the position of the IRS as stated therein.

In Revenue Ruling 58-301, an employee and employer entered an agreement in which both agreed the employee would work for the employer for five years.¹⁶ When the parties decided to cancel the agreement after two years, the employer paid a lump sum payment to the employee for the relinquishment of his right to be employed for the remaining three years. The IRS states in the revenue ruling that the lump sum payment was not remuneration for employment, but rather a payment to give up a contract right, and therefore the payment was not subject to FICA. The Plaintiffs in *Appoloni* argued that the ESP payments closely resembled the payments in Revenue Ruling 58-301 and therefore should not be subject to FICA.

However, in Revenue Ruling 74-252 the IRS determined that payments made to an employee for the early termination of a three-year employment contract were wages subject to FICA.¹⁷ The terms of the employment contract stated that if the contract was terminated early, the employer was required to pay the employee the equivalent of six months salary. The IRS distinguished the facts of this ruling from those of Revenue Ruling 58-301 on the basis of the nature of the payments. In the earlier ruling, the payment was on account of the employee’s relinquishment of contract rights, whereas in Revenue Ruling 74-252 the employee received payments contemplated in the employment contract and therefore constituted wages.

In Revenue Ruling 75-44, a lump sum payment received by a railroad employee for giving up his seniority rights was considered to be wages. The employee had earned certain seniority rights, such as additional pay, based on his longevity with his employer. However, he was an at-will employee and the seniority rights did not guarantee his employment. The railroad offered the employee a lump sum payment if he would transfer to a different position, causing him to lose his seniority rights, and the employee accepted. The IRS states that the payment was equivalent to a severance package, and since the payment was based on past services (*i.e.*, seniority), the payment constituted wages.¹⁸ The government argued that Revenue Ruling 75-44 was most analogous to the facts of *Appoloni* and should therefore control the outcome.

North Dakota State University v. U.S.

At the trial court level in both *Klender* and *Appoloni*, the Plaintiffs relied on *North Dakota State University v. U.S.* in support of their position that the ESP payments were not wages.¹⁹ In *North Dakota*, the Eighth Circuit held that payments from North Dakota State University (NDSU) to tenured faculty members for the relinquishment of their tenure rights were not wages subject to FICA. The facts in *North Dakota* were similar to those in *Klender* and *Appoloni*. NDSU offered an early retirement program to tenured faculty and certain administrators. Tenured faculty had a right continuous employment absent the presence of adequate cause (such as fiscal emergencies or incompetence in teaching). Administrators did not enjoy such guaranteed employment, however they did have a right to extended notice before being dismissed. The notice period varied from three to twelve months depending on the length of employment. Once the notice requirements were satisfied, administrators could be dismissed without cause. Participation in the program was entirely voluntary, and the payments were capped at 100 percent of the participant's most recent annual salary. In exchange, the participants agreed to give up their tenure rights, if applicable, as well as any other employment rights. In addition, the participant waived any rights against NDSU under the Age Discrimination in Employment Act.

NDSU initially withheld FICA from the early retirement payments to the tenured faculty and administrators. However, several participants inquired as to whether this was proper, prompting the payroll director at NDSU to contact the Social Security Administration (SSA). According to NDSU, the SSA responded that a payment made pursuant to a "Tenure Buy-Out Program" was "in effect, a payment to secure the release of an unexpired contract of employment," and were not considered wages for purposes of FICA.²⁰ Accordingly, NDSU ceased withholding and paying FICA on the early retirement payments. In 1995, NDSU was audited by the IRS and was assessed deficiencies in FICA taxes relating to the early retirement payments. NDSU paid the deficiency and filed for refund, and when the IRS denied the refund claim, NDSU filed suit in federal district court for the district of North Dakota.²¹

The district court distinguished the payments made to administrators from the payments made to the tenured faculty.²² The former, the court said, were wages because the administrators were "at-will" employees, and therefore the payments represented wages. The tenured faculty, however, were compensated for the release of their tenure rights – rights in which they had a property interest. Due to this property interest, the district court held that the payments to tenured faculty were not wages.

