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Serfs at the Mercy of a Hungry Beast: Aggressive Regressivity, Private Equity, and the Quandary of the St. Luke Imperative

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**SERFS AT THE MERCY OF A HUNGRY BEAST:**
*Aggressive Regressivity, Private Equity, and the Quandary of the St. Luke Imperative*

**Abstract**

In 2008, for the first time in United States taxation history, the FICA Wage Base exceeds $100,000. With respect to the vast majority of workers who toil away at lower salaries, the payroll tax uptick will go unnoticed. Those comfortably in the near-six-figure club, however, have felt the flame licking higher and higher for years. After setting forth the disturbing truth about the siphoning of regular and excess payroll taxes from the so-called “Social Security Trust Fund” for incremental federal budget deficit reduction, this Article turns to the troubled concept of “wages;” a deepening rift has generated at least one clear split in the United States Courts of Appeals. Though some courts have struggled to draw policeable lines of demarcation to separate “wages” from “income” and the income tax conception of “wages” from the payroll tax conception, other courts, yielding to expansive conceptual pressures, have pursued regressive taxes from low- and mid-wage earners by embracing tangential precedent, importing broad conceptions of “wages” and “employment,” and looking to shifting administrative interpretations for guidance. And yet, at the same time that Congress, certain courts, and administrative agencies have undertaken to sniff out the merest trace of low- and mid-wage earner revenue (lest the serfs take tax holiday), certain entities/individuals in the “capital-gain” Mecca of private equity have managed, in breathtaking defiance of longstanding tax principles, to evade strict scrutiny despite raking in billions of dollars as compensation for services rendered. Having presented commentary on this contrast, the Article turns to the impending Social Security crisis and presents rational alternatives to the enhancement of systemic vertical inequity which would result from raising payroll tax rates, sharply increasing the FICA Wage Base, or reducing benefit levels for those who have, quite literally, earned the right to retire with financial dignity.
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SERFS AT THE MERCY OF A HUNGRY BEAST:

Aggressive Regressivity, Private Equity, and the Quandary of the St. Luke Imperative

Unbeknownst to most rank and file workers, management types and their ilk will get tax candy this year as soon as they clear $102,000.¹ Last year, the management types will fondly recall, the magic number was $97,500,² but alas, Uncle Sam has yanked the piñata higher for 2008, necessitating a few more strikes at the belly before the sugary rain can fall into their back pockets.

In 2008, for the first time in United States taxation history, the FICA³ Wage Base⁴ has topped $100,000.⁵ For the Average Joe who has toiled away at $50,000 per year for the past decade, this news either evades him or, at best, ranks as highly irrelevant. After all, unlike those accustomed to clearing the six-figure mark, he has never seen his take-home pay bump up inexplicably in the fourth quarter or at any other point in the calendar year, and he has no reason

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¹ Only 6.5% of U.S. workers have wages in excess of $102,000. See Karen Tumulty, The $102,000 Debate, TIME, December 3, 2007, at 26 (highlighting the differing perspectives of Senators Hillary Clinton and Barack Obama with respect to the propriety of having a “FICA Wage Base”). The FICA Wage Base, currently set at $102,000 for 2008, is the amount of an individual’s annual wage-based compensation subject to the tax for Old Age, Survivors, and Disability Insurance (OASDI). The annually-adjusted amount has increased steadily for decades. See http://www.ssa.gov/OACT/cola/cbb.html (last visited March 22, 2008). Amounts earned during a given calendar year in excess of the cap escape OASDI taxation, and accordingly, the employee notes and presumably enjoys a modest increase in (post-cap) take-home pay. See 26 U.S.C. § 3101(a) (2007) (imposing the OASDI tax on individuals); § 3121(a)(1) (defining “wages” and carving out amounts in excess of the FICA Wage Base). Note that the tax for Hospital Insurance (HI or “Medicare”) is not subject to an annual wage-based cap. See § 3101(b) (imposing the HI tax on individuals); § 3121(a)(1) (defining “wages” and carving out amounts in excess of the FICA Wage Base but only (with respect to individuals) the tax imposed by § 3101(a)).


³ “FICA” refers to the Federal Insurance Contributions Act, 26 U.S.C. §§ 3101 - 3128 (2007), which generally imposes taxes on an individual’s “wages” earned with respect to “employment.” See generally § 3121(a) and (b) (defining “wages” and “employment,” respectively). For purposes of this Article, the phrase “FICA taxes” or, more commonly, “payroll taxes” is a collective reference to two separate taxes, the tax for OASDI and the tax for Medicare. Although the Article makes occasional reference to payroll tax withholding as separate and distinct from general income tax withholding, note that with respect to the employee, payroll taxes also constitute income taxes. See § 3101(a) and (b). With respect to the employer, however, payroll taxes are excise taxes “imposed on every employer . . . with respect to having individuals in his employ . . . .” Id. §§ 3111(a) and (b) (imposing FICA taxes); see also § 3301 (imposing taxes under the Federal Unemployment Tax Act).

⁴ For a discussion of “FICA Wage Base,” see supra note 1.

to entertain such a fantasy. In fact, he might be shocked and a bit disgruntled to find out that the “FICA” deduction (or at least a healthy chunk of it) eventually disappears for the higher-ups who, in his view, do little more than arrange meetings, drink coffee, complain, read the paper, and monitor the minions, all while raking in relatively obscene amounts of dough. For the higher-ups, of course, clearing the FICA Wage Base is an annual ritual. They watch patiently as their aggregate taxable gross income builds, and sure enough, when the first notable uptick hits their direct deposit account, they have ample justification for a modest shopping spree, dinner at the newest swank restaurant, or maybe even a hot night on the town. If it’s any consolation to the Average Joe, the uptick for Management Joe will take longer to arrive in 2008, and with a little timing luck, Halloween might just feature a new tax horror!

As one might readily guess, the annual increase in the FICA Wage Base is but a small icicle hanging off the edge of a much larger federal tax glacier. Yet, as icicles go, this one is particularly sharp at the point because FICA’s larger component (the tax for Old Age, Survivors, and Disability Insurance (OASDI)) falls more heavily on low wage earners on a per-dollar-earned basis. Thus, the tax, which generated approximately $655 billion in 2007, is considered “regressive.” Technically, the rates used to calculate payroll tax liabilities (OASDI and Hospital Insurance (HI)), are “proportional” in that the aggregate rate (i.e., 7.65% for employees) remains constant even as the amount subject to tax rises. Experts, however, generally consider

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6 Relative to the $6,045 maximum payment in 2007, the $6,324 maximum in 2008 will yield an additional $279 from certain taxpayers. In the aggregate, however, social insurance taxes constitute a substantial percentage of all federal tax revenues; in 2006, the percentage was 35%. See http://www.heritage.org/research/features/BudgetChartBook/charts_R/r4.cfm (last visited March 22, 2008).

7 See CONGRESSIONAL BUDGET OFFICE, HISTORICAL EFFECTIVE FEDERAL TAX RATES: 1979 – 2004, at 5 (2006) [hereinafter CBO EFFECTIVE TAX RATES] (indicating that, with respect to social insurance taxes, those in the lowest income quintile shoulder an effective tax rate of 8.2% while those with incomes placing them in the top 1% of the population pay an effective rate of only 2.0%).

8 See Tumulty, supra note 1.

9 By definition, a proportional tax is one in which the “tax rate is fixed as the amount to which the rate is applied increases.” http://en.wikipedia.org/wiki/Regressive_tax (last visited March 22, 2008).
the OASDI component of FICA to be regressive\(^\text{11}\) because 1) the amount of annual wage-based income subject to the OASDI tax cannot exceed the FICA Wage Base,\(^\text{12}\) and 2) the aggregate payroll taxes paid constitute a smaller and smaller percentage of total income as a taxpayer’s gross income rises.\(^\text{13}\) Table 1 documents this phenomenon.

### Table 1

<table>
<thead>
<tr>
<th>Gross Income</th>
<th>Wages Subject to OASDI Tax in 2008</th>
<th>Maximum OASDI Tax Liability at 6.2% Rate</th>
<th>OASDI Tax Paid as a Percentage of Gross Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>$20,000</td>
<td>$20,000</td>
<td>$1,240</td>
<td>6.2%</td>
</tr>
<tr>
<td>$50,000</td>
<td>$50,000</td>
<td>$3,100</td>
<td>6.2%</td>
</tr>
<tr>
<td>$102,000</td>
<td>$102,000</td>
<td>$6,324</td>
<td>6.2%</td>
</tr>
<tr>
<td>$200,000</td>
<td>$102,000</td>
<td>$6,324</td>
<td>3.16%</td>
</tr>
<tr>
<td>$500,000</td>
<td>$102,000</td>
<td>$6,324</td>
<td>1.26%</td>
</tr>
<tr>
<td>$10,000,000</td>
<td>$102,000</td>
<td>$6,324</td>
<td>0.06%</td>
</tr>
</tbody>
</table>

Table 2 documents this phenomenon in more comprehensive effective federal tax rate terms.

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10 Employees pay OASDI taxes at the rate of 6.2% and HI taxes at the rate of 1.45%. See 26 U.S.C. §§ 3101(a) and (b)(6) (2007).

11 Noted one commentator, “As a tax, FICA is highly regressive because it is imposed on a worker’s first dollar and contains an earnings cap. Average tax rates are flat from $1 in wages until the cap is reached, and then decline as wages exceed the cap.” Linda Sugin, *Theories of Distributive Justice and Limitations on Taxation: What Rawls Demands from Tax Systems*, 72 FORD. L. REV. 1991, 2004 - 05 (2004); see also Morris D. Bernstein, *Social Security Reform and the Growth of Inequality*, 8 KAN. J.L. & PUB. POL’Y 57, 59 (1999) (noting that universal participation in Social Security has made the program mildly redistributive and that Social Security’s benefit calculation formula ultimately gives low wage earners a proportionately higher return than that received by high wage earners).

12 See 26 U.S.C. § 3121(a) (excluding remuneration paid beyond the contribution and benefit base from the definition of “wages” with respect to taxes imposed by § 3101(a)).

13 Definitionally, a regressive tax is one “imposed so that the tax rate decreases as the amount to which the rate is applied increases.” [http://en.wikipedia.org/wiki/Regressive_tax](http://en.wikipedia.org/wiki/Regressive_tax) (last visited March 22, 2008). *Id.* By contrast, a progressive tax is one in which the “tax rate increases as the amount to which the rate is applied increases.” *Id.* Note that “[a] regressive tax system does not mean and likely would not result in low income earners paying more taxes than the wealthy, only that the effective tax rate relative to income or consumption would be a larger tax burden to low income earners.” *Id.*
### Table 2

**CONGRESSIONAL BUDGET OFFICE**  
*Historical Effective Federal Tax Rates: 1979 – 2004 (Select 2004 Data)*

<table>
<thead>
<tr>
<th>Income Category</th>
<th>Millions of Households</th>
<th>Average Pretax Income (2004 Dollars)</th>
<th>Effective Tax Rate (Individual Income Taxes)</th>
<th>Effective Tax Rate (Social Insurance Taxes)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lowest 20%</td>
<td>23.6</td>
<td>$15,400</td>
<td>-6.2%</td>
<td>8.2%</td>
</tr>
<tr>
<td>Second 20%</td>
<td>21.9</td>
<td>$36,300</td>
<td>-0.8%</td>
<td>9.1%</td>
</tr>
<tr>
<td>Middle 20%</td>
<td>22.0</td>
<td>$56,200</td>
<td>2.9%</td>
<td>9.4%</td>
</tr>
<tr>
<td>Fourth 20%</td>
<td>22.2</td>
<td>$81,700</td>
<td>5.9%</td>
<td>9.7%</td>
</tr>
<tr>
<td>Highest 20%</td>
<td>23.0</td>
<td>$207,200</td>
<td>13.9%</td>
<td>6.6%</td>
</tr>
<tr>
<td>All</td>
<td>113.3</td>
<td>$78,700</td>
<td>8.7%</td>
<td>8.0%</td>
</tr>
<tr>
<td>Top 10%</td>
<td>11.6</td>
<td>$297,800</td>
<td>15.9%</td>
<td>5.4%</td>
</tr>
<tr>
<td>Top 5%</td>
<td>5.8</td>
<td>$443,400</td>
<td>17.6%</td>
<td>4.0%</td>
</tr>
<tr>
<td>Top 1%</td>
<td>1.2</td>
<td>$1,259,700</td>
<td>19.6%</td>
<td>2.0%</td>
</tr>
</tbody>
</table>

Holistically, then, low wage earners pay employment taxes at a higher rate (per dollar earned) than those fortunate enough to be far at the other end of the wage-based income spectrum. The news gets worse. First, most taxpayers never clear the FICA Wage Base hurdle. Thus, it is likely that many remain blissfully unaware that high wage earners enjoy eventual relief from the tax with respect to post-wage-base income; those lawmakers with the power to effect change probably feel no widespread pressure to curtail the regressivity or otherwise seek refuge from

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14 See CBO Effective Tax Rates, supra note 7, at 5.

15 Some may feel that the FICA tax should not be considered regressive because the untaxed income beyond the wage base cannot be taken into consideration in calculating retirement benefits. Thus, the ultimate redistribution of the tax is progressive, because the low income earners receive a higher percentage than high income earners (i.e., high earners get no Medicare benefit and cannot participate fully in the Social Security program). See http://en.wikipedia.org/wiki/FICA (last visited March 22, 2008). Others contend that payroll taxes are regressive because FICA tax imposition is capped and because high wage earners receive more non-wage income (e.g., dividends) than low wage earners. See JEFFREY ROHALY, TAX POLICY CENTER, THE DISTRIBUTION OF FEDERAL TAXES (2007) (indicating, per more recent data, that the average effective rate (with respect to payroll taxes) is 2% for the top 1% of wage earners and 7.3% for those in the lowest quintile). Those in the second, middle, and fourth quintiles pay at an effective rate of 8.9%, 10.7%, and 10.8%, respectively. Thus, payroll taxes consume a larger share of middle-class income than upper- or lower-class income. See id.

16 In 2004, the FICA Wage Base was $87,900. See http://www.ssa.gov/OACT/COLA/cbb.html (last visited March 22, 2008). Accordingly, in that year, 80% of households (on an average pretax income basis), failed to clear the FICA Wage Base hurdle. See CBO Effective Tax Rates, supra note 7, at 5. With the FICA Wage Base currently set at $102,000, 93.5% of households will fail to clear the hurdle. See Tumulty, supra note 1.
grassroots ire. Second, given the volatility, financial impact, and political celebrity of actual or promised progressive tax rate modifications, regressive taxes glide quietly under the popular radar screen, receiving little, if any, attention on the political stage. Consider the perspective of former Democratic presidential candidate Senator John Edwards who, to his credit, believes that “[t]he engine of our economy is not Washington, D.C., or Wall Street. It is the tens of millions of men and women in offices, factories and fields across America who go to work every day trying to do right by their families.” To rescue them and combat what he described as a “War on Work” (and otherwise assault America’s rich/poor dichotomy), he planned to overhaul the tax system by raising the capital gains tax rate for the “most fortunate” taxpayers, repealing Bush-era tax cuts for the wealthy, closing various tax loopholes, and, among other things, targeting tax shelter promoters and tax havens. Such tax progressivity enhancements promise notable vertical equity benefits, but regressive tax reform certainly merits a spot in the tax headline of any candidate intent on alleviating working class plight. To be fair, and to the good senator’s credit, he has briefly gone on record at least once regarding his intentions with respect to the FICA Wage Base, noting that he would turn the heat up on those earning over


19 Id.

20 See id.

21 Vertical taxpayer equity refers to the notion that those with higher levels taxable income should pay tax at a higher rate on marginal income than those with lower levels of taxable income because such a system reduces the inequity of widely disparate incomes. See KLEIN, BANKMAN, BITTKER AND STONE, FEDERAL INCOME TAXATION 20 (8th ed. 1990). Horizontal equity refers to the notion that taxpayers who are similarly-situated (from a taxable income perspective) should shoulder the same tax burden. See id. at 19.

22 See Tumulty, supra note 1.
$200,000.\textsuperscript{23} Initially eschewing moderation, Senator Obama proposed elimination of the wage cap altogether. That move would impose payroll taxes on 100% of wages earned,\textsuperscript{24} and, had it been done in 2008, would have raked an additional $122 billion into the system.\textsuperscript{25} More recently, it appears, Senator Obama has embraced the notion that those earning $100,000 -$200,000 deserve a break.\textsuperscript{26} In the end, serious candidates for the Democratic presidential nomination have weighed in on the employment tax issue and its link to the solvency of the Social Security system, but in terms of salience, other issues have enjoyed far more spotlight. He (or she) who ultimately takes the oath of office must contend with the fact that employment taxes will remain an every day, every week, paycheck to paycheck reality for most working men and women, and Social Security benefits a guardian of compelling necessity against poverty in the elderly population.

Rounding out the trio of bad news is the third segment which anchors its roots in the Internal Revenue Code. Its generally baroque detail notwithstanding, the Code provides a minimal, bare bones definition of “wages”\textsuperscript{27}—the base on which payroll taxes are imposed\textsuperscript{28}—as “all remuneration for employment.”\textsuperscript{29} As a result, courts confronted with thorny payroll tax issues have substantial leeway in terms of reading the statute (or, more likely, applying interpretive authorities) narrowly\textsuperscript{30} or broadly,\textsuperscript{31} depending on their view of what constitutes

\textsuperscript{23} See id.
\textsuperscript{24} See id. Those with $1 million in earnings would pay an additional $55,676. See id.
\textsuperscript{25} See id. Senator Clinton pleads the need for a commission to study the problem but otherwise laments that uncapping the FICA Wage Base is “a $1 trillion tax increase” that the country does not need. See id. She does however, consider shoring up the solvency of the Social Security Trust Fund among her chief goals as president. See Kathy Kiely, \textit{Asks to be judged on career in its entirety}, USA TODAY, December 31, 2007, at 7A.
\textsuperscript{26} See Andrew G. Biggs, Opinion, \textit{The Obama Tax Hike}, WALL ST. J., March 12, 2008, at A20 (noting that Senator Obama wants to “create a ‘donut hole’ in the taxing mechanism that pays for the nation’s largest retirement program”).
\textsuperscript{27} 26 U.S.C. § 3121(a) (2007).
\textsuperscript{28} Id. § 3101(a).
\textsuperscript{29} Id. § 3121(a).
\textsuperscript{30} See, \textit{e.g.}, N.D. State Univ. v. United States, 255 F.3d 599 (8th Cir. 2001) (viewing the wage concept narrowly).
“wages” or “employment.” So, the larger stage is exceptionally well set for post-election machinations (given the range of available options), regulatory abuse of the taxing scheme (given the pliability of key statutory terms), and some degree of judicial conflict when any form of compensation passes from employer (or former employer) to employee, especially at the terminal periphery of a professional relationship.