The government appealed the district court's decision with regard to the tenured faculty to the Court of Appeals for the Eighth Circuit. The government made several arguments to support its position that payments for the release of tenure rights are wages. First the government argued that tenure rights cannot be contract rights because tenure rights have no economic value that can be bought and sold. The Eighth Circuit disagreed, stating that "[I]ack of a market in which to sell tenure rights does not prevent those rights from having value to the faculty member to whom tenure has been granted."²³ The government also argued that tenure is granted as recognition for past services, and therefore is analogous to Revenue Ruling 75-44 which determined that payments for past services are wages because they are remuneration for services. Again,

the Eighth Circuit disagrees. Noting that although past service does play a role, the grant of tenure is not automatic and does not accrue over time. The court explains:

A tenured professor . . . experiences two successive relationships with the university: the initial at-will relationship during the probationary period and the subsequent tenured relationship. They are two distinct relationships. . . Tenure rights are established at the outset of the tenured relationship. Tenure is a recognition of contributions to the academic world and is given in exchange for continuing contributions. . . [T]enure also serves the purpose of protecting academic freedom. It provides a secure forum for the germination, cultivation, and exchange of ideas without fear that expression of viewpoints will result in retribution. It is this unique relationship and its accompanying rights, formed only when and if tenure is granted, that give tenure its significance and value.²⁴

Therefore, the court held that tenure is not based solely on past services, and therefore Revenue Ruling 75-44 should not control the outcome of the case. Finally, the government contended that the payments for relinquishment of tenure rights are wages because the amount of the payments was based on the participant's salary. In response, the Eighth Circuit stated any prior caselaw holding that the method used to calculate a payment indicated that such payment was subject to FICA involved at-will employees. Where, as here, the recipients are not at-will employees, but contracted employees, the basis for the payments is dispositive in determining whether the payments are subject to FICA.²⁵ Unpersuaded that the early retirement payments were wages, the Eighth Circuit affirmed the district court's opinion that the payments to tenured faculty were not subject to FICA.

At the trial court level, the Plaintiffs in both *Klender* and *Appoloni* argued that the reasoning in *North Dakota* should be applied. The Klender Plaintiffs were successful, and the District Court for the Eastern District of Michigan held the payments under the ESPs were not wages. The District Court for the Western District of Michigan, however, declined to follow *North Dakota*, holding the payments were wages subject to FICA – a position which was affirmed upon appeal to the Court of Appeals for the Sixth Circuit.

THE SIXTH CIRCUIT'S HOLDING

The Sixth Circuit heard the *Appoloni* appeal in June 2006 and held that the payments made to the Appoloni plaintiffs and the Klender plaintiffs (together, the Plaintiffs) pursuant to the ESPs were subject to FICA because the payments constituted wages. First, the Sixth Circuit noted that the eligibility requirements for the ESPs indicate that the payments were being made on account of services performed, and not for the relinquishment of tenure rights as the Plaintiffs argued. Specifically, participation in the ESPs was conditioned on a minimum number of years of service. For example, in *Appoloni*, the ESP was only available to those teachers with at least ten years of service with the district. Based on this, the Sixth Circuit found that the payments were based on

longevity of employment, not tenure, and since the payments arose out of the employment relationship, they were wages.

Secondly, in response to the Plaintiffs argument that the school districts were essentially “buying” their tenure rights, the Sixth Circuit noted that the ESP payments were not paid solely in exchange for the tenure rights. Rather, the payments were made in exchange for the Plaintiffs’ early retirement and therefore were equivalent to severance payments. Noting that almost every severance package involves an employee relinquishing some type of employment right, and also that courts have consistently held that severance payments constitute wages, the Sixth Circuit could not justify why the Plaintiffs’ ESP payments should be treated differently merely because the teachers gave up tenure rights.²⁶ Further the court noted that the primary reason the Plaintiffs’ were offered ESPs was to encourage high pay-scale employees to retire, and therefore the relinquishment of tenure rights was merely an incidental – albeit necessary – byproduct of the Plaintiffs’ acceptance of the severance payments.