A significant proportion of tax scholarship addresses various practical and theoretical aspects of the progressive income taxing scheme. This Article brings sharper focus to the regressive elements, arguing that under current law and practice, the aggressive (if not abusive) pursuit of regressive taxes offends well-established notions of vertical taxpayer equity on several different levels. In Part I, I set forth relevant background concerning the development of the current payroll tax scheme before going on to discuss troubling aspects of the larger system. At present, payroll tax withholding substantially exceeds the country’s prevailing pay-as-we-go needs. Although the original justification for the excessive withholding in prior years was to beef the system up and thereby enable it to meet the benefit needs of Baby Boomers in later periods, the reality is that the excess is siphoned off to reduce annual federal budget deficits; the Baby Boomer crisis still looms. Ultimately, then, current payroll tax overwithholding merely shifts a portion of the burden of annual budget deficit reduction to the sweat-laden backs

31 See, e.g., Appoloni v. United States, 450 F.3d 185 (6th Cir. 2006) (viewing the wage concept broadly).
32 Indeed, one commentator quipped that “[t]he FICA tax is the neglected stepchild of tax policy analysis.” Patricia E. Dilley, Breaking the Glass Slipper – Reflections on the Self-Employment Tax, 54 TAX LAW. 65 (2000).
35 See Buchanan, supra note 33, at 271.
36 See id. at 272.
37 See President George W. Bush, Address before a Joint Session of the Congress on the State of the Union (Feb. 2, 2005) [hereinafter Bush State of the Union, 2005] (noting that in a few years, the Social Security system will be exhausted and bankrupt).
of low- and middle-wage earners, and annual increases in the FICA Wage Base thus serve no legitimate immediate benefits-related need; rather, such increases simply exacerbate the burden-shifting, albeit more gradually onto the not-so-sweat-laden backs of the upper middle class, “six figure” set.

Enhancing the gravity of arguably illegitimate payroll tax diversion is the problem of abusive regressivity by judicial definitional overreach. I develop this argument in Part II. Under current law, workers must pay employment taxes on “wages” with respect to “employment.” Over the years, however, courts have mired the concept of “wages” for payroll tax purposes in an analytical bog. Arguably, both the prevailing sense that a Social Security crisis looms and the consistent swiping of Trust Fund monies in the wake of recurring federal budget deficits have exerted, even if only indirectly, expansive pressure on the ambit of the “wages” concept and thereby triggered a split between at least two United States Courts of Appeals, a situation which promises ultimate resolution by the U.S. Supreme Court. What is more, certain courts, in seeking to justify their widescreen views, rely, without sound justification, on oft-cited but

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40 In North Dakota State University v. United States, 255 F.3d 599 (8th Cir. 2001), the United States Court of Appeals for the Eighth Circuit held that lump sum payments made to tenured faculty members voluntarily retiring early were not “wages” for FICA purposes because in the court’s view, the faculty members received the payments for relinquishing due process and basic tenure rights, not for prior services rendered. In 2006, however, in Appoloni v. United States, 450 F.3d 185 (6th Cir. 2006), the United States Court of Appeals for the Sixth Circuit held that instructors receiving payments in exchange for relinquishing their tenure rights and retiring early had, in fact, received “wages” subject to payroll taxes because the tenure rights at issue had been earned through prior service to the educational institution. More recently, in University of Pittsburgh v. United States, 507 F.3d 165 (3d Cir. 2007), the United States Court of Appeals for the Third Circuit sided with the Sixth Circuit in holding that tenure relinquishment payments constituted “wages” subject to payroll taxes.
41 See Brief for the United States in Opposition at 16, Appoloni v. United States, 450 F.3d 185 (6th Cir. 2006), petition for cert. filed, 2006 WL 2582496 (U.S. Sept. 5, 2006) (No. 06-334) (noting that “the question presented . . . may ultimately warrant resolution by [the U.S. Supreme Court]” but arguing that a current grant of certiorari would be premature).
substantively tangential precedent. Worse yet, rather than heeding the warning of language in binding precedent and steering clear of discernable lines of judicial demarcation, 42 those same courts appeal to the logic of non-binding IRS pronouncements which, even if taken at face value, portray an inexplicable migration over time from one conceptual mindset to another wholly at the other end of the analytical spectrum. 43 Such a state of affairs inures to the detriment of the working, taxpaying public.

Part III of the Article unveils a remarkable contrast. Alongside the aggressive expansion of the “wages” concept for payroll tax purposes in some judicial quarters, Congress has enacted various Internal Revenue Code provisions to sniff out the merest trace of low-wage earner revenue (lest the serfs take tax holiday). 44 At the high end of the gross income spectrum, however, in what many would readily consider a “compensation for services context,” billions of dollars have been handed over in the so-called “private equity” world, 45 yet the income has apparently faced neither ordinary income tax rates nor the irritant of payroll tax burdens. 46 Commentary in this part focuses not only on Congress’s avowed intent to stand still in the near term, but also on the IRS’s apparent failure to select and employ any number of longstanding tax

42 See United States v. Cleveland Indians Baseball Co., 532 U.S. 200, 212 (2001) (noting that “wages” need not be measured in the same way in the discrete taxation and benefits eligibility contexts); see also Cent. Ill. Pub. Serv. Co. v. United States, 435 U.S. 21, 25 (1978) (distinguishing “income” and “wages”); Newhouse v. McCormick & Co., 157 F.3d 582 (8th Cir. 1998) (holding that damages received by a litigant in an age discrimination suit (i.e., back pay, front pay, and liquidated damages for refusal to hire) did not constitute “wages” because the suit did not arise from an employer-employee relationship).

43 Compare Rev. Rul. 2004-110, 2004-2 C.B. 960 (concluding that payments made to an employee as consideration for early contract cancellation (when the contract was silent on the issue of early termination payments) were “wages” subject to FICA taxation), with Rev. Rul. 55-520, 1955-2 C.B. 393 (concluding that money paid as compensation for the early termination of an employment contract did not constitute “wages” for services performed for federal employment tax and income tax withholding purposes but did constitute gross income for federal income tax purposes).

44 See, e.g., 26 U.S.C. § 6053(c)(1)(C) and (c)(3)(A) (2007) (requiring that certain food establishments report charged tips to the Secretary of the Treasury and allocate certain amounts to tip-receiving employees for reporting purposes).


46 See id.
principles to address the egregious vertical inequity of this state of affairs. The private equity party rages on.47

In Part IV, the focus shifts to the near future, a time when payroll taxes will surely fall short of then-current retiree need and so-called Social Security Trust Funds will be depleted.48 Given the dire political consequences of imposing wide-scale benefit reductions on large segments of the population with a strong reputation for voting,49 there is a very real danger that enhanced benefit demand will be met either or by raising the OASDI tax rate or – as promised at one time by Senator Obama50 – by sharply increasing the FICA Wage Base51 (an approach similar to the aggressive increase in the Medicare Wage Base in 199052 before the extension of that tax to all wage-based income in 1993).53 Thus, in Part IV, I present what I consider rational and fair alternatives to further depletion of systemic vertical equity before moving on to Part V in which I set forth a brief conclusion and an exhortation to halt the pick-pocketing of those who truly labor in caring for the old, the sick, and the disabled.

47 See Henny Sender, Buy-out firms raise billions for new funds, FINANCIAL TIMES, February 29, 2008, at 1 (“Several leading private equity firms are raising tens of billions of dollars for new funds . . .”).

48 See Bush State of the Union, 2005, supra note 37.

49 But see Bernstein, supra note 11, at 57 (indicating that although Social Security used to be the “third rail” of American politics, the program has lost its historical immunity). In this regard, I will simply point out that discussing Social Security is one thing, but reducing or tampering with benefit levels is quite another. Indeed, annual adjustments typically increase benefit levels to ensure adequate payment levels.

50 See Tumulty, supra note 1.

51 See U.S. DEP’T OF THE TREASURY, ISSUE BRIEF NO. 1 SOCIAL SECURITY REFORM: THE NATURE OF THE PROBLEM 1, available at http://www.treas.gov/press/releases/hp571.htm (last visited March 22, 2008) (indicating that fixing Social Security will require reducing future benefits and/or increasing current payroll tax rates by stating that “Social Security can be made permanently solvent only by reducing the present value of scheduled benefits and/or increasing the present value of scheduled tax revenues”).


53 See id. at 2.4 tbl.2.A3 & n.e.
PART I

The Current System

Social Security Act

The current panoply of available Social Security benefits arose largely as a response to the Great Depression of the early 1930s which ravaged the lifetime savings of retired workers and substantially reduced overall employment opportunities for the able-bodied. Responding to the crisis, President Franklin D. Roosevelt introduced economic security legislation in the form of the Social Security Act and ultimately signed it into law on August 14, 1935. Over the years, program coverage broadened substantially such that benefits became available to the dependents of retired workers, surviving dependents of deceased workers, the disabled, and dependents (including surviving dependents) of the disabled. Benefit eligibility, of course, has never been automatic. Since their inception, the various Social Security programs have maintained a strong “social insurance” character. The programs exist to insure the replacement of income lost due to the death, disability, or retirement of a principal breadwinner, but the benefits attach only to those who have worked in jobs subject to Social Security payroll taxes.

54 Before the Great Depression, several distinct problems faced working-class Americans. In the absence of federal-government-mandated programs requiring retirement savings or providing health insurance for the elderly, those who lived to retirement age and left the work force lost both their regular income stream and the ability to pay for necessary medical care. Similarly, those injured on the job (or those born with congenital defects) could expect no disability benefits. See http://en.wikipedia.org/wiki/FICA (last visited March 22, 2008). The New Deal introduced Social Security (funded by FICA taxes) as a means of correcting retirement and disability-related problems. See id. Later, in the 1960s, Medicare (funded by a separate tax) was introduced to address the problem of providing health care for the elderly. See id.


58 See id. at 3.

59 See id.

60 Originally, not all jobs were covered by Social Security. Over time, the number of jobs covered broadened such that today, the program is national, and “coverage is generally compulsory and nearly universal.” 2000 GREEN BOOK, supra note 57, at 3.
for the requisite time period (currently, forty calendar quarters) at sufficient wages (currently, $1,050 for one quarter of credit);\(^{61}\) assuming clearance of the “amount earned” and “time-worked” hurdles, an individual earns protection against specific risks/eventualities as a matter of right both for himself and his qualifying beneficiaries.\(^{62}\)

As programs go, Social Security started out as one of the truly great ideas. Yet, several years ago, President Clinton issued a grim warning concerning the status of Social Security.

Early in this century, being old meant being poor. When President [Franklin D.] Roosevelt created Social Security, thousands wrote to thank him for eliminating what one woman called “the stark terror of penniless, helpless old age.” Even today, without Social Security, half our nation’s elderly would be forced into poverty. Today, Social Security is strong, but by 2013, payroll taxes will no longer be sufficient to cover monthly payments. By 2032, the trust fund will be exhausted[,] and Social Security will be unable to pay the full benefits older Americans have been promised.\(^{63}\)

Thus, with 2013 fast approaching and 2032 arriving as many currently-working adults reach or approach 65, President Franklin Roosevelt’s vision of Social Security—an untouchable promise of future payment\(^{64}\) extended in exchange for current payment of payroll taxes—may ultimately falter because at the precise time when earmarked revenue could help offset a spike in future benefit demand, prevailing policies and procedures have mired the payroll tax scheme in the

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\(^{61}\) An individual generally qualifies for Old-Age Insurance benefits if they are “fully insured,” have attained the age of 62, and have applied for the benefits. See 42 U.S.C. § 402(a) (2007). Essentially, an individual is “fully insured” if they have earned sufficient wages for the requisite number of calendar year quarters (e.g., 40 quarters). See id. § 414(a). In 2007, the amount of earnings needed to qualify for one quarter of coverage was $1,000. See http://www.ssa.gov/OACT/COLA/QC.html (last visited March 22, 2008). Annual (rather than quarterly) reporting of wages by employers will result in an individual earning 4 quarters of coverage after earning $4,000 in wages in 2007, regardless of the quarter in which the wages were actually earned. See id.

\(^{62}\) See id.

\(^{63}\) President William J. Clinton, Address before a Joint Session of the Congress on the State of the Union (Jan. 19, 1999) [hereinafter Clinton State of the Union]. But see Bernstein, supra note 11, at 57 (arguing that the belief that Social Security is in crisis lacks factual support); Buchanan, supra note 33, at 262 (arguing that if we look at the Social Security program not in isolation but as part of a larger federal fiscal picture, there is no strong case for immediate concern and asserting that if problems should appear on the horizon, there will be sufficient time to modify tax and/or benefit levels).

\(^{64}\) See Bernstein, supra note 11, at 62 (“We put those payroll contributions there so as to give the contributors a legal, moral, and political right to collect their pensions . . . . With those taxes in there, no damn politician can ever scrap my social security program.” (quoting President Franklin D. Roosevelt)).
larger federal budget swamp. If the failure should come to pass, that reality will, of course, substantially offend the social insurance model; the broad contribution base we enjoy should afford everyone who has contributed to the system the opportunity to receive adequate income when work ceases due to age or disability. But must the chicken necessarily come home to roost? After all, the employment tax contribution base is necessarily immense. Indeed, despite the withering objections of highly-paid professionals in the early years of the program, the contribution base gradually extended almost from the program’s inception. Properly assessing the question requires a slightly more comprehensive understanding of the payroll tax scheme and its link to the larger federal budget.

**Payroll Taxes**

The United States uses payroll taxes collected today to pay (immediately) those currently entitled to receive Social Security program benefits; no money is earmarked and set aside to accumulate interest. Several decades ago, program administrators realized that as Baby Boomers entered retirement and began to request benefits, the level of contributing workers would be unable to meet the demand. Accordingly, excess payroll taxes have been withheld from workers since 1983. Supposedly, the “excess” would become part of the Social Security

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65 See id. at 60.
66 See id. at 59 (noting that “only a universal program has a contribution base broad enough to attain the goal of adequate benefits for all participants”). The current system, which aims for adequate benefits, rejects a residualist model whereby an individual would collect from the system no more than he or she put in, even if that amount only afforded benefits at the poverty level. See id.
67 See id. at 73 (noting that the principles of universal coverage and universal taxation eventually outweighed any concerns about expanding the Social Security programs to cover highly-paid professionals).
68 See id. at 72 – 73. The expansion of the payroll tax scheme beyond industrial workers was gradual, but thorough. The program was extended to cover farm and domestic workers, then to self-employed farmers and professionals (except attorneys and physicians). While the physicians lasted longer than their brethren in the bar in fighting off inclusion, the tax scheme ultimately snared both doctors and lawyers. See id.
69 See 2000 GREEN BOOK, supra note 57, at 6.
70 See id.
71 See Buchanan, supra note 33, at 270 - 71.
72 See id., at 271.
Trust Fund, which the government could (theoretically) set aside and eventually call on to meet the extraordinary benefit demands anticipated. In reality, “Trust Fund” amounts are immediately invested in U.S. Treasury Bonds. Accordingly, in times of federal budget deficit, the government is able to borrow less from the markets than it otherwise would. Trust Fund monies fill the gap and eventually become part of the larger federal revenue stream funding ordinary government expenditures. When Baby Boomers retire en masse and then-current workers eventually prove unable to meet the growing benefit demand levels, the Social Security Administration will call on Trust Funds (i.e., liquidate the Treasury Bonds) to meet demand. In the face of Trust Fund depletion, Congress will have to act (or allow Social Security to languish). President Clinton warns that the rubber will hit the pavement in 2013, and we’ll burn through the stash of Treasury Bonds by 2032. Absent Congressional action, benefit levels will fall or payroll taxes will increase. Most people with money to bet would likely put it on the latter possibility, not the former (at least in the early stages of crisis).

Are there practical alternatives? One might logically reason that before raising the payroll tax rates across the board, to the chagrin of all Average Joes and Management Joes, Congress will first extract more payroll taxes by first increasing the FICA Wage Base,

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73 See id. (noting that more payroll taxes had to be collected over several decades than would be paid out, and surpluses had to be accounted for in the Trust Funds).
74 See id. at 272 – 73.
75 See id. at 272 (pointing out that rather than having such Trust Funds invest directly in the private financial markets, those funds are used, each year, to reduce the amount of federal borrowing from the private financial markets via investing them directly in Treasury securities). In the aggregate, the Trust Fund held approximately $1.858 trillion at the end of 2005. See id. This amount indicates that the so-called Trust Fund is building at a pretty healthy clip. See Martin J. McMahon, The Matthew Effect and Federal Taxation, 45 B.C. L. REV. 993, 1028 (2004) (pointing out that “[a]t the end of 2002, ‘the trust fund’ held approximately $1.4 trillion, meaning that cumulatively nearly $1.4 trillion dollars collected by the payroll tax ostensibly to fund Social Security and Medicare had been spent on general government operations”).
76 See 2000 GREEN BOOK, supra note 57, at 5 – 6.
77 See Buchanan, supra note 33, at 272.
78 See id.
79 See Clinton State of the Union, supra note 63.
80 See Bush State of the Union, 2005, supra note 37.
dramatically if need be. Back in 1937, when the Social Security program was new, the FICA Wage base was a mere $3,000,\(^{81}\) and the rate of tax was an equally mere 1%.\(^{82}\) Over the years, both the amount subject to tax and the rate imposed have gradually increased.\(^{83}\) Since 1990, however, the aggregate OASDI rate has held at 6.2%,\(^{84}\) at least on surface examination. As Table 3 demonstrates, the dirty work of regular tax increase—a slow speed mugging of the middle class some might say—has been re-verbalized as an annual, politically-palatable\(^{85}\) “adjustment” to the FICA Wage Base. In a mere 11 years, the maximum amount of OASDI tax to be paid has increased from $4,054.80 in 1997 to $6,324.00 in 2008, a tax hike of over 50% (at least in non-inflation-adjusted dollars).

[Next Page]

\(^{81}\) See ANNUAL STATISTICAL SUPPLEMENT,” supra note 52, at 2.4 tbl.2.A3.
\(^{82}\) See id.
\(^{83}\) See id.
\(^{84}\) See id.
\(^{85}\) Regarding the importance of proper verbal packaging of tax increases, one commentator argues that “[t]he vehicle of the lottery allows government officials to raise revenue without mentioning the word ‘tax.’” Todd A. Wyett, Note, State Lotteries: Regressive Taxes in Disguise, 44 TAX LAW. 867, 871 (1991). He further argues that state lotteries are the most regressive tax in existence in the United States, reasoning that “[l]ottery revenues have been used by state legislators to avoid having to impose direct taxes on their constituents.” Id. at 867. Proper verbal packaging (or repackaging) also holds promise as a means of retaining various tax benefits. See Dorothy A. Brown, Race and Class Matters in Tax Policy, 107 COLUM. L. REV. 790 (2007) (predicting the preservation of the Earned Income Tax Credit if related race and class information can be properly “packaged”).
Table 3

<table>
<thead>
<tr>
<th>Year</th>
<th>Annual Social Security Wage Base</th>
<th>Maximum Annual Social Security Tax Withholding (Excluding Medicare)</th>
<th>Percentage Increase Relative to Prior Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>$102,000</td>
<td>$6,324.00</td>
<td>4.61</td>
</tr>
<tr>
<td>2007</td>
<td>$97,500</td>
<td>$6,045.00</td>
<td>3.50</td>
</tr>
<tr>
<td>2006</td>
<td>$94,200</td>
<td>$5,840.40</td>
<td>4.66</td>
</tr>
<tr>
<td>2005</td>
<td>$90,000</td>
<td>$5,580.00</td>
<td>2.38</td>
</tr>
<tr>
<td>2004</td>
<td>$87,900</td>
<td>$5,449.80</td>
<td>1.03</td>
</tr>
<tr>
<td>2003</td>
<td>$87,000</td>
<td>$5,394.00</td>
<td>2.47</td>
</tr>
<tr>
<td>2002</td>
<td>$84,900</td>
<td>$5,263.80</td>
<td>5.59</td>
</tr>
<tr>
<td>2001</td>
<td>$80,400</td>
<td>$4,984.80</td>
<td>5.51</td>
</tr>
<tr>
<td>2000</td>
<td>$76,200</td>
<td>$4,724.40</td>
<td>4.95</td>
</tr>
<tr>
<td>1999</td>
<td>$72,600</td>
<td>$4,501.20</td>
<td>6.14</td>
</tr>
<tr>
<td>1998</td>
<td>$68,400</td>
<td>$4,240.80</td>
<td>4.58</td>
</tr>
<tr>
<td>1997</td>
<td>$65,400</td>
<td>$4,054.80</td>
<td>5.99</td>
</tr>
</tbody>
</table>

As the data indicate, the FICA Wage Base rises, on average, at the rate of 4.28% per year. Though the wage base ostensibly climbs as a result of increases in average national wages, the annual FICA Wage Base remains impervious to gripping recessions, stock market collapses, or any other economic shock because, by statute, it either remains the same or increases.


The FICA Wage Base has an intriguing history. The wage base started at $3,000 in 1937, and the tax was imposed at the rate of 1% for Old Age and Survivors Insurance. See ANNUAL STATISTICAL SUPPLEMENT, supra note 52, at 2.4 tbl.2.A3. Over time, disability insurance (1957 – 58) and hospital insurance (1966) were added to the scheme. See id. The OASDI wage base has gradually increased since 1937, though in prior decades, the wage base would remain the same for years. See id. For example, the wage base was $7,800 from 1968 – 1971. See id. Since then, however, the wage base, apparently impervious to recessions and wars, has steadily increased. See id. For 2007, the wage base was $97,500, and it is currently $102,000. See [http://www.ssa.gov/OACT/COLA/cbb.html](http://www.ssa.gov/OACT/COLA/cbb.html) (last visited March 22, 2008). Although the hospitalization insurance component of the payroll taxes used to rise to a cap (generally applying to the same amount subject to the OASDI wage base), the HI tax is now imposed on 100% of taxable wage-based earnings. See ANNUAL STATISTICAL SUPPLEMENT, supra note 52, at 2.4 tbl.2.A3 & n.e.

Under the FICA Wage Base calculation formula, the base will either stay the same or increase. It will not go down. See [http://www.ssa.gov/OACT/COLA/cbbdet.html](http://www.ssa.gov/OACT/COLA/cbbdet.html) (last visited March 22, 2008) (indicating that if new contribution and benefit base calculations produce a number lower than the current base, the base is not to be reduced).
regardless of then-prevailing wage levels. Thus, FICA has the distinction of being a tax that, by current law, cannot decrease. And even though many have enjoyed reductions in progressive income tax rates in recent years, the FICA tax rates have remained unchanged even though the “excess” could have been trimmed without a reduction in outgoing Social Security payments. If large scale tax reductions were put in the queue, why were FICA taxes overlooked? Would that overlooking was the worst of it. At the same time that progressive tax rates were falling, FICA Wage Base adjustments marched onward and upward, essentially turning up the heat (already beyond beneficiary need) on “tens of millions of men and women in offices, factories and fields across America who go to work every day trying to do right by their families.” Of course, working Americans enjoyed progressive rate reductions, but if vertical equity is a primary goal of our tax system, it makes more sense to ease the pressure on those bearing the brunt of regressive taxes by targeting employment tax relief or reductions before turning down the heat on the progressive side and most assuredly before handing out tax candy to those raking in capital gains.

Ideally, Social Security would entail an overt and true earmarking of specific taxes for the care of the elderly and the disabled. Yet, the program’s funding mechanism has gradually morphed into a system of annual tax increases which, incrementally, serve to fund general government expenditures. Further, the hollow notion of a “Social Security Trust Fund” has somehow softened the bite of excessive withholding, and the facially-constant rate of the tax has, for almost two decades, helped the substantive tax increase evade heightened public scrutiny in


\footnote{Building One Economy with Tax Reform to Reward Work, at \url{http://johnedwards.com/issues/tax-reform/} (last visited March 22, 2008).}
the political arena. Thus, FICA’s regressivity promises to remain an entrenched burden on low wage earners and to encroach further and further on the middle class.

Wholly aside from the diversion of Trust Fund monies to wrestle prevailing federal budget realities, there remains a larger conceptual problem which has systemic ramifications, definitional overreach with respect to “wages.” As was noted earlier, “wages” earned with respect to “employment” constitute the payroll tax base, and various disputes, both inter-Branch and inter-Circuit, have arisen over time with respect to the proper scope of the term. Are “wages” in the Social Security benefit eligibility context the same as “wages” in the tax world? After all, each arena is a soaring statutory edifice (though one can scarcely ignore the link between the two towers). And even within the confines of the tax structure, are the “wages” subject to withholding for payroll tax purposes the same as the “wages” subject to withholding for general income tax purposes? Are signing bonuses “wages” (for any purpose) when paid well before an employee gets on the clock? And if so, what about payments made at the end stage of an employment relationship such as severance paid to professors for relinquishing tenure and voluntarily retiring early? Should we consider such payments “wages” subject to payroll taxes or mere “liquidated damages” for the relinquishment of a separate and distinct right. At least two United States Courts of Appeals have weighed in with different answers.95

92 See McMahon, supra note 75, at 1027 (noting that “increased payroll taxes fund expenditures that generally are thought by most taxpayers to be funded primarily by the income tax”).
93 By enacting the Social Security Amendments of 1983, Pub. L. No. 98-21, 97 Stat. 65 (1983), Congress consciously nullified the U.S. Supreme Court’s decision in Rowan Cos. v. United States, 452 U.S. 247 (1981). In that decision, the Court held that “wages” meant the same thing in the income tax withholding context and the FICA/FUTA context. See id.
94 Compare Univ. of Pittsburgh v. United States, No. 06-1276, 2007 WL 3226505, at *8 (3d Cir. Nov. 2, 2007) (holding that instructors receiving payments in exchange for relinquishing their tenure rights and retiring early had, in fact, received “wages” subject to payroll taxes), and Appoloni v. United States, 450 F.3d 185 (6th Cir. 2006) (same), with N.D. State Univ. v. United States, 255 F.3d 599 (8th Cir. 2001) (holding that lump sum payments to retiring faculty members as consideration for relinquishing tenure did not constitute “wages” for FICA purposes).
95 See cases cited supra note 94.
Those in the academy contemplating lucrative early retirement packages may consider the Circuit split financially alarming, but rather than merely exploring that fact-specific, inter-Circuit conflict, my goal in the next Part is to place the conflict in context by painting the larger analytical picture and thereby opening and broadening the discussion platform. Although I will focus some commentary on the apparent pliability of the critically important “wage” and “employment” concepts, I will also discuss the aggressive and arguably erroneous application of binding precedent. Key statutory and regulatory authorities serve as logical and necessary starting points. After presenting those, I turn to what courts generally regard as seminal U.S. Supreme Court precedent concerning the meaning of “wages,” Social Security Board v. Nierotko. From there, I discuss various post-Nierotko judicial developments, demonstrating not only clear attempts to draw lines of demarcation, but also a degree of arguably defiant application of the Nierotko standard to reach well beyond what the Supreme Court appears to confirm as the rational limit of the decision’s reach in United States v. Cleveland Indians Baseball Co. To highlight the contours of the prevailing conceptual schism, I discuss both the aforementioned inter-Circuit conflict and critique the perplexing evolution of the Service’s mindset.

**PART II – JUDICIAL DEFINITIONAL OVERREACH**

**Statutory and Regulatory Framework**

Both OASDI and Medicare are funded primarily by the collection of payroll taxes. Although employers and employees each bear responsibility for specific payroll taxes, § 3101 imposes those taxes on employees. Specifically, § 3101 imposes the 6.2% OASDI tax on

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96 327 U.S. 358 (1946).
“wages” received by an individual with respect to his “employment.” 98 Similarly, for the funding of Medicare, § 3101(b)(6) imposes a 1.45% tax on the same “wages” received with respect to an individual’s “employment.” 99 Section 3121(a) of the Code generally defines “wages” as “all remuneration for employment, including the cash value of all remuneration . . . paid in any medium other than cash . . . ,” though there is a necessary statutory carveout for wages received beyond the FICA Wage Base. 100 The Code generally defines “employment” as “any service, of whatever nature, performed . . . by an employee for the person employing him . . . .” 101

Treasury Regulations interpreting § 3121 restate the basic statutory definition of “wages” as “all remuneration for employment unless specifically excepted . . . .” 102 The regulations go on to indicate that the name given to the remuneration (e.g., salaries, bonuses, commissions) is immaterial 103 as is the basis 104 upon which the remuneration is paid (e.g., hourly, monthly, piecework, annually, etc.) and the medium 105 in which it is paid (e.g., cash, goods, clothing, lodging, etc.). Notwithstanding an employee’s absence from work, vacation pay constitutes “wages” as do certain payments made after the termination of the employer/employee

99 In the midst of subtleties, distinctions, and exceptions of limited significance here, § 3121(b) generally defines employment as “any service, of whatever nature, performed . . . by an employee for the person employing him . . . .” Id. § 3121(b).
100 Thus, the individual who earned $10,000,000 in 2007 paid $145,000 in Medicare taxes. He was responsible for only $6,045 in OASDI tax because, by definition under § 3121(a)(1), $9,902,500 of his earnings did not constitute “wages” for purposes of § 3101(a). This limiting definition of “wages” is solely for purposes of Chapter 21 of the Code, and because the Medicare tax must be imposed on ALL earnings, the definitional exclusion for amounts in excess of the FICA Wage Base applies only with respect to the OASDI component. See id. § 3121(a)(1).
101 § 3121(b)(flush language).
102 Treas. Reg. § 31.3121(a)-1(b).
103 See id. § 31.3121(a)-1(c).
104 See id. § 31.3121(a)-1(d).
105 See id. § 31.3121(a)-1(e).
106 See id. § 31.3121(a)-1(g).
relationship.\textsuperscript{107} Thus, the regulations emphasize that “[r]emuneration for employment, unless such remuneration is specifically excepted . . . , constitutes wages 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.”\textsuperscript{108} As for proper timing, the Treasury Regulations clarify that wages are generally considered “received” by an employee whenever the amounts are paid,\textsuperscript{109} and such payment may be actual or constructive.\textsuperscript{110} Payment timing will, of course, have tangible repercussions. From a tax perspective, the timing of a given wage payment may result in the imposition of a different rate of tax (to the extent OASDI rates do note remain static), and given the gradual rise of the FICA Wage Base, timing may well alter the amount of the wages subject to tax (or, if the taxpayer is lucky, result in the allocation of wages to years in which the taxpayer has already paid the maximum FICA tax liability). From a Social Security perspective, the timing of wage payments may prove equally critical, given that an individual’s basic eligibility for various benefits under the broader program scheme turns, at least in part, on working in a qualifying position for a requisite minimum time period.\textsuperscript{111} Indeed, the U.S. Supreme Court’s landmark decision in \textit{Social Security Board v. Nierotko} directly addressed an issue concerning the proper timing of back pay in the benefits eligibility context. In reacting to its concerns with respect to the litigant’s benefit eligibility, the Court unwittingly gave lower courts fodder for what some might consider unduly expansionist conceptualizations of “employment” and “wages” wholly outside the benefits eligibility context.

\textsuperscript{107} See id. § 31.3121(a)-1(i).
\textsuperscript{108} Id.
\textsuperscript{109} See id. § 31.3121(a)-2(a).
\textsuperscript{110} See id.
\textsuperscript{111} See sources cited \textit{supra} note 61.
Nierotko and the Apparent Broad Construction Mandate

As the facts would have it, Joseph Nierotko’s original gripe was not with the Social Security Board. Rather, it was with Ford Motor Company which wrongfully discharged him for engaging in union activity. For this transgression, the National Labor Relations Board not only ordered Ford to reinstate Nierotko, but also awarded him back pay. Although Nierotko wanted this back pay to constitute “wages” for his Old Age and Survivor’s Insurance account, the Social Security Board formally refused to credit the back pay as “wages” and thereby prompted the litigation. The U.S. Supreme Court held that the back pay constituted “wages” and that the relevant amounts were to be allocated to the periods in which they would have been earned and paid over to Nierotko. Sensitive to the link between earning “wages” over time and qualifying for Social Security program benefits, the Court emphasized that individuals receiving back pay for periods during which they were wrongfully separated from employment were entitled to have the award treated as wages for purposes of the Social Security Act. Over the objection of the Social Security Board that no services were, in fact, performed during the wrongful discharge period, the Court stated the following:

The [Social Security Board] urges that Nierotko did not perform any service. It points out that Congress in considering the Social Security Act thought of benefits as related to “wages earned” for “work done.” We are unable, however, to follow the Social Security Board in such a limited circumscription of the word “service.” The very words “any service performed for his employer,” with the purpose of the Social Security Act in mind import breadth of coverage. They admonish us against holding that “service” can be only productive activity. We think that “service” as used by Congress in this definitive phrase means not only

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113 See id.
114 See id.
115 See id. at 360.
116 See id. at 364.
117 See id. at 370.
118 See id. at 364.
119 See id. at 365.
work actually done but the entire employer-employee relationship for which compensation is paid to the employee by the employer.\textsuperscript{120}

Several courts at varying levels of the judiciary have repeatedly turned to this language from \textit{Nierotko} for support.\textsuperscript{121} All too commonly, however, courts either choose to ignore the directive that the broad construction be embraced “with the purpose of the Social Security Act in mind”\textsuperscript{122} or proceed to draw in any legislation with a possible link to the Social Security Act. Other courts wisely refrain from taking this language and running with it. Yet and still, those differences in judicial approach have given us a very clear split in the U.S. Courts of Appeals and, fortuitously, a concrete factual lens through which we can more effectively perceive and address the core issues.

The following discussion starts in a fact specific context, highlighting the conceptual contrast between the United States Court of Appeals for the Eighth Circuit and other Circuits on the issue of the proper tax treatment of payments to professors opting for early retirement and relinquishing tenure; as the Circuit split portends, the Supreme Court may ultimately have to gear up\textsuperscript{123} and weigh in as to whether such payments constitute “wages” with respect to “employment.”\textsuperscript{124} From that context, the discussion platform broadens, first by focusing on the Service’s perplexing abandonment of its prior litigating position in favor of its current posture

\textsuperscript{120} \textit{Id.} at 365 – 66 (citations omitted) (emphasis added). The Court also pointed out that both Social Security Board Regulations and Treasury Regulations treated vacation allowances, among other things, as “wages.” \textit{See id.} at 365 - 66 & n.17.

\textsuperscript{121} \textit{See, e.g.}, Assoc. Elec. Coop. v. United States, 226 F.3d 1322, 1327 (Fed. Cir. 2000) (rejecting the argument that a broad reading of \textit{Nierotko} reads the service performance requirement out of § 3121(b) by noting that “[p]ayments for hard work and faithful service arise directly from the employer-employee relationship and are payments which recognize the value or character of the services performed for the employer”); Cohen v. United States, 63 F. Supp. 2d 1131, 1135 (C.D. Cal. 1999) (relying on the broad sweep “dictated” by \textit{Nierotko} and thereby concluding that “[b]ecause the payments are based on the plaintiff’s lengthy service to his employer, the payments can be considered compensation arising out of the employment relationship”).

\textsuperscript{122} \textit{See Nierotko}, 327 U.S. at 365.

\textsuperscript{123} The U.S. Supreme Court denied certiorari in \textit{Appoloni v. United States}. \textit{See} 127 S. Ct. 1123 (2007).

\textsuperscript{124} \textit{See id.}
and then by surveying the Supreme Court’s repeated attempts first to clarify and, later, to curb the aggressive growth of the “wages” concept.125

The Perils of Relinquishing Tenure

Professors and their beloved universities part ways for any number of reasons. Under prior law, dismissal payments—involuntary severance granted at the discretion of the employer—were not included in “wages,” but with the passage of the Social Security Act of 1950, the exclusion no longer applied, and severance payments arising from involuntary dismissal became subject to FICA taxation.126 But what about the money changing hands when the cutting of the cord is quite amicable (i.e., severance paid in the wake of a voluntary separation from employment)? The court in North Dakota State University v. United States127 (NDSU) answers the question with what some would consider a fine example of a rationally-circumscribed conception of “wages.”