Third, the Sixth Circuit agreed with the government that the ESP payments most closely resembled those in Revenue Ruling 75-44, and not Revenue Ruling 58-301 as the Plaintiffs argued. Most important to the court was that the Plaintiffs’ tenure rights were earned through service, rather than being contracted for when the Plaintiffs’ were hired.

The Sixth Circuit declined to follow *North Dakota*, noting that the Court of Federal Claims also rejected *North Dakota* in *CSX Corp. v. U.S.* for similar reasons.²⁷ Holding that the early retirement payments were wages subject to FICA, the Sixth Circuit reversed *Klender* and affirmed *Appoloni*.

IMPLICATIONS OF APPOLONI

Tax treatment to similarly situated taxpayers will depend on where they live. For taxpayers that receive early retirement payments and are within the jurisdiction of the Eighth Circuit, such payments will be free from FICA pursuant to *North Dakota*. Taxpayers within the jurisdiction of the Sixth Circuit will be subject to FICA. As for the other circuits, only time will tell. In the mean time, taxpayers should be aware that the official position of the IRS is that such payments are subject to FICA – and any other result, while possible, would require litigation.

¹ *North Dakota State University v. U.S.*, 255 F.3d 599 (8th Cir., 2001).

² *Appoloni v. U.S.*, 450 F.3d 185 (6th Cir., 2006).

³ *Appoloni v. U.S.*, 333 F.Supp. 2d 624 (W.D. Mich., 2004).

⁴ *Id.*

⁵ *Id.*

⁶ A grant of summary judgment is appropriate where there are no genuine issues of fact, but rather the case can be decided as a matter of law without referring the case to a jury. There were no factual disputes in either *Appoloni* or *Klender*. The sole issue in both trial court cases was whether the payments for the relinquishment of tenure rights are “wages” for purposes of FICA.

⁷ *Klender v. U.S.*, 328 F.Supp. 2d 754 (E.D. Mich., 2004).

⁸ *Id.*

⁹ Code §§ 3102 and 3111.

¹⁰ Treas. Reg. § 31.3121(a)-1(i).

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- ¹¹ Treas. Reg. § 31.3121(a)-1(c).
- ¹² 164 F.3d 1015, 1026 (6th Cir., 1999).
- ¹³ 327 U.S. 358 (1946).
- ¹⁴ *Id.* at 366.
- ¹⁵ *Rowan Cos. v. U.S.*, 452 U.S. 247 (1981).
- ¹⁶ Rev. Rul. 58-301, 1958-1 C.B. 23.
- ¹⁷ Rev. Rul. 74-252, 1974-1 C.B. 287.
- ¹⁸ The issue in Rev. Rul. 75-44 was whether the payment was “wages” for purposes of the Railroad Retirement Tax Act, which is the equivalent of FICA for railroad employees.
- ¹⁹ 255 F.3d 599 (8th Cir., 2001).
- ²⁰ *Id.* at 602.
- ²¹ 84 F.Supp. 2d 1043 (N.D., 1999).
- ²² *Id.* at 1048 – 1052.
- ²³ 255 F.3d at 605, *citing* *Vail v. Bd. of Educ.*, 706 F.2d 1435, 1451 (7th Cir., 1983)(“A contract that gives a teacher the right to be employed till he retires is special, for unless he is old or rich the present value of his tenure right is probably hi biggest asset.”), *aff’d*, 466 U.S. 377 (1984).
- ²⁴ 255 F.3d at 606.
- ²⁵ *Id.* at 606-7.
- ²⁶ The Sixth Circuit cites *Abrahamsen*, 228 F.3d 1360 (Fed. Cir., 2000)(holding that severance payments made in exchange for the employees’ waiver of all future claims against the employer were subject to FICA) and *Associated Electric*, 226 F.3d 1322 (Fed. Cir., 2000)(holding that severance payments made to union employees in exchange for their agreement not to strike were subject to FICA).
- ²⁷ 52 Fed. Cl. 208 (2002).