The employment tax issue in NDSU arose in connection with the university’s early retirement program.128 Under it, certain tenured faculty members and high-level administrators could retire early and receive a negotiated amount from the university in exchange for their relinquishment of tenure/employment.129 Originally, the university withheld employment taxes from the payments,130 but in response to faculty inquiries regarding the applicability of such taxes to retirement program payments, the university sought guidance from the Social Security
Administration (SSA).\textsuperscript{131} The SSA responded that “as described by NDSU, the program was ‘in effect, a payment to secure the release of an unexpired contract of employment,’ and as such, under the Social Security Procedure Operations Manuals, was not considered wages for purposes of determining benefit amounts or for deduction of benefits purposes.”\textsuperscript{132} Accordingly, the university stopped withholding and paying over employment taxes with respect to the retirement payments.\textsuperscript{133} The IRS later audited the university and assessed deficiencies; having paid the assessed taxes and having been denied its request for a refund, the university filed suit.\textsuperscript{134}

Both the district court\textsuperscript{135} and the United States Court of Appeals for the Eighth Circuit\textsuperscript{136} held that lump sum payments made to tenured faculty members voluntarily retiring early were not “wages” with respect to prior service to the university but due consideration tendered for the relinquishment of the full panoply of rights, privileges, and protections afforded by “tenured” status. Thus, in their view, tenure itself constitutes a distinct property right that cannot be taken away without substantive justification and procedural due process.\textsuperscript{137} Rejecting the argument that tenure rights cannot be relinquished because they have no economic value that can be bought and sold,\textsuperscript{138} the Eighth Circuit reasoned that “[l]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

\begin{footnotesize}
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\item\textsuperscript{131} See id.
\item\textsuperscript{132} Id. at 602.
\item\textsuperscript{133} See id.
\item\textsuperscript{134} See id.
\item\textsuperscript{135} See id.
\item\textsuperscript{136} See id. at 607.
\item\textsuperscript{137} Note that administrators were held subject to FICA taxes. See id. at 608. Although it was argued that some administrators had tenure and should have been exempt from FICA taxation to the extent they participated in the early retirement program, see id. at 607, the court dismissed the undocumented factual allegations as “bald assertions.” Id. At least one commentator feels that tenured faculty members deserve no free ride here. See Heather L. Turner, Note, \textit{Disparate Treatment of University Administrators’ and Tenured Faculty Members’ Early Retirement Payments for FICA Taxation:} North Dakota State University v. United States, 54 TAX LAW. 233, 237 (2000) (arguing that payments made to both university administrators and tenured faculty members should have been subject to FICA taxation because payment amounts were based on employment factors such as length of service and previous salary).
\item\textsuperscript{138} See NDSU, 255 F.3d at 605.
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been granted.” The court also responded to the argument that tenure rights accrue over time (and thus that the grant of tenure is a form of compensation for prior services) by asserting that “tenure is much more than a recognition for past services.” The court went on to point out that universities do not grant tenure automatically; in addition to teaching during a probationary period, instructors must produce scholarship, conduct research, and serve the university and the larger community.

In varying degrees of contrast, we have both the decision of the United States Court of Appeals for the Sixth Circuit in Appoloni v. United States and that of the United States Court of Appeals for the Third Circuit in University of Pittsburgh v. United States. Appoloni involved payments made for the relinquishment of tenure rights but did not involve university professors. Instead, the early retirement program participants were public school teachers who generally earned tenure automatically after completing a probationary period. In concluding that the payments made in exchange for relinquishing tenure were subject to employment taxes, the Sixth Circuit emphasized that “a court must not look simply at what is being relinquished at the point a severance payment is offered, but rather, how the right relinquished was earned. Thus, we cannot understate the importance of the fact that a teacher earns tenure by successfully completing a probationary period.” The court further emphasized that in its view, the tenure involved was earned by service to the employer and that it could not justify distinguishing payments for the relinquishment of tenure from payments for the relinquishing of seniority rights, litigation rights, and the like which courts had previously subjected to employment taxes.

139 Id.
140 Id.
141 See id.
142 See id. at 605 – 06.
143 See Appoloni, 450 F.3d 185, at 187.
144 See id.
145 Id. at 192.
taxes.\textsuperscript{146} To distinguish \textit{NDSU}, the court pointed out that even though length of service was a factor in that case, the tenure rights arose from a single contract entered into at the commencement of the tenure relationship.\textsuperscript{147}

The \textit{University of Pittsburgh} decision shares a healthy degree of factual parity with the \textit{North Dakota State University} decision, but the Third Circuit goes toe to toe with the Eighth Circuit and affirmatively rejects that court’s view of tenure. Concluding that the early retirement program payments were, in fact, subject to FICA taxes, the Third Circuit reasoned that the program’s years-of-service-based eligibility requirements linked the payments to prior service and not the relinquishment of tenure. Further, the court noted that retirement program descriptions clarified the reward-for-service nature of the payments and that even if the payments partially compensated recipients for the relinquishment of tenure rights, the primary payment purpose was to provide for early retirement, making the money “indistinguishable from severance payments, which are generally taxed as wages.”\textsuperscript{148} Although the court in \textit{NDSU} found the selective and discretionary awarding of university tenure significant, the Third Circuit discounted that reality, reasoning that such factors “do not change the fact that [tenure] is awarded based on service to the University.” Steadfast in adhering to what it perceived as \textit{Nierotko}’s mandate to construe “services” and “employment” (and thus “wages”) broadly, the court concluded that early retirement payments made to tenured university faculty members constituted “wages” subject to FICA taxation.

In dissent, Chief Judge Scirica largely emphasized the fact that the grant of tenure requires the consideration of a host of factors and reflects a university’s conclusion with respect to the faculty member’s capacities in many respects, not the mere completion of a probationary

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\item See id. at 195.
\item See id. at 195 n.5.
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period. It was further noted that the commencement of tenure marks a new and distinct relationship between the professor and the university. Accordingly, Judge Scirica agreed with the approach taken in *NDSU* and would have ruled in favor of the university.

Not surprisingly, the IRS has not sat comfortably on the sidelines while the United States has taken the battlefield. Instead, it has sharpened its blade at every opportunity and rattled its sabers with every victory of note. In the wake of *NDSU*, the Service had no choice but to signal its intent to fight by issuing a prompt non-acquiescence. Given the weight of *NDSU* as binding precedent in the Eighth Circuit, however, the Service issued an Action on Decision (AOD) to clarify its intent to defer to the *NDSU* holding in cases appealable to the Eighth Circuit but to litigate cases otherwise. Years later, of course, the Service made a more widespread and candid announcement of its nationwide litigation intent in Revenue Ruling 2004-110. Technically, the 2004 Revenue Ruling conflicted with the Service’s prior AOD with respect to certain cases appealable to the Eighth Circuit. To the extent the Service intended to litigate cases appealable to the Eighth Circuit after the issuance of Rev. Rul. 2004-110, it should have overtly clarified its position by new AOD concurrent with the issuance of that Revenue Ruling in 2004. The Service did not grow those new teeth, however, until after the government scored a Circuit-level victory in *Appoloni* in 2006. With a victory in *Appoloni*, the Service issued AOD 2007-01, thereby clarifying that, consistent with its policy outside the Eighth Circuit and Rev. Rul. 2004-110, it would challenge cases appealable to the Eighth Circuit even if they shared factual

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148 *University of Pittsburgh*, 507 F.3d at 172.
150 See Action on Dec. 2001-08 (Dec. 31, 2001), 2002 WL 16072 (“Although we disagree with the decision of the court, we recognize the precedential effect of the decision to cases appealable to the Eighth Circuit, and therefore will follow it within that circuit only with respect to cases that have the exact facts as this case; that is, cases involving payments to college or university professors made in exchange for the relinquishment of their tenure rights. We will continue to litigate our position in cases having different facts in the Eighth Circuit, and in all cases in other circuits.”).
parity with *NDSU* to the extent payments were made on or after January 12, 2005.\(^{153}\) These developments present no real surprise. What is analytically jarring, however, is the fact that the IRS of yesteryear viewed early contract termination payments as falling outside the “wages” concept (even in pronouncements put forth (in 1955) in the towering shadow of *Nierotko* (decided in 1946)).

*Shifting IRS Perspectives*

Oddly enough, IRS pronouncements issued shortly after *Nierotko* was handed down make no mention of it, even though the decision could have been forcibly stretched beyond the benefits context to yield a result more favorable to the Service. Fortuitously, then, we are able to see the Service’s conception of “wages” shift in broad daylight from rationally narrow to aggressively broad over the course of a few decades.

In Revenue Ruling 55-520,\(^{154}\) an individual originally accepted employment under a two-year contract. During the second year, the employer requested and received the employee’s resignation. The employee’s resignation was conditioned, however, on the payment of amounts due for the remaining contract period. After litigation ensued, the company offered and eventually paid a lump sum in lieu of monthly payments, and the employee signed a general release which ultimately brought the litigation to an end. Regarding the tax issues presented, the Service concluded that the money paid as compensation for the early termination of the employment contract did not constitute “wages” for services performed for federal employment tax and income tax withholding purposes but did constitute gross income for basic federal

\(^{152}\) 450 F.3d 185 (6th Cir. 2006).

\(^{153}\) See Action on Dec. 2007-01 (Jan. 19, 2007), 2007 WL 121345. Ostensibly, the Service issued the new Action on Decision to “reflect the change in its published rulings.” See id. Given that Rev. Rul. 2004-110 was issued three years earlier, however, it seems more likely that the Sixth Circuit’s decision in *Appoloni* (decided June 7, 2006) prompted the new pronouncement.

\(^{154}\) 1955-2 C.B. 393.
income tax purposes.\textsuperscript{155} The Service reached the same conclusion just a few years later in Revenue Ruling 58-301,\textsuperscript{156} but, intervening and scantily-reasoned developments aside,\textsuperscript{157} we see a complete about face in the aforementioned Revenue Ruling 2004-110.

In Rev. Rul. 2004-110,\textsuperscript{158} the Service concluded that payments made to an employee as consideration for early contract cancellation (when the contract was silent on the issue of early termination payments) were “wages” subject to FICA taxation.\textsuperscript{159} Adopting a decidedly Nierotko tone, the Service reasoned that

\begin{quote}
[e]mployment encompasses the establishment, maintenance, furtherance, alteration, or cancellation of the employer-employee relationship or any of the
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\item This result simply means that although the individual owed taxes with respect to the amounts received, the employer was not legally obligated to withhold those taxes as they would have been so obligated with respect to amounts constituting “wages.” Employers erroneously failing to withhold payroll or basic income taxes become liable for those taxes. \textit{See} 26 U.S.C. § 3403 (2007).
\item 1958-1 C.B. 23 (noting, as well, that the employee’s contract right was not a capital asset and that any amounts received with respect to the relinquishment of that right constituted ordinary income and not capital gain). The U.S. Supreme Court also spoke to the income character issue. In \textit{Commissioner v. P.G. Lake, Inc.}, 356 U.S. 260 (1958), Justice Douglas noted that “[t]he lump sum consideration seems essentially a substitute for what would otherwise be received at a future time as ordinary income.” \textit{P.G. Lake}, 256 U.S. at 265. Accordingly, the Court held that a lump sum payment with respect to future income is ordinary income and not capital gain. \textit{See also} \textit{Comm’r v. Gillette Motor Transp., Inc.}, 364 U.S. 130 (1960) (holding, in a case involving payment for the involuntary use of the taxpayer’s property in the war effort, that not every property right is a capital asset); \textit{Rothstein v. Comm’r}, 90 T.C. 488, 497 (1988) (holding that amounts received pursuant to an employment contract after the disposition of substantially all of the assets of a business constituted ordinary income (deferred compensation for services) and not capital gain because the employees did not hold an equity interest in the company).
\item In Revenue Ruling 74-252, 1974-1 C.B. 287, the parties entered into a 3-year contract which provided that the employer could terminate the contract early if the employee was paid an amount equal to six months of salary above and beyond any previously-earned salary. \textit{See id.} Having restated general definitions of “wages,” the Service appealed to Treasury Regulations promulgated under §§ 3121 and 3306 of the Code emphasizing that the term “wages” includes remuneration for employment made when the individual is no longer an employee. \textit{See id.} But that wasn’t enough. The Service proceeded to reference Treasury Regulations from the income tax withholding arena which directly addressed the question of dismissal payments. Acknowledging that similar regulations did not exist in the employment tax context, the Service nonetheless concluded that FICA and FUTA taxes applied to the dismissal payments. \textit{See id.} The Service makes a feeble effort to distinguish Rev. Rul. 58-301. Given that (in the current ruling) the payments “were made pursuant to the provisions of the contract rather than as consideration for the relinquishment of interests the employee had in his employment contract in the nature of property,” the Service concluded that the payments constituted wages. \textit{See id.} Thus, “wage” characterization somehow turned on the existence or non-existence of an early termination contract clause rather than on a focused analysis of whether remuneration was, in fact, paid for services rendered. For additional developments, see Rev. Rul. 75-44, 1975-1 C.B. 15, in which the Service concluded that a lump sum paid to a railroad employee constituted wages for federal income tax withholding purposes because the amount compensated the employee for relinquishing seniority rights acquired through prior service rather than compensating him for waiving any employment contract rights acquired via original negotiation.
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terms and conditions thereof. If the employee provides clear, separate, and adequate consideration for the employer’s payment that is not dependent upon the employer-employee relationship and its component terms and conditions, the payment is not wages for purposes of FICA, FUTA, or Federal income tax withholding. * * * [Under the current facts, however,] the employee receives that payment as consideration for cancelling the remaining period of his employment contract and relinquishing his contract rights. As such, the payment is part of the compensation the employer pays as remuneration for employment. 160

So, if the IRS of 2004 is to be believed, the IRS of 1955 simply got it wrong. Either that or the notion of “wages” has somehow managed to broaden gradually such that the same type of terminal payment which would ordinarily fall outside its ambit now comfortably falls within it. Far more likely is the reality that the Service has grown much more comfortable indulging its own tax-producing presumptions, 161 and it’s not alone. Oddly, the court in University of Pittsburgh devoted a great deal of discussion to its view of the fundamental nature of tenure, concluding that the payments for relinquishing it were, in fact, compensation for prior services to the university. The court makes no mention of, less the more acknowledges or considers, that which those in the academy consider reasonably obvious when it comes to recognizing admirable long-term service; universities routinely reward distinguished service to the university by awarding “emeritus” 162 status both to tenured professors and administrators; indeed, the word itself derives from emereri, Latin for “earn one’s discharge by service.” So, despite the limited,

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160 . Id. Despite the disparaging tenor of the ruling, the Service does note that, per § 7805(b), it will not apply the position set forth in the ruling to payments made by an employer to an employee or former employee before January 12, 2005, so long as the payments were made under facts and circumstances substantially similar to those in Rev. Rul. 55-520, 1955-2 C.B. 393, or Rev. Rul. 58-301, 1958-1 C.B. 23.

161 . One commentator notes the following: Earnings or wages cannot be distinguished from any other type of income except by the circumstances of receipt. The tax system frequently functions based on presumptions and circumstantial evidence that indicate the existence of one type of income or another, rather in the way astronomers detect black holes in space by noting the absence of other stars around them. For example, capital gains exist only in the context of a sale or exchange, just as compensation for services is presumed to exist (in the absence of other evidence to the contrary) whenever value passes from employer to employee. Dilley, supra note 32, at 67.

162 . The word “emeritus” is the past participle of emereri, a Latin word meaning “earn one’s discharge by service.” See http://en.wikipedia.org/wiki/Emeritus (last visited March 22, 2008).
facial appeal of the argument that the tenure relinquishment payments reward praiseworthy service, the (presumably) cashless emeritus machinery predates the cash windfall by a long shot. Additional problems and ramifications emerge from viewing tenure relinquishment payments as compensation for prior services rendered. I will address and examine some of these issues in the next session as part of the broader discussion platform.

Although it remains true that clear lines of definitional demarcation have emerged, the facial interrelation of the “wages” concept in the benefits eligibility context, the payroll tax context, and the income tax withholding context enhance the likelihood that irreconcilable differences will recur. The IRS surprises no one in gleefully siding with any court willing to fly the Nierotko flag, but tax equity demands consistency which certainly does not take the form of contrasting judicial treatments of similarly-situated taxpayers appealing to the same statute. The slipperiness of the “wages” concept – chameleon in some quarters and spotted leopard in others – makes this level of uncertainty possible, and more than one court has struggled to grab hold. The word “wages” certainly appears in many statutory contexts, and when there exists some clear link between those the relevant areas, logic suggests that the same word enjoy a consistent meaning. As the courts and Congress have made clear, however, such is not always the case. What follows is a discussion of various “evolutionary” cases in which courts struggled to distinguish the notion of “wages” from the notion of “income” and the income tax conception of “wages” from the payroll tax conception. With that necessary background in mind, the discussion narrows significantly to focus on cases seeking to ascertain the nature of “wages” specifically in the payroll tax context (and the various factors taken into consideration) before moving on to the Cleveland Indians decision in which the U.S. Supreme Court decisively pulled the reigns on the apparent Nierotko standard.
“Wages” v. “Income” and the Free Lunch Skirmish

Even if only begrudgingly, most workers would concede that a healthy chunk (if not all) of their gross income constitutes “wages” from which their employer must withhold state and federal income taxes. And a few would go on to concede that, like it or not, they’re obligated to part with FICA taxes on the very same amounts. Congress, however, in its legislative grace has carved out various undeniable accessions to wealth from employers as amounts to be excluded from gross income for general federal income tax purposes. Should those same exclusions relieve taxpayers of the corresponding payroll tax burden? In answering that question, the Supreme Court issued a rather saucy clarification of the difference between “wages” and “income.”

In *Central Illinois Public Service Co. v. United States*, the company/employer reimbursed the lunch expenses of employees working offsite who, nonetheless, were not on jobs requiring that they stay overnight. The employer failed to withhold federal income taxes with respect to these lunch payments, and accordingly, the Service took issue. Although the district court ruled in favor of the company, the United States Court of Appeals for the Seventh Circuit reversed. To resolve the freshly-created conflict between the Fourth and Seventh Circuits on the issue, the U.S. Supreme Court granted certiorari.

Under the opinion of Justice Blackmun, the Supreme Court reversed. Noted the Court, “the two concepts—income and wages—obviously are not necessarily the same. Wages usually

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165 See id. at 22.

166 See id. at 22 – 23.

167 See id. at 24.


are income, but many items qualify as income and yet clearly are not wages. Interest, rent, and dividends are ready examples.”

To this, the Government argued that the word “wages” in § 3401 (governing withholding of income tax from wages) corresponds readily with the word “wages” in § 61(a)(1) (defining gross income) and “that the two statutes ‘although not entirely congruent . . . have ‘equivalent scope’ . . .’.” The government further contended that the payments were compensatory because they were paid for services rendered, that there was a direct causal link between the payment and the services, and that the payment was part of a total remuneration package. After citing various authorities in support of a broad reading of the word “wages” in tax statutes generally, the government ultimately “urge[d] that what is important is that the payments at issue were a result of the employment relationship and were part of the total of the personal benefits that arose out of that relationship.” Justice Blackmun refuted that argument and, one could argue, chastised the government for putting it forth:

We do not agree with this rather facile conclusion advanced by the Government. The case, of course, would flow in the Government’s favor if the mere fact that the reimbursements were made in the context of the employer-employee relationship were to govern the withholding tax result. That they were so paid is obvious. But it is one thing to say that the reimbursements constitute income to the employees for income tax purposes, and it is quite another thing to say that it follows therefrom that the reimbursements in 1963 were subject to withholding. There is a gap between the premise and the conclusion[,] and it is a wide one.

Well aware of the fact that employers are liable for employee taxes that should have been withheld but were not, the court emphasized the impropriety of forcing an employer to carry the risk of his employee’s tax liability and the relatively narrow scope of income subject to

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170 See id. at 33.
171 Id. at 25 (citations omitted).
172 Id. at 28.
173 See id.
174 See id. at 28 – 29.
175 Id. at 29.
176 Id. at 29.
177 See id. at 31.
employer withholding. After noting repeated instances of courts distinguishing “wages” and “income” and refusing to equate the two, the Court commented on the fundamental importance of rationally confining the meaning of “wages” and the need to steer clear of any unwarranted expansionist constructions:

An expansive and sweeping definition of wages . . . is not consistent with the existing withholding system. As noted above, Congress chose simplicity, ease of administration, and confinement to wages as the standard in 1942. This was a standard that was intentionally narrow and precise. It has not been changed by Congress since 1942, although, of course, as is often the case, administrative and other pressures seek to soften and stretch the definition. Because the employer is in a secondary position as to liability for any tax of the employee, it is a matter of obvious concern that, absent further specific congressional action, the employer’s obligation to withhold be precise and not speculative.

So, with Central Illinois, the Supreme Court issues a stern reminder that not all “income” constitutes “wages” and that the “wages” concept is “narrow and precise” and not the be softened and stretched as an administrative palliative or as an analytical relief valve for “other pressures.” But just how wide or narrow is the “wage” concept when “wage” characterization is the core issue? As we shall see in short order, the Supreme Court deemed a single “wage” concept broad enough to encompass two critical tax arenas, income tax and payroll tax withholding. Congress, however, felt it necessary to point out the error of that way and stepped in to sever what the Court conceptually sutured for the sake of administrative simplicity and ease.

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178 Id. (“To require the employee to carry the risk of his own tax liability is not the same as to require the employer to carry the risk of the tax liability of its employee. [Income subject to] [r]equired withholding, therefore, is rightly much narrower [in scope] than [income subject] to income taxation.” (emphasis added)).

179 Id. (emphasis added).
Income Tax Conception of “Wages” v. Payroll Tax Conception of “Wages”

In Rowan Cos. v. United States, the taxpayer provided meals and lodging to its employees working on offshore oil rigs as a cost-effective alternative to transporting them to and from shore for each shift. The taxpayer excluded the value of the meals and lodging from employee “wages” for federal income tax withholding purposes as well as from “wages” for employment tax withholding purposes. Though the IRS did not object to the wage exclusion with respect to federal income taxes, the Service argued, consistent with governing Treasury Regulations, that the value of the meals and lodging should have been included in “wages” for employment tax withholding purposes. Justice Powell and several of his brethren disagreed. Citing relevant legislative history with respect to federal statutes authorizing FICA, FUTA, and income tax withholding, the Court emphasized that Congress intended to coordinate income tax and payroll tax withholding and would not have used substantially identical definitions to refer to different concepts.

Thus, in the eyes of the Court, a wage exclusion for income tax withholding purposes would generally result in an identical exclusion for payroll tax purposes. To the IRS, this result

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See Rowan Cos., 452 U.S. at 248.

See id. at 249.

See id. at 249 – 50.

Justice Sandra Day O’Connor joined the Court several months after this case was decided. See http://en.wikipedia.org/wiki/Sandra_Day_O’Connor (last visited March 22, 2008).

See Rowan Cos., 452 U.S. at 250.

See id. at 255 – 56.

Id. at 256 – 57 (“Congress intended . . . to coordinate the income-tax withholding system with FICA and FUTA. In both instances, Congress did so to promote simplicity and ease of administration. Contradictory interpretations of substantially identical definitions do not serve that interest. It would be extraordinary for a Congress pursuing this interest to intend, without ever saying so, for identical definitions to be interpreted differently.”)
was unbearably good news for the taxpayer. Arguing that FICA and FUTA “compose a distinct system of taxation to which the rules of income taxation . . . do not apply,”188 the Government complained that “Congress intended to impose the taxes under FICA and FUTA upon a broad range of remuneration in order to accomplish the [Social Security] Act’s purposes.”189 To support this position, the Government noted that in the legislative history of the Social Security Act, Congress made it clear that the term “wages” for employment tax purposes was to include cash as well as non-cash compensation, including room and board (items that might well have qualified for exclusion from wages for income tax purposes).190 Flatly rejecting the notion of a categorically broad construction of “wages” in the FICA and FUTA context, the Court reasoned that nothing in the legislative history of the Social Security Act (including the specific reference to “room and board”) “mean[t] that Congress intended to tax remuneration in kind without regard to principles developed under income taxation, such as the convenience of the employer rule.”191 The Court also pointed out that including room and board in wages for employment tax purposes was, in no way, inconsistent with the convenience-of-the-employer rule because the items would constitute wages unless they had been provided for the convenience of the employer.192

In response to the Court’s holding in *Rowan Companies*,193 Congress changed the law in the Social Security Amendments of 1983 to clarify that the existence of a wage exclusion in the income tax context need not carry over to the employment tax context unless Congress provides an explicit employment tax exclusion.194 Congress also emphasized, as a general matter, that “an

188 Id. at 257.
189 Id.
190 See id. at 257.
191 Id. at 257 – 58.
192 See id. at 258 n.12.
193 See Senate Report, supra note 180, at 42.
194 See id.
employee’s ‘wages’ for Social Security tax purposes may be different from the employee’s ‘wages’ for income tax withholding purposes.”

Thus, at least from 1983 forward, we have formal segregation of the employment tax conception of “wages” and the income tax withholding conception of “wages” per Congressional mandate. Pair this with the U.S. Supreme Court’s decision in *Central Illinois*

and one can appreciate the gradual forming of a “wage” construct solely for the payroll tax arena. But just how concrete and discernible is that construct? Knowing that not all “wages” are “income” and that “income tax wages” need not equal “payroll tax wages” does not necessarily help one ascertain whether a given amount actually constitutes “wages” for a given purpose.

*The Mess: Various Considerations in Finding “Wages”*

Despite the Supreme Court’s clear directive in *Central Illinois* to confine the concept of “wages,” some courts continue to attach the “wages” label to almost any form of payment flowing from employer (or former employer) to employee, even when the payment represents damages to compensate the employee for unlawful employer conduct. Commonly, they reach and explain these results by pairing what they consider key factors with *Nierotko*’s apparent mandate for the broadest possible conception of the employer/employee relationship. The following discussion presents and critiques specific factors previously found to be determinative or, at the least, highly persuasive by some courts. The judicial struggle to find truly firm footing is not a pretty sight.

195 *Id. See also* Hirsch, *supra* note 126, at 812 (noting that per the decoupling amendments to § 3121 in 1983, the current concept of “wages” for FICA tax purposes is not identical to the concept of “wages” for federal income tax withholding purposes).


198 *See, e.g.*, Cohen v. United States, 63 F. Supp. 2d 1131 (C.D. Cal. 1999) (holding that post-resignation severance payments paid constituted “wages” subject to FICA taxation and that such payments were taxable in the individual years of receipt).
Consideration of Eligibility Factors

In their efforts to ascertain whether a given payment constitutes “wages,” some courts reason that “eligibility requirements provide the most accurate test to determine whether a payment is truly in consideration for services rendered.”\(^\text{200}\) Thus, in *Sheet Metal Workers Local 141 Supplemental Unemployment Benefit Trust Fund v. United States*,\(^\text{201}\) the court held that certain payments made to union members constituted “wages” because eligibility for receipt of a payment turned on past or present employment by a contributing employer/contractor.\(^\text{202}\) Likewise, the court in *Cohen v. United States*\(^\text{203}\) concluded that post-resignation severance payments constituted “wages” subject to FICA taxation after pointing out that the determination of “wage” status turned on both payment eligibility requirements and the method by which the payment amount was calculated.\(^\text{204}\) Relying on *Nierotko*’s prophylactic employer-employee relationship notions, the court concluded that “[b]ecause the payments are based on the plaintiff’s lengthy service to his employer, the payments can be considered compensation arising out of the employment relationship.”\(^\text{205}\)

Facially, the eligibility approach has some appeal given that lengthy prior service requirements would certainly make it seem as though the amounts paid constitute compensation for services rendered. But eligibility factors standing alone prove little and reflect, in some instances, a degree of backward reasoning. Contested cases will routinely involve those who were, in fact, eligible to receive the payment, so the choice of test itself introduces risk because

\(^{199}\) See, e.g., Mayberry v. United States, 151 F.3d 855 (8th Cir. 1998) (concluding that that ERISA settlement awards constituted “wages” for FICA purposes); Hemelt v. United States, 122 F.3d 204 (4th Cir. 1997) (same).
\(^{200}\) *Sheet Metal Workers Local 141 Supplemental Unemployment Benefit Trust Fund v. United States*, 64 F.3d 245, 251 (6th Cir. 1995).
\(^{201}\) 64 F.3d 245 (6th Cir. 1995).
\(^{202}\) See *id.* at 250 – 51.
\(^{203}\) 63 F. Supp. 2d 1131 (C.D. Cal. 1999).
\(^{204}\) *Id.* at 1134. The court also concluded that the payments were taxable in the individual years of receipt.
\(^{205}\) *Id.* at 1135.
that choice may plot the analytical course for a given result. Courts relying heavily on eligibility as a determinant fail to appreciate what one might call an “eligibility continuum” in which eligibility parses very well at one end and very poorly at the other.

Consider, for example, the annual bonus a law firm associate might qualify for as a result of working (and billing!) 2,400 hours (as opposed to a mere 2,200 hours) in a given fiscal year. Surely in this context eligibility accurately identifies differing levels of service and effectively links additional compensation and the additional services rendered. The same result would appear appropriate if in addition to working and billing 2,400 hours the associate had to perform some ministerial act to secure final payment of the bonus. At the other end of the spectrum, we have situations in which mere eligibility is a basic threshold but the triggering of the prize requires that the potential recipient tender forth or surrender some form of consideration. Here, mere eligibility loses considerable luster as means of truly informing (less the more parsing) the character of post-eligibility consideration exchanges, because the link between the eligibility and the prize is attenuated (at best) or irrelevant (at worst). Thus, for example, a seventeen-year-old may gain admission to an R-rated movie without the accompaniment of a parent or adult guardian. That same seventeen-year-old, however, must pay the price of admission in order to see the feature presentation. Of course, the provision of mature entertainment is related in some sense to the time previously lived. In fact, one might go so far as to say that the individual has presumably gone through a maturation process and thus “earned” the right to see the movie. Yet, maturation can be a passive process, and arguably, the rating agency simply assumes that the individual can understand or process the entertainment. But it is hard, in the end, to argue against the notion that the provision of the entertainment (the “prize”) is in exchange for the youngster’s $10 (as opposed to being in exchange for his having lived seventeen years of life).
In the tenure relinquishment context, one can certainly argue that living 70 years of life establishes mere eligibility and that, for example, the rendering of seven pre-tenure (or thirty-three post-tenure) years of service to the university serves as consideration for the prize of payment (i.e., compensation for services previously rendered); the relinquishing of tenure merely serves as the necessary but ministerial act required to trigger payment. Several problems present with this approach. As an initial matter, it makes little sense to pay a substantial sum solely for pre-tenure years of service when the bulk of years served occur post-tenure. Second, characterizing the payment as compensation for post-tenure (or all) years of service might make sense but only if one can realistically argue that the relinquishing professor has willingly suffered underpayment during the employment period (i.e., he or she has salary in escrow) and that the cash-out is automatic. After all, by analogy, once the teenager pays his $10, he has the right to see the movie. The tenure relinquishment context is simply not analogous. At the same time, the tenured professor must have something to surrender if the relinquishment payment is to avoid “elaborate gold watch” status and take on a character fully analogous to the teenager’s payment of the price of admission (i.e., an event having significance independent of the mere satisfying of transaction-entering eligibility requirements).

What, then, does the tenured professor hand over at the “box office”/moment of retirement truth? He hands over his legally-protected freedom from the vagaries of at-will employment. Tenured employees are fundamentally different from most workers in that relative to them, the entire at-will edifice has been destroyed and accordingly, the employee holds a valuable “employment power” which he can relinquish as a separate and distinct property right in exchange for negotiated consideration. Like others, tenured professors can receive taxable

bonuses during their careers and gold watches at retirement, but as was noted earlier, the “gold watch” ordinarily takes the form of “emeritus” status.

Thus, in this context, eligibility ultimately fails as a reliable parsing concept because mere eligibility cannot rationally and consistently inform an analysis of related or subsequent transactions. To the extent that eligibility can serve as a proxy for anything in this context, it is an extremely poor proxy, and courts relying heavily on eligibility as a factor may well be veering hard for a given result. Certainly, there are some circumstances (e.g., bonuses) in which there is a clear link between service performance and benefit eligibility, and in the employment context at least, one might well find eligibility rationally linked with service performance more often than not. But the existence of the cart does not lead invariably to the existence of the horse, though the two commonly end up attached and in the same place.

**Consideration of the Allocation of Damages**

In addition to looking at eligibility requirements, courts also consider damage allocation in determining whether to treat a given amount as “wages” with respect to “employment.” At first glance, one might casually conclude that damage awards allocated to back pay surely constitute “wages.” After all, had the employee been paid the compensation in the ordinary course of business, the employer would have withheld both basic federal income taxes and employment taxes. Likewise, to the extent that the parties or courts allocate damages to other categories (e.g., personal injury caused by an employer), “wage” characterization seems patently inappropriate.\(^{207}\) But rational and favorable allocation is no cake walk.\(^{208}\) Courts routinely put

\(^{207}\) See Dotson v. United States, 87 F.3d 682, 690 (5th Cir. 1996) (holding that ERISA-related settlement award amounts allocated to personal injury would not constitute “wages”).

\(^{208}\) See Assoc. Elec. Coop., Inc. v. United States, 226 F.3d 1322 (Fed. Cir. 2000) (holding that workers relinquished their right to strike for payments and other benefits granted by the agreements); see also Abrahamsen v. United States, 228 F.3d 1360 (Fed. Cir. 2000) (holding that severance-type payments made to former employees constituted wages for FICA purposes). In *Abrahamsen*, the court emphasized that the employees “failed to
payees to the test, and plaintiffs may face harsh results if they cannot make the case for favorable damage allocation.\textsuperscript{209}

Arguably, allocation analysis turns out to be a pretty blunt instrument not well suited for the making of fine distinctions. Allocation of a given damage amount to X simply means that an arbitrary decision has been made such that $Y$ damages are deemed to compensate for X wrong. It remains true that well-reasoned allocations may make some sense, but the damage allocation science is woefully inexact, and final allocations likely reflect little more than the relative strength of the reasoning of the parties. Even at its best, however, reasoned allocation does not alter the character of what is truly at hand, damages awarded not as compensation for services but as compensation for a wrong suffered. It would be truly egregious to impose additional (payroll) taxes on an individual recovering amounts due to offensive harms suffered at the hands of her employer. Yet, an unfavorable allocation of damages (to include some compensatory component) has that result. Thus, a non-employee litigant suffering a given harm at the hands of a given company may, in fact, face a lower overall tax liability than a similarly-situated employee litigant suffering the same exact harm or some harm that is equally illegal. Such is the inevitable result when courts hurriedly sweep almost any money changing hands from master-employers to servant-employees into the shadow of “wages,” notwithstanding the existence of facts making it abundantly if not patently clear that the money was not tendered in exchange for services rendered. For example, in 1983, George Hemelt and others filed a class action against

\begin{itemize}
\item \textsuperscript{209} See Donnel v. United States, 50 Fed. Cl. 375, 386 - 87 (2001) (concluding, in the absence evidence allowing bifurcation, that a severance-type payment constituted “wages” for FICA purposes because the facts and circumstances indicated that the amount was paid primarily as a reward for prior service and not as consideration for a release of rights). One commentator agrees with this approach, at least under some circumstances, because in his view, releases are standard components of separation agreements and, unless such releases relate to a specific claim, courts should treat the entire severance payment as “wages” for FICA tax purposes. See Hirsch, supra note 126, at 820.
\end{itemize}
their former employer, Continental Can Company, under ERISA claiming that the company discharged them so as to prevent them from receiving their pensions.\textsuperscript{210} Although the parties ultimately settled their dispute,\textsuperscript{211} Hemelt and various other class members sought to recover income and employment taxes withheld from their settlement payments.\textsuperscript{212} Despite the existence of gross employer misconduct and the settlement of highly-specific claims for a sum certain, the court in \textit{Hemelt v. United States}\textsuperscript{213} was apparently blinded by the glare of the employer/employee relationship. In its view, “payments based on section 502(a)(3) [ERISA] claims, like claims under Title VII and the ADEA, are analogous to, and were designed to approximate, recovery for lost wages and other economic harms.”\textsuperscript{214} Thus, reasoned the court, “because the payments from Continental to taxpayers and other class members arose out of their employment relationship, they fit within the statutory and regulatory definition of wages . . . .”\textsuperscript{215} Fortunately, cooler heads will occasionally prevail. In \textit{Wilson v. AM General Corp.},\textsuperscript{216} the court held (in an age discrimination suit) that since the plaintiff performed no services for the employer with respect to lost back wages, lost future pension benefits, or lost front pay, the amounts awarded were not remuneration for employment and thus not “wages” subject to withholding.\textsuperscript{217} Thus, unlike others, the \textit{Wilson} court applied firm analytical grasp in keeping \textit{Nierotko}-based notions on a tight leash. Though acknowledging that \textit{Nierotko} interpreted “services performed” broadly (so as to encompass the entire employer-employee relationship for

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\item \textsuperscript{210} See \textit{Hemelt v. United States}, 122 F.3d 204 (4th Cir. 1997).
\item \textsuperscript{211} See \textit{id.} at 206.
\item \textsuperscript{212} See \textit{id.}
\item \textsuperscript{213} 122 F.3d 204 (4th Cir. 1997).
\item \textsuperscript{214} \textit{Id.} at 209.
\item \textsuperscript{215} \textit{Id.} at 210; see also \textit{Mayberry v. United States}, 151 F.3d 855 (8th Cir. 1998) (concluding that ERISA settlement awards constituted “wages” for FICA purposes); \textit{Cohen v. United States}, 63 F. Supp. 2d 1131 (C.D. Cal. 1999) (holding that post-resignation severance payments paid constituted “wages” subject to FICA taxation and that such payments were taxable in the individual years of receipt).
\item \textsuperscript{216} 82 Fair Empl. Prac. Cas. (BNA) 1146 (1999).
\item \textsuperscript{217} See \textit{id.}
\end{itemize}
which compensation is paid to the employee), Judge Miller noted that in *Nierotko*, the wrongfully-discharged individual remained, per Labor Act definitions, an “employee” during the period of inactivity, regardless of the fact that the employee was not rendering services to the employer. That fact pointed up a key distinction, the fact that Mr. Wilson was effectively terminated, not reinstated, and not deemed a continuing employee.

**Is There Still a “Service” Requirement?**

Given that § 3121(b) generally defines “employment” as “any service, of whatever nature, performed . . . by an employee for the person employing him . . .,” some have argued that a broad reading of *Nierotko* (e.g., to cover remuneration for back pay, future pay, severance, and other items) effectively reads the “service” requirement out of the statute. Courts frequently reject this notion, some by seeing the payment as having its natural origin in the employment relationship and others by hypothecating. The court in *Gerbec v. United States* reasoned that

> [h]ad Plaintiffs in this case actually worked . . . during the periods for which they sought back wages and future wages lost as a result of the firing, the wages indisputably would have been subject to FICA taxation. We conclude that it would be improper to exempt Plaintiffs from mandatory FICA taxes merely because they were not employees . . . at the time the payments were made and because the payments were not in return for actual services performed.

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218 See id.
219 See id.
220 Id. (“Like Nierotko, Mr. Wilson did no work for the monies at issue, but unlike in *Nierotko*, Mr. Wilson’s judgment is not compensation within even a broadly-defined employer-employee relationship. Mr. Wilson was not reinstated and did not remain AM General’s employee by operation of the ADEA or any other statute or provision. * * AM General . . . succeeded in terminating its employment relationship with Mr. Wilson.”)
223 See id.
224 See id. (holding that severance and early-out payments constituted “wages” for employment tax purposes after noting that “[p]ayments for hard work and faithful service arise directly from the employer-employee relationship and are payments which recognize the value or character of the services performed for the employer”).
225 164 F.3d 1015 (6th Cir. 1999).
Putting criticism of hypothecation aside, the court’s logic works, at best, with respect to damage awards allocated specifically to back pay. By the forcing hand of litigation or settlement, the employer must tender forth what it should have tendered forth originally. Regarding future pay and damages for various forms of employer misconduct, the reasoning collapses; no worker gets on the clock to suffer discrimination or harassment, and future “pay,” viewed broadly, need not take the form of remuneration subject to income or payroll taxes. And even regarding damages allocated to back pay, it is Justice Scalia himself who challenges oft-prevailing notions to reveal the naked truth in Cleveland Indians; damages allocable to back pay are exactly that. They are “damages,” not “‘wages’ within the normal meaning of that term.”

(Trying to) Clean Up the Mess

The U.S. Supreme Court’s landmark decision in Cleveland Indians, drew a much-needed and critically important line of demarcation. The Court previously clarified the difference between “wages” and “income” in Central Illinois Public Service Co., and Congress stepped in to segregate the income tax conception of “wages” from the employment tax conception of “wages” with the Social Security Amendments of 1983. Yet, it is with Cleveland Indians, discussed in detail below, that the Court severs the concept of “wages” in the Social Security

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226 In addition to designated fringe benefits qualifying for exclusion from gross income, see 26 U.S.C. § 132 (2007), non-taxable compensation may come in the form of job-related perks.

227 532 U.S. 200 (2001) (deferring to longstanding IRS interpretations of governing statutes by holding that back wages are to be taxed (under FICA and FUTA) in the year in which such wages are actually paid as opposed to being taxed in the prior year(s) to which the back wages relate). For further discussion of this case, see Dimitra Doufekias Joannou, The IRS Gets Its Money When You Do: FICA and FUTA Taxation in United States v. Cleveland Indians Baseball Co., 55 TAX LAW. 319 (2001) (reasoning that public policy dictates the imposition of payroll taxes when the amounts are actually paid because employers who have failed to withhold the tax should not have the opportunity to take advantage of (or plead exception to) any changes in tax rates or otherwise petition for beneficial tax treatment). See also Jeffrey C. Honaker, Note, United States v. Cleveland Indians: FICA and FUTA Taxes v. The Social Security Act – Why Have Different Definitions for Identical Language?, 17 AKRON TAX. J. 99 (2002) (arguing that the Court ignored convincing arguments for reading Social Security benefits provisions and Social Security tax provisions in pari materia).

228 Cleveland Indians, 532 U.S. at 221 (Scalia, J., concurring).


benefits context from the “wages” concept in the entire tax arena and thereby disallows any meaningful attempt to rely on Nierotko, a benefits case, to characterize a given payment as “wages” for tax purposes.

Per settlement agreement with the Major League Baseball Players Association, the Cleveland Indians Baseball Company (Company) agreed to pay back wages to eight players (asserting salary damage claims relating to their free agency rights). Though allocable to 1986 and 1987, the damages were paid by the Company in 1994. The parties stipulated that the back pay constituted “wages” within the meaning of FICA and FUTA but differed with respect to the year in which the amounts were subject to tax. Relying on the prior period allocation rule dictated by Nierotko with respect to Social Security benefits determinations, the Company reasoned that the back pay awards should be allocated to 1986 and 1987 and, therefore, subject to FICA and FUTA taxation in accord with tax rates and wage base limits prevailing in 1986 and 1987 (a result that, generally, would not give rise to additional tax liability under the prevailing facts and circumstances). The Government countered that such amounts were actually paid in 1994 and, per longstanding interpretive regulations, should be taxed in accord with rates and wage base limits in effect in 1994.

The Government first argued that the FICA and FUTA statutes, on their face, apply to “wages paid during a calendar year.” The Court, showing due regard to its precedent, deemed the plain language argument unpersuasive. In Nierotko, the Court required the allocation of a current payment of back wages to the prior periods in which the wages should have been paid,

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See Cleveland Indians, 532 U.S. at 204.
See id.
See id. at 205.
See id. at 212.
See id. at 206.
See id. at 209 – 10.
See id. at 209.
despite the fact that the governing statute referred specifically to “wages” “paid” “in” “a calendar quarter.” Thus, the Court concluded that the plain language of the statute was not dispositive. And yet, in a matter of sentences, we see the Court refusing to import Nierotko’s back pay allocation mandate.

Because Nierotko read the 1939 “wages paid” language for benefits eligibility purposes to accommodate an allocation-back rule for backpay, the Company urges, the identical 1939 “wages paid” language for tax purposes must be read the same way. We do not agree that the latter follows from the former like the night, the day. Nierotko dealt specifically and only with Social Security benefits eligibility, not with taxation. * * * Nierotko thus does not compel symmetrical construction of the “wages paid” language in the discrete taxation and benefits eligibility contexts.

Putting “paid” aside, the Court affirmatively clarifies the notion that “wages” need not mean the same thing in the discrete taxation and benefits contexts. In rejecting the argument that Congress changed language in the FICA and FUTA tax provisions to incorporate, albeit indirectly, Nierotko’s backpay allocation rule, the Court emphasized that Congress amended the tax provision to ensure that “wages” were measured in both the tax and benefits eligibility contexts based on “the amount paid during the calendar year,” not, as the company would have it, to incorporate Nierotko’s backpay allocation rule. So, the Court notes clear Congressional intent with respect to a consistent time period for the measurement of “wages.”

The Court then states the following:

Because the concern that animates Nierotko’s treatment of backpay in the benefits context has no relevance to the tax side, . . . it makes no sense to attribute to Congress a desire for conformity not only with respect to the general rule for measuring “wages,” but also with respect to Nierotko’s backpay exception.
The Court has already explained the impropriety of attributing to Congress an intent to incorporate a back pay allocation rule, and the Court has itself noted that “Congress sought conformity”\textsuperscript{246} with respect to the consistent timing of the measurement of wages (i.e., use of the calendar year).\textsuperscript{247} The Court goes on, however, to state that “it makes no sense to attribute to Congress a desire for conformity . . . with respect to the general rule for measuring ‘wages’ . . .”\textsuperscript{248} Per the Court’s own opinion, calendar year conformity was sought, even if \textit{Nierotko}’s back pay allocation rule could be understood as a timing exception.\textsuperscript{249} And the remainder of the sentence clarifies that, with the preceding language, the Court is referring to something other than the back pay exception (i.e., not only X, but also Y). So, given that the \textit{Nierotko} Court itself dictates that its conception of “wages” be understood with the purposes of the Social Security Act in mind, the \textit{Cleveland Indians} Court rightly digs a deeper trench between the land of benefits and the land of tax in asserting that one cannot attribute to Congress an intent either to impose a uniform back pay allocation scheme or to require that the “wages” (which, in any event, must be ascertained on a calendar year basis) actually be measured substantively in precisely the same way. Bear in mind that Joseph Nierotko filed suit against the Social Security Board, not the Commissioner of Internal Revenue. Thus, if Congress has dictated that “wages” need not mean the same thing within the income tax statutes in Title 26 per the Social Security Amendments of 1983, then surely the notion of “wages” within a given section of Title 26 need not be the same as a similar notion wholly outside Title 26. The \textit{Cleveland Indians} decision contains a valuable directive, and language from the face of precedent should be featured prominently in any future efforts to secure the issuance of a writ of certiorari on this issue.

\textsuperscript{246} \textit{Id.} at 215.

\textsuperscript{247} \textit{See id.}

\textsuperscript{248} \textit{Id.} at 216.
Although it is true that the parties in the case stipulated that “wages” were at hand, the justices had ample cause and opportunity to weigh in. In his concurrence, Justice Scalia momentarily sidesteps litigant stipulations and hammers the definitional issue squarely on the head:

In fact, I do not think that the text of the FICA and FUTA provisions . . . addresses the issue we face today. Those provisions, which direct that taxes shall be assessed against “wages paid” during the calendar year, would be controlling if the income we had before us were “wages” within the normal meaning of that term; but it is not. The question we face is whether damages awards compensating an employee for lost wages should be regarded for tax purposes as wages paid when the award is received, or rather as wages paid when they would have been paid but for the employer’s unlawful actions. * * * The proper treatment of such damage awards is an issue the statute does not address . . . .

So, Justice Scalia unambiguously opines that back pay damage awards are not, in fact, “wages” in the traditional sense, but ultimately shifts the question to one of mere timing. He goes on to confirm what he sees as the propriety of currently taxing the Company in light of the fact that the proper treatment of the amounts paid is not addressed by the statute and thus “left to the reasonable resolution of the administering agency, here the Internal Revenue Service.”

Other U.S. Supreme Court justices (e.g., Justice Rehnquist in his dissent in Bob Jones University) have been known to resist such deference, affirmatively rejecting administrative agency interpretations, including those of the IRS, despite overwhelming consistency of the interpretation with prevailing public policy. Though administrative interpretations are often faithful to the relevant statutory letter and spirit (in addition to producing wise and just results like that obtained in Bob Jones University), administrative interpretations may also give rise to irrational or decidedly inappropriate ramifications, a result which counsels against granting that

249 See id. at 215 – 16.
250 Cleveland Indians, 532 U.S. at 221 (Scalia, J., concurring).
251 Id.
252 Id.
254 See id. at 622 – 23 (Rehnquist, J., dissenting).
interpretation any measure of deference. In *Cleveland Indians*, for example, the Service inadvertenty argues the merits of double-dipping. By insisting that back wages paid during a given year be taxed, per Treasury Regulations, in the year paid (and not allocated to the prior period), the Service might well allow a taxpayer to receive four quarters of Social Security benefits eligibility credit in a given year and *four more quarters* for the *same* prior period when back wages are paid in a later period, especially when the four-quarter threshold is low (e.g., $4,200). The Social Security Administration would consider such a result *mala prohibita* under federal law dictating that an individual receive no more than four quarter credits for a given year of work. 255 The same double dipping problem arises, in the tenure relinquishment context as well as in any context in which the government’s current payment-for-prior-services-rendered argument manages to get traction. To the extent the United States was willing to take the payroll taxes and deny quarters of coverage credit on the Social Security eligibility side of the equation, it did not clarify this position in *Cleveland Indians*.

Although the Court provided highly useful precedent in *Cleveland Indians* which should effectively confine *Nierotko*–based notions to the Social Security benefits eligibility context, the problem of viewing the employer/employee relationship expansively (and thereby casting the widest possible “wage” net) persists. Arguably, the practical impact, whether achieved intentionally or inadvertently, is that the courts are effectively attempting to tax or succeeding in taxing the employment relationship itself from before the Alpha to after the Omega. But hasn’t Congress already panned that shiny nugget? Inasmuch as § 3101 works its taxing magic on employees with respect to wages received with respect to employment, Congress already imposes on every employer, per § 3111, “an excise tax, with respect to having individuals in his

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employ.” So, the appropriate excise taxes are collected over the years during the working relationship. To collect more from the employer and the employee at the bitter end arguably amounts to a death tax on the employment relationship. As we have it currently, and despite the lessons of Cleveland Indians, various courts have become way too comfortable with easy piggybacking off the employment relationship. The case that follows, CSX Corp. v. United States, clarifies the impropriety of this “all aboard!” approach. Payments that, under prevailing notions, would have easily been swept into the “wage” trough were ultimately found to fall outside it.

The court in CSX addressed issues concerning the taxability of supplemental unemployment compensation benefits paid to employees suffering an involuntary separation from work. The court ultimately held (with respect to some workers) that the payments were not subject to FICA taxes largely because, as laid-off employees performing no services, the workers had suffered the requisite “separation from employment.” Rejecting the government’s assertion that the benefits did, in fact, constitute “wages,” the court appealed to legislative history. By enacting § 3402(o), noted the court, Congress overtly required withholding with respect to what it did not regard as “wages” largely to head off any potential problems with respect to payment of the resulting income tax liability.

The court emphasized that “payments that are non-wage payments from the start are beyond FICA taxation as much as they are beyond income-tax withholding. The taxation of such payments requires their specific

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256 This 6.2% tax simply represents the employer’s portion of the OASDI tax. See 26 U.S.C. § 3111(a) (2007). For the provision imposing the employer’s portion of the Medicare tax, see § 3111(b).
258 See id. at 209 – 10.
259 See id. at 218 – 19.; see also 26 U.S.C. § 3402(o)(2)(A).
261 See CSX, 52 Fed. Cl. at 211.
Although I agree with the result reached in CSX with respect to laid-off employees, the court and I reach the conclusion via different paths.

In the court’s view, “wages” need not necessarily mean the same thing in the income tax arena and the FICA tax arena, but in the absence of an express exclusion from gross income or express exclusion from FICA taxation, there is no basis for distinguishing the meaning of “wages” in one context as opposed to the other. Accordingly, the court feels the need to explain § 3402(o) as an exception to Nierotko.

In reaching this conclusion, we remain mindful of the Supreme court’s reading of the words “any service” in the Social Security Act’s definition of employment: “‘service’ . . . means not only work actually done but the entire employer-employee relationship for which compensation is paid to the employee by the employer.” While these words are certainly expansive enough to sweep into the employment relationship any payment made by an employer on account of an employee—hence making any such payment a wage—nevertheless, § 3402(o) payments must be regarded as an exception to this broad pronouncement.

The court’s discussion at this juncture is troubling on three levels. First, the court embraces the Rowan Companies notion that “wages” must mean the same thing in the payroll tax and income tax arena barring express Congressional inclusion or exclusion in a given taxing scheme. By doing so, the court attempts to reverse Congress’s conceptual surgery and forcibly reattach statutory twins because of their facial similarity. Second, the court hemmed and hawed its way around Nierotko when it could just as easily have dismissed Nierotko-based notions on the authority of Cleveland Indians (i.e., confining Nierotko’s expansionist notions to the Social Security benefits eligibility context). Third, the court misses a golden opportunity. Rather than explaining § 3402(o) as an exception to Nierotko’s apparent mandate, the court could have

262 Id. at 215.
263 Id. at 213.
264 Id. at 218.
clarified that the income tax withholding concept of “wages” is, in fact, narrower than the benefits eligibility concept (as § 3402 confirms) and that some courts incline towards overstating Nierotko’s legendary prowess. Over time, both Nierotko and Nierotko-like notions (in the tax arena) will seek out new revenue territory as the American population ages and the need to secure employment tax revenue intensifies. Payments on the periphery of (or arguably outside ) the employment relationship (e.g., settlement damages, severance, etc.) make easy targets; such was the case in University of Pittsburgh. The Circuit split over the treatment of tenure-relinquishment payments serves as a fine example of prevailing conceptual unrest and the Service’s willingness to undertake aggressive pursuit of employment taxes. And given the holistic regressivity of taxes like FICA, the working poor and the comfortably middle class should brace themselves for more conceptual impacts.

**PART III - COMMENTARY**

Even in the wake of confining directives from the U.S. Supreme Court, both courts and administrative agencies persist in adhering to an uncomfortably broad conception of “wages,” even if they fail to mention the Nierotko standard by name. That tenacity transcends the merely unfortunate. Regressive taxes, by their very nature, hamper the pursuit of vertical taxpayer equity, so aggressive pursuit of regressive tax revenues via expansionist conceptions of the relevant tax base represents a spirited, in-season targeting of low- and middle-wage earners. Additional revenue collected via an expansionist conception of “wages” (like much standard employment tax revenue) will wind up in the Social Security Trust Fund, and as was noted above, there’s a virtual certainty that those amounts will not reach Social Security/Disability Beneficiaries or Medicare recipients in the near term because the federal government will siphon

265 *See id.* at 213.

266 *See Buchanan, supra* note 33, at 272 – 73.
off the revenue for incremental federal budget deficit reduction. Further, an expansionist conception of “wages” combined with annual increases in the FICA Wage Base results in an arguably exponential increase in what is already an unfair burdening of the middle class with the aforementioned federal budget deficit reduction. And that’s not the worst of it. At the same time that some individuals in the wage-earning work force bear searing scrutiny, lest a dollar of compensation pass without the collection of the payroll tax toll, billions of dollars have sailed through (apparently untouched by FICA or ordinary income tax rates) to the hands of those providing what even a docile court would affirmatively label compensation for services. The aforementioned hands are “carried interests” in so-called “private equity” funds. Relative to the pursuit of income and payroll taxes with respect to the compensation of low-wage earners, the tax-imposing attention given to carried interests in private equity funds is truly a study in stark contrast. Problems present both from vertical and horizontal inequities.

**Private Equity**

In general, private equity funds operate as partnerships whose general business purpose is the generation of substantial long-term capital gains. The funds accomplish this by various means but commonly by purchasing the equity of a privately-held company, nourishing its growth, and selling it off at a profit. Though many of the limited partners of the fund contribute seed capital to purchase targeted companies, the carried interest (general partner)
makes a nominal/negligible capital contribution (and shares in no losses); thus, the general partner is “carried” by the others.\textsuperscript{274} The carried interest partner does, however, receive an allocation of the capital gain generated,\textsuperscript{275} and it earns this allocation by providing investment advisory services, among other things.\textsuperscript{276} It is particularly important to note that the general partner itself is organized as a partnership with individuals serving as partners.\textsuperscript{277} The end result is that the long-term capital gain generated at the private equity fund level will end up (at least in part) in the pockets of individual partners in the carried interest partnership as \textit{long term capital gain}, though clearly earned as compensation\textsuperscript{278} for various services rendered (i.e., managing the fund). Noted one commentator, “private equity firms are not leaving money on the table, but rather they are entering into contracts that pay them what they are worth.”\textsuperscript{279} The following diagram presents the structure visually:

\begin{quote}
[Next Page]
\end{quote}

\begin{itemize}
\item \textsuperscript{273} See id.
\item \textsuperscript{274} See id. at 3 & n.9. Note that the receipt of a carried interest is not, itself, a taxable event. See id. at 4.
\item \textsuperscript{275} See id. at 3. The carried interest realizes profits, if any, on receipt. See id. at 4.
\item \textsuperscript{276} See id.
\item \textsuperscript{277} See Fleischer, supra note 269, at 10.
\item \textsuperscript{278} See Knoll, supra note 270, at 1 (indicating that such characterization is the scholarly consensus).
\item \textsuperscript{279} \textit{Id.} at 8.
\end{itemize}
As of this writing, the taxation of carried interests at ordinary income rates is a pressing tax policy matter and the subject of Congressional legislation. Should it be? Private equity firm proponents essentially contend that any change to the treatment of carried interest will surely trigger a falling of the sky, starving entrepreneurial babes in their very wombs.

[Private equity venture] capital funds often provide financing to risky infant firms that are unable to borrow from banks or traditional capital markets. * * Carried interests are deeply woven into the fabric of U.S. tax law. It would be very difficult to deny general partners in hedge funds and private equity funds the

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280 See Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong. (2007) [hereinafter TRRA]. Various scholars have urged Congress to tax the earnings of carried interests as ordinary income. See Knoll, supra note 270, at 1 n.2. The TRRA proposes this treatment. See TRRA, § 1201.
tax benefits of carried interests without fundamentally changing the taxation of all partnerships and other flow-through entities . . . . * * * Changing tax laws regarding carried interests may slow business incubation and restructuring.\(^{281}\) Other proponents reason that the work done by private equity firms is no different than that done by private investors diligently researching, choosing, and making their own investments.\(^{282}\) If those investors can reap capital gains as a result of their labors without attendant brouhaha, why shouldn’t private equity firms be able to do the same thing?

To be blunt, the short answer is that the tax character/status of the income generated does and cannot determine the tax character/status of income earned. Those employed in some capacity by tax-exempt entities manage to emerge unconfused by any notion that they are themselves exempt from tax! What, then, of the argument that even if those providing services as carried interests are to be taxed at ordinary income tax rates, they should be taxed at a favorable rate given that they work to nourish “incubating” if not “infant” firms? After all, some would point out that, dollar for dollar, capital gains enjoy a favorable tax rate relative to ordinary income because such treatment encourages desirable investment activity. Is not the favorable treatment of carried interests a logical and equally desirable corollary or next step? Relative to the favorable tax treatment of real nurses who nourish and care for real infants, I would say “no.” To the extent that a policy choice could be made such that certain categories of work qualify for highly favorable tax treatment, carried interests place very low on the list. If anything, those providing investment advisory services in the private equity world and those seeking such services should negotiate a tax mark-up for the service provider long before asking Congress to stay its hand; those enjoying the benefit of what private equity investments yield

\(^{281}\) JIM SAXTON, JOINT ECON. COMM., CARRIED INTERESTS, TAXATION, AND ENTREPRENEURSHIP 1, 3 (2007).
should directly shoulder the full burden of reaping those gains. And if tax benefits are to be
handed out to encourage new worker interest, the Average Joe would more likely sign off on
granting that relief to nurses and others charged with the labor-intensive work of caring for the
sick and shut-in, educators charged with the challenging task of teaching and monitoring the
young in public schools, and various emergency first-responders committed to preserving the
health, safety, and welfare of the general public, frequently at the risk of their own lives.

Those alternatives aside, the critical point to be made here is that in at least one context at
the high end of the income scale, hawkish attention to the proper taxation of compensation for
services rendered lags substantially behind the attention directed at the low end. As a result,
principals of private equity firms pocket a “massive give-away,” paying far less than their fair
share of federal income taxes. The disparity is particularly nefarious in light of the fact that
proper taxation of carried interest would have a direct reductive impact on the extent to which
the federal government must borrow, raid the Social Security Trust Fund, or do both in order to
meet budget. In the private equity context, unfortunately, some have decided that foot-dragging
is the best policy. Per Senate Majority Leader, Harry Reid, it appears that the Senate has
promised to stay its hand for the moment with respect to addressing any of the issues associated
with private equity firms. The good news is that proper resolution of this problem does not, in
my view, require the infamous “Act of Congress.” To start with, Treasury Regulations are on

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the performance of these tasks were sufficient to deprive [private equity fund sponsors] of capital gains treatment, capital gains treatment would not be available to any investor.”).

283 At the same time hundreds of millions of dollars in carried interest allocations escape payroll taxes, statutory provisions devoted to policing the reporting of tips have been vigorously enforced. See Jonathan H. Lehr, Assessing Employer FICA Tax on the Estimated Aggregate Unreported Tips of Employees: Quietwater Entertainment, Inc. v. United States, 53 TAX LAW. 781 (2000) (discussing § 6053(c), a provision of the Code which exists largely to help the IRS root out and pursue the underreporting of taxable tip income).

284 Knoll, supra note 270, at 1.

285 See id.
point. Thus, the name given the compensation (e.g., allocable share of long-term capital gain) is just as irrelevant as the basis (e.g., per deal or transaction consummated) upon which it is paid as is the medium (e.g., cash or carried partnership interest) in which it is paid.\textsuperscript{287} If the courts have to be dragged in, they have a well-worn menu of doctrines and principles to choose from in arriving at the right result. Today’s special is an erstwhile perennial favorite, the doctrine of substance over form. Thus, a court might reason, even if the parties have arranged an elaborate two-tiered partnership form, the carried interest partner, in substance, earns ordinary income for services performed in the very same way that a waiter or waitress earns tips for quality service to customers. Tip transactions typically take the form of a voluntary gratuity which some would certainly like to classify as an excludable gift; after all, patrons are often free to leave nothing. The IRS, of course, has long considered tips plain, old fashioned income subject to plain, old-fashioned taxation. Courts could also appeal to assignment of income principles, reasoning that what the limited partners are attempting to do is assign a portion of their long-term capital gains (along with its favorable tax character) to the carried interest partner to compensate that partner for investment advisory and other services rendered. Longstanding assignment of income principles prohibit even the more elaborate, complex, and entity-laden attempts to shift income from one taxpayer to another. Application of foundational doctrines and principles is all the more paramount if we risk pairing low “wage” scrutiny with high “wage” laxity and thereby egregiously offend traditional notions of vertical and horizontal taxpayer equity. The systemic fix, at least for the apparent ills of the Social Security system, may require an approach with

many prongs, at least one of which should be judicial appeal to longstanding core tax principles to get more revenue into federal coffers.

**PART IV – RATIONAL ALTERNATIVES**

*Introduction*

How best, then, do we respond to the Social Security problem on the horizon? Arguably, a just and fair solution begins with the elimination of annual federal budget deficits. By increasing marginal tax rates, President Clinton balanced the federal budget and gave the country the opportunity to save Social Security by effective use/investment of anticipated budget surpluses.\(^{288}\) In the absence of a federal budget deficit, there is no true need to raid the Social Security Trust Fund. To be sure, the solution is not aggressive collection of regressive taxes as we have seen in various courts. In a budget deficit climate, enlargement of the “wage” concept to effect the aggressive collection of regressive taxes does little more than shift the burden of annual budget deficit reduction onto the backs of low- and middle-class workers. The current progressive tax scheme reflects the vertical equity notion that those who earn more should pay a higher percentage of their income in taxes to smooth out, even if only modestly, differences in income. Why should those who earn lower wages shoulder a burden that could be eliminated or minimized by, among other things,\(^ {289}\) enhancing tax rate progressivity (or simply applying the law in some circles)? Better yet, given the consistent raiding of the Social Security Trust Fund over the past 20 years, fundamental fairness dictates the pursuit of a series of alternative remedies long before resort to either benefit reductions or increases in the payroll tax rate (or

\(^{288}\) *See* Clinton State of the Union, *supra* note 63.

\(^{289}\) In addition to enhancing progressivity, the government might collect substantial revenue by reducing the tax gap. The gross tax gap is the difference between aggregate tax liability in a given year and the amount paid voluntarily and on time. *See* ERIC TODER, URBAN INST. AND URBAN-BROOKINGS TAX POLICY CTR., *Reducing the Tax Gap: The Illusion of Pain-Free Deficit Reduction* (2007). The tax gap for 2001 was estimated at $345 million, most of which comes from the underreporting of tax on the returns of individuals (largely underreported business and self-employment income). *See id.*
FICA Wage Base). In this Part, I discuss the alluring potential of various easy ways out, before moving on to the merits of enhancing wage progressivity, curtailing wage regressivity, increasing non-wage progressivity, and generally adopting a more realistic and responsible tax policy ethos.

*The Easy Ways Out – Turn Up the Heat and Hold the Funeral Flowers*

The specter of skyrocketing benefit demands from retiring Baby Boomers has, for over 20 years, “justified” excessive payroll tax withholding and gradual increases in the FICA Wage Base. Should the Social Security system make its way to full-scale crisis, the federal government will find itself contemplating various unpalatable options. In his February 2, 2005, State of the Union Address, President Bush provided an up-to-date assessment of the difficulties ahead:

For example, in the year 2027, the government will somehow have to come up with an extra $200 billion to keep the system afloat -- and by 2033, the annual shortfall would be more than $300 billion. By the year 2042, the entire system would be exhausted and bankrupt. If steps are not taken to avert that outcome, the only solutions would be dramatically higher taxes, massive new borrowing, or sudden and severe cuts in Social Security benefits or other government programs.

The President proceeded to lay out various options including limiting benefits for wealthy retirees, increasing the retirement age, discouraging early collection of benefits, and changing benefit calculation methodology. Regardless of any sincere intentions regarding Social Security, budget deficit realities make progress towards any real solution virtually impossible. Shockingly, the President who ushered in breathtaking tax reduction legislation managed to mouth a plea for solutions before a joint session of Congress.

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290 See Buchanan, *supra* note 33, at 271.
292 See *id.*
I know that none of these reforms would be easy. But we have to move ahead with courage and honesty, because our children’s retirement security is more important than partisan politics. I will work with members of Congress to find the most effective combination of reforms. I will listen to anyone who has a good idea to offer.\textsuperscript{293}

Necessarily, push will come to shove, and when it does, any number of options will likely spring forth. First thing to go? Probably lump sum death benefits, which ultimately means that Uncle Sam will no longer be sending flowers to the funeral. According to Congressional Budget Office (CBO) data, elimination of the $255 lump sum death benefit for those dying after September 30, 2007, would reduce outlays by $1 billion from 2008 – 2012.\textsuperscript{294} Add an additional 5 years, and the reduction amounts to $2.050 billion.\textsuperscript{295} But why tinker with the chump change? If FICA Wage Base increases have managed to avoid the political spotlight and evade noteworthy taxpayer criticism, why not leave the rate in place and jack the FICA Wage Base through the roof? The vast majority of taxpayers won’t notice, and the strong possibility is that no one in the six-figure club (the only ones who will suddenly feel the pain) will complain, at least not in the same way that they would in the face of an increase in progressive tax rates. Congressional Budget Office projections indicate that aggressive increases in the FICA Wage Base would yield hundreds of billions of dollars in the near term.\textsuperscript{296} Table 4 sets forth the relevant figures.

\textsuperscript{293} Id.
\textsuperscript{294} CONGRESSIONAL BUDGET OFFICE, BUDGET OPTIONS 222 (February 2007) [hereinafter BUDGET OPTIONS].
\textsuperscript{295} See id.
TABLE 4

CONGRESSIONAL BUDGET OFFICE
Option 39
Increase the Maximum Taxable Earnings for the Social Security Payroll Tax

<table>
<thead>
<tr>
<th>FICA Wage Base</th>
<th>Change in Federal Revenue 2008 – 2012 (Billions)</th>
<th>Change in Federal Revenue 2008 – 2017 (Billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$250,000</td>
<td>+$284.7</td>
<td>+$682.7</td>
</tr>
<tr>
<td>$214,000</td>
<td>+$253.5</td>
<td>+$604.3</td>
</tr>
<tr>
<td>$186,000</td>
<td>+$221.1</td>
<td>+$524.4</td>
</tr>
</tbody>
</table>

If dramatic increases in the FICA Wage Base do not alone do the trick, the government may well resort to a practice already in effect, gradually raising the normal retirement age (NRA) for Social Security. Assuming staggered raises in the NRA for those born in or at some point after 1946, federal outlays could be reduced (during 2008 – 2012) by $6.2 billion. Tack on another 5 years, and the amount reaches $86.2 billion. And if the NRA for Social Security rises, there may well be little incentive for allowing Medicare eligibility to stagnate at 65; such an eligibility hike would yield savings over the long haul.

No matter what the financial impact of the foregoing alternatives, each amounts to forcing those who have already made “excess” payments into the system to hitch themselves to a new and heavier yoke in the form of more taxes, more work, and likely both. Fairness commands a different approach.

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296 See id. at 308.
297 See id.
298 See id. at 217.
299 See id.
300 See id. at 166.
Enhance Wage Progressivity

During the Clinton presidency, healthy progressive income tax rates and fiscal discipline yielded a balanced budget and a white hot economy.\(^{301}\) He capitalized on this in his 1999 State of the Union Speech:

Tonight, I stand before you to report that America has created the longest peacetime economic expansion in our history with nearly 18 million new jobs, wages rising at more than twice the rate of inflation, the highest home ownership in history, the smallest welfare rolls in 30 years, and the lowest peacetime unemployment since 1957. For the first time in three decades, the budget is balanced. From a deficit of $290 billion in 1992, we had a surplus of $70 billion last year. And now we are on course for budget surpluses for the next 25 years.\(^{302}\)

Indeed, with the budget surplus, there was no need to raid the Social Security Trust Fund, and President Clinton exhorted Congress to seize the opportunity to save Social Security:

The best way to keep Social Security a rock solid guarantee is not to make drastic cuts in benefits; not to raise payroll tax rates; not to drain resources from Social Security in the name of saving it. Instead, I propose that we make the historic decision to invest the budget surplus to save Social Security. Specifically, I propose that we commit 60 percent of the budget surplus for the next 15 years to Social Security, investing a small portion in the private sector just as any private or state government pension would do. This will earn a higher return and keep Social Security sound for 55 years. But we must aim higher. We should put Social Security on a sound footing for the next 75 years. We should reduce poverty among elderly women, who are nearly twice as likely to be poor as are other seniors.\(^{303}\)

Of course, since the stirring delivery of that speech, things have changed dramatically. With the gradual reduction in progressive tax rates which commenced in 2001 (and were fully phased in by 2003),\(^{304}\) the federal government now boasts one of the largest budget deficits in U.S. history.

\(^{301}\) See Clinton State of the Union, supra note 63.

\(^{302}\) Id.

\(^{303}\) Id.

Logically, this signals the renewed siphoning of Social Security Trust Funds while those at the upper end of the wage spectrum enjoy a tax siesta of sorts. Modest increases in individual income tax rates would produce robust revenue.\textsuperscript{305} Table 5 maps this out under various scenarios.

\textbf{Table 5}\textsuperscript{306}

\textit{CONGRESSIONAL BUDGET OFFICE}

\textit{Option 1}

\textit{Increase Individual Income Tax Rates}

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase all ordinary income tax rates by 1%</td>
<td>+$176.3</td>
<td>+$445.2</td>
</tr>
<tr>
<td>Increase all ordinary income and alternative minimum tax rates by 1%</td>
<td>+$283.0</td>
<td>+$667.8</td>
</tr>
<tr>
<td>Increase all ordinary income, alternative minimum tax, dividend, and capital gains tax rates by 1%</td>
<td>+$293.8</td>
<td>+$685.6</td>
</tr>
</tbody>
</table>

By contrast, permanent extension of tax cuts brought about by the Economic Growth and Tax Relief Reconciliation Act of 2001 would cut government revenue by over $1.2 trillion from 2008 – 2017,\textsuperscript{307} and permanent extension of the 0% and 15% tax rates for capital gains and dividends would cost the government over $208 billion in revenue over the same period.\textsuperscript{308} In addition to producing new revenue approaching or exceeding half of $1 trillion, the across-the-board increases in Table 5 have the benefit of enhancing vertical taxpayer equity. And calls for enhanced taxpayer equity have been loud and clear for years. Notes Professor Martin McMahon,

\textsuperscript{305} See BUDGET OPTIONS, supra note 294, at 255.
\textsuperscript{306} See id.
\textsuperscript{307} See id. at 258.
“during the last two decades of the twentieth century, the distribution of income and wealth in
the United States reached levels of inequality that have not been seen since the Roaring
Twenties.”  He encourages the elimination or mitigation of this inequity by raising marginal
tax rates for those at or near the very top of the income scale, pointing out that income tax
rates, especially at the highest marginal rates, have dropped dramatically over the past 40 years
while the rate of tax on payroll amounts (as well as the amount subject to payroll taxation) has
substantially increased over the same time period; most households, he later adds, pay more in
payroll taxes than they do in income taxes. Properly targeted, enhanced wage progressivity
exact more from the wealthy while shielding low- and middle-wage earners, a result that
presumably boosts the larger economy. Yet, enhanced wage progressivity alone does nothing to
relieve the burden of regressive taxes on low wage earners.

Curtail Wage Regressivity

Although one rational means of curtailing existing payroll tax regressivity would be by
lowering the applicable rate imposed on “wages” with respect to those with low earnings, at least
once commentator reasons that relief for low wage earners already exists in the form of the
refundable Earned Income Tax Credit (EITC) which was formulated in the 1970s to return FICA
taxes paid by low income earners to them and thereby offset the tax’s regressivity. Others
contend, however, that it is inappropriate to see the EITC as a corrective of the FICA tax because

\[\text{See id. at 260.}\]
\[\text{McMahon, supra note 75, at 994.}\]
\[\text{See id. at 997 – 98. Professor McMahon argues that one can mitigate the so-called Matthew Effect—the rich getting richer, and the poor getting poorer—by enhancing income tax progressivity. More specifically, he encourages the raising of marginal tax rates for those whose income exceeds $500,000 (and even higher rates for those whose income exceeds $1 million and $5 million). See id.}\]
\[\text{Id. at 1026.}\]
\[\text{Id. at 1033.}\]
\[\text{See Dilley, supra note 32, at 66 n.5.}\]
there is no true link between the two programs.\textsuperscript{314} Thus, they reason that “nothing in the logic of the EITC restricts our ability to make the payroll tax structure less regressive”\textsuperscript{315} Even if the EITC relieves a degree of regressive pressure on the lowest average income quintiles, the second, middle, and fourth quintiles still labor under a regressive yoke while those in the professional classes (more likely to be either in or approaching the highest average income quintile) enjoy relief from the tax on a substantial portion of their income, a result faithfully consistent with their initial objection to inclusion in the benefit scheme altogether.\textsuperscript{316} Further, even if the EITC restores FICA taxes to low wage earners, it does nothing to correct the depression of employee wages brought about by the imposition of the employer’s portion of employment taxes on those hiring them.\textsuperscript{317}

Several options exist, regardless of intended or unintended impact of the EITC. Rather than merely shifting the brunt of the regressive burden from the low-wage earners to mid-range and upper mid-range earners,\textsuperscript{318} the OASDI tax rate could be lowered yet applied to all income across the board in the same way that HI is. This approach would eliminate the OASDI regressivity (for everyone) and render both OASDI and HI taxes proportional and, thus, more fair. Although one could readily contemplate a progressive rate structure for payroll taxes, a proportional payroll tax has the benefit of sparing high wage earners a modest amount of grief as they shoulder the burden of progressive income tax rates elsewhere. Alternatively, instead of permanently eliminating the OASDI burden for amounts exceeding the FICA Wage Base, the


\textsuperscript{315} Id. at 722.

\textsuperscript{316} See Dilley, supra note 32, at 72 – 73.

\textsuperscript{317} See McMahon, supra note 75, at 1003 & n.168 (pointing out that the nominal payment of employment taxes by employers is actually borne by the employee in the form of depressed wages).
OASDI tax could be scheduled to phase back in gradually (or reappear at full strength) as taxable gross exceeds a certain threshold.\footnote{319} This “phase-back-in” (tax hike) would be analogous to the phaseout of personal exemptions and other items as adjusted gross income exceeds specified dollar thresholds. Other creative options surely exist, but those mentioned bear some resemblance to equity-driven techniques already in use in the current tax scheme.

One possible, though not truly earth-shattering, avenue of regressivity relief could take the form of a redefinition of payroll tax “wages” and Social Security “wages” to exclude categorically any amount not satisfying a strict “sweat of the brow” standard; to the extent that Old Age benefits are intended to support those who have retired after years of service and contribution to the commercial engine of the U.S. economy, this seems entirely appropriate. That approach will still generate some controversy. For example, despite the possible rationality of the argument that an end of the year bonus constitutes pay connected with the success of the business (and has no ascertainable link to an individual employee’s service), one could justifiably respond that year end bonuses (like sick pay and vacation pay) simply constitute traditional components of a standard compensation package and are, in fact, paid for the sweat of a worker’s brow. That argument is more difficult to make, however, with respect to signing bonuses, golden parachute payments, and the like. One could argue both that signing bonuses are not standard and that such bonuses actually compensate the individual for forgoing the right to contract with others and have nothing to do with compensating the not-quite-yet employee for services rendered. Likewise, one could argue that a golden parachute payment to a departing executive is non-standard and actually constitutes a form of liquidated damages, not

\footnote{318} See Lehman, \textit{supra} note 314, at 722 (criticizing the characterization of the concern about the regressivity of payroll taxes as a “partial misapprehension” and emphasizing that “[e]ven if the FICA-plus-EITC package does not take too much from the poor, it can still take too much from the middle class and too little from the rich”).

\footnote{319} As was noted earlier, Senator Obama appears now to embrace this approach. See Tumulty, \textit{supra} note 1.
compensation for services previously rendered (for which they may have already enjoyed egregiously handsome pay). The sweat of the brow standard also has the benefit of avoiding the double dipping problem. Thus, for example, to the extent that a signing bonus or golden parachute payment is paid in a given year in which services are not, in fact, rendered (though theoretically allocable to a prior period), then a payroll tax carve-out means that the recipient will not be able (for Social Security benefit eligibility purposes) to claim four quarters of coverage with respect to that payment in a low quarter-of-coverage-threshold regime.

One practical way to deconstruct the “wage” edifice while preventing cataclysm is to take baby steps. As a first, I would suggest changing the treatment of damages paid over by an employer for legally-recognized harms inflicted on employees such that the employee shoulders no payroll tax burden because the amounts do not, in any real sense, compensate the individual for services performed, even with respect to amounts quantifiably allocable to “back pay.” Does this mean that an employer paying damages for employment-related harms would escape payroll tax obligations merely because the employee escaped taxation under a rationally-confined conception of “wages”? For the sake of analytical purity, the answer would have to be yes. One solution, however, would be to impose an excise tax on every employer with respect to damages paid over to employees as a punishment for legally-recognized harm caused in connection with having individuals in his employ on the principle that the current excise tax rate does not contemplate employer misconduct and that the additional tax compensates the larger society for work force disruption. Such an approach would also lay the groundwork for further, equity-induced distinctions with respect to various “wage” categories beyond the obvious numerical differences we have in current statutory law. Consider the following graphical illustrations:
**Numerical Distinctions – 2008 Data**

<table>
<thead>
<tr>
<th>Amount</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>$250,000</td>
<td>“Income”</td>
</tr>
<tr>
<td>$200,000</td>
<td>“Wages”</td>
</tr>
<tr>
<td>$102,000</td>
<td>FICA “Wages”</td>
</tr>
<tr>
<td>$4,200</td>
<td>“Wages” Granting four “Quarters of Coverage” (Social Security Eligibility)</td>
</tr>
</tbody>
</table>

**Actual and Potential Substantive Distinctions**

<table>
<thead>
<tr>
<th></th>
<th>“Income”</th>
<th>“Wages” for General Income Tax Withholding</th>
<th>“Wages” for Payroll Tax Withholding</th>
<th>“Wages” for Quarter of Coverage Purposes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income from Non-Employer</td>
<td>✓</td>
<td>✗</td>
<td>✗</td>
<td>✗</td>
</tr>
<tr>
<td>Vacation or Sick Pay</td>
<td>✓</td>
<td>✗/✓</td>
<td>✗/✓</td>
<td>✗/✓</td>
</tr>
<tr>
<td>Signing Bonus or Severance Payment</td>
<td>✓</td>
<td>✗</td>
<td>✗</td>
<td>✗</td>
</tr>
<tr>
<td>Damages from Employer for Non-Physical Personal Injury</td>
<td>✓</td>
<td>✗</td>
<td>✗</td>
<td>✗</td>
</tr>
<tr>
<td>(but impose additional excise taxes on employer for compensable harm)</td>
<td>✗</td>
<td>✗ (but impose additional excise taxes on employer for compensable harm)</td>
<td>✗ (per Nierotko, but only to the extent that federal double-dipping will not result)</td>
<td>✗ (per Nierotko, but only to the extent that federal double-dipping will not result)</td>
</tr>
<tr>
<td>Damages from Employer Allocable to Back Pay</td>
<td>✓</td>
<td>✗</td>
<td>✗</td>
<td>✗</td>
</tr>
</tbody>
</table>
Enhance Non-Wage Progressivity

In addition, to enhancing income tax progressivity and curtailing payroll tax regressivity, perhaps we should take a page from Senator John Edward’s book and consider enhancing non-wage progressivity by taxing capital gains at a higher rate across the board. An additional benefit of taxing non-wage income (like capital gain) at rates closer to ordinary income rates would be a likely reduction in aggressive schemes (which often go undetected) to disguise or alter the character of earned income. From the perspective of the carried interest discussed above, one chief benefit to participating in the private equity partnership was the realization of what it viewed as tax-favored capital gain. Maybe it’s time to apply the brakes on the capital gain train, even if some modest amount of tax-favored preference is to remain as a means of luring investors to the capital markets.

Balance the Budget, Reduce the Tax Gap, and Consider More

One blindingly simple means of eliminating the need to siphon off Social Security Trust Fund surpluses to fund general government expenditures is balancing the federal budget, a goal which might readily be achieved by allowing the tax cuts ushered in by President Bush to expire. Further, aggressive steps should be taken to reduce the tax gap. For 2001, the aggregate tax gap—the difference between aggregate tax liability in a given year and the amount paid

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320 Citizens for Tax Justice notes the following: One extremely good idea proposed by John Edwards is to end the tax subsidy for people who have capital gains. One signature tax cut enacted by President [George W.] Bush reduced the tax rate on capital gains from 20% to 15% and made dividends, which had been taxed as ordinary income, also taxed at 15%. But even the 20 percent tax rate is a break for the wealthy investors whose other income is mostly taxed at the highest ordinary income rate (currently 35 percent). [Citizens for Tax Justice] recently found that the cost of the current tax treatment of capital gains and dividends was about $92 billion in 2005 alone and three fourths of that went to the richest 0.6 percent. Edwards has proposed taxing capital gains at 28 percent, which is certainly a huge step in the right direction. 

voluntarily and on time—was estimated at $345 billion,\textsuperscript{321} most of which comes from the underreporting of business and self-employment income.\textsuperscript{322}

And, of course, there’s a great deal more that can be done. In addition to collecting substantial revenue from the proper taxation of private equity carried interests,\textsuperscript{323} we might consider other options. The following is a short list of what the author considers viable means of enhancing federal revenue while minimizing the negative impact on the larger taxpaying citizenry.

\[\text{[Next Page]}\]

\textsuperscript{321} See TODER, supra note 289.

\textsuperscript{322} See id. “Underreporting of business and self-employment income accounts for 63 percent of total underreporting of tax due on individual tax returns (individual income tax and SECA tax) and 43 percent of the tax gap.” Id.

\textsuperscript{323} See Knoll, supra note 270, at 18 (estimating, based on certain assumptions, that an additional $2 to $3 billion in additional tax revenue could result from accelerating taxation of carried interest to the time when such interest are granted and imposing that tax at ordinary income rates).
### Table 7

**CONGRESSIONAL BUDGET OFFICE**

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Eliminate the Presidential Election Campaign Fund</td>
<td>$447M</td>
<td>$703M</td>
<td>Major party candidates are already well-financed.</td>
</tr>
<tr>
<td>Delay NASA’s Constellation Program by 5 Years</td>
<td>$16.14B</td>
<td>$45.80B</td>
<td>Manned missions to Mars serve no practical purpose; America put Neil Armstrong on the moon July 20, 1969.</td>
</tr>
<tr>
<td>End the Space Shuttle Program and Additional Assembly of the International Space Station</td>
<td>$24.43B</td>
<td>$53.28B</td>
<td>Impractical launch schedule, safety concerns in light of multiple catastrophes, and reduced scope of ISS activities now planned</td>
</tr>
<tr>
<td>Reduce the Maximum Mortgage on which Interest Can Be Deducted from $1M to $400,000</td>
<td>$30.3B</td>
<td>$88.1B</td>
<td>Those who can afford a $1M residence can take the heat (or will learn to). The shift will also promote economic efficiency.</td>
</tr>
<tr>
<td>Set the Corporate Tax Rate at 35% for All Corporations</td>
<td>$13.2B</td>
<td>$27.6B</td>
<td>Many beneficiaries of the progressive rate structure are not the intended beneficiaries.</td>
</tr>
<tr>
<td>Increase the Excise Tax on Cigarettes by 50 Cents per Pack</td>
<td>$26.6B</td>
<td>$53.2B</td>
<td>May reduce consumption and external costs</td>
</tr>
<tr>
<td>Increase All Taxes on Alcoholic Beverages to $16 per Proof Gallon</td>
<td>$28B</td>
<td>$59.5B</td>
<td>May reduce consumption and external costs</td>
</tr>
</tbody>
</table>

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324 See BUDGET OPTIONS, supra note 294, at 41 (discussing the impact of ending the Space Shuttle program), 42 (discussing the impact of delaying NASA’s Constellation Program by 5 Years), 244 (discussing the impact of eliminating the Presidential Election Campaign Fund), 267 (discussing the impact of reducing the mortgage interest deduction), 289 (discussing the impact of setting the corporate tax rate at 35% for all corporations), 320 (discussing the impact of increasing the excise tax on cigarettes), and 322 (discussing the impact of increasing all taxes on alcoholic beverages).
PART V - CONCLUSION

A few short years ago, Professor McMahon urged mitigation of the so-called [Saint] Matthew Effect—the rich getting richer and the poor getting poorer—by encouraging the raising of specific marginal tax rates.\(^{325}\) This Article’s exhortations respond, to some extent, from an implicit imperative analogous to one found in the Gospel of Saint Luke. There, Christ, responding to a potential follower’s plea that he be allowed first to go and bury his father,\(^{326}\) said “Let the dead bury their dead . . . .”\(^{327}\) Wage earners at the low end of the pay scale bearing the brunt of regressive payroll taxes labor under a similar, albeit non-vocalized, imperative. Per mandatory withholding,\(^{328}\) the not-so-well-off have no choice but to care for those who are retired or disabled and generally share their financial posture, yet for decades, the excessive taxes dutifully paid over to bolster a burgeoning benefit demand have been siphoned off to reduce annual federal budget deficits. Thus the quandary: How can the young wage earners of today and tomorrow care for retired wage earners without shouldering the heavier side of the yoke if surplus trust funds (which have been aggressively collected and systematically swiped for use elsewhere) remain on course for future misappropriation and the attendant retarded rate of return? The solution will certainly call for an unprecedented level of compassionate creativity (or outright tax ruthlessness). For now, prevailing fiscal pressure to extract more from certain taxpayers can be relied on, in many instances, to produce the aggressive expansion of tax-snaring concepts, even if that means that the letter of the most relevant law must itself sit second or third chair. The *University of Pittsburgh* \(^{329}\) decision is a prime example. Obligated to discuss the tax definition of “wages” under FICA, the court gives first and immediate prominence not to the

\(^{325}\) See McMahon, *supra* note 75, at 997 – 98.


\(^{327}\) Luke 9:60.

Internal Revenue Code but to the importance of payroll taxes as a funding mechanisms for “extensive social security and medicare health programs.” Next, the court highlights the importance of the Social Security program as an income cushion for the retired and the disabled. It is only then that the court turns to the most relevant law governing the issue at hand, the Code’s definition of “wages.”

Given that substantial cuts in progressive tax rates (and the resulting federal budget deficits) have sharpened the need to raid payroll tax surplusage, vertical taxpayer equity dictates the pursuit and implementation of a wide range of progressive tax strategies long before resort to any direct or indirect enhancements of systemic regressivity. If anyone is to be asked, at the moment of truth, to pay a great deal more, it should certainly not be those who put in tax overtime while others took tax holiday. Those entering retirement fully deserve the benefits not only promised to them, but also, and more importantly, earned by them. President Clinton’s plea of 1999 maintains its urgency:

Now, these changes will require difficult, but fully achievable choices over and above the dedication of the [budget] surplus. They must be made on a bipartisan basis. They should be made this year. So let me say to you tonight, I reach out my hand to all of you in both houses in both parties and ask that we join together in saying to the American people, we will save Social Security now.

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

Id. at 167.

See id. Note that the legislative history relied on by the court to bring this message home relates to the impropriety of parallel “income” exclusions (absent Congressional action), an issue wholly separate and distinct from the question whether a given amount constitutes “wages” for FICA tax purposes.

See id. at 168.

Clinton State of the Union, supra note 63.