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COLUMNS

MAYO CLINIC CASE RAISES ISSUES AS TO MEANING OF EDUCATIONAL ORGANIZATION

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***Mayo Clinic* offers excellent insight into issues relating to the meaning of an "educational organization" under Section 170(b)(1)(A)(ii),**

In *Mayo Clinic v. United States*[1] the issue presented was whether the Mayo Clinic ("Mayo") qualifies as an "educational organization" under Section 170(b)(1)(A)(ii). At stake in this case was whether Mayo was liable for nearly $12 million in taxes on unrelated business taxable income ("UBTI"), which both the government and Mayo agreed would not apply if Mayo was in fact described as an educational organization.[2]

After invalidating a Treasury Regulation requiring the *primary purpose* of an "educational organization" to be educational, the Federal District Court in this case held that Mayo met the definition of an "educational organization" as specifically prescribed by Section 170(b)(1)(A)(ii). On appeal, the 8th Circuit Court of Appeals reversed the District Court, holding that the primary purpose requirement in the regulation had a valid role in interpreting the meaning of an "educational organization" under Section 170(b)(1)(A)(ii). However, the 8th Circuit invalidated the requirement of the very same regulation that limited educational organizations to those organizations whose primary function is the presentation of formal instruction. In Action on Decision 2021-04,[3] the IRS announced on December 3, 3021 that it would not acquiesce with the decision of the 8th Circuit invalidating the Treasury Regulation requirement that the primary function of an "educational organization" must be formal instruction.

This article addresses the statutory and regulatory authority defining an "educational organization" under Section 170(b)(1)(A)(ii), the holdings of the Federal District Court and 8th Circuit Court of Appeals in the *Mayo Clinic* case, and the subsequent IRS nonacquiescence.

Background

Mayo is a Minnesota nonprofit corporation that is classified as a tax-exempt organization under Section 501(c)(3). Mayo oversees health-care system subsidiaries and operates the Mayo Clinic College of Medicine and Science ("Mayo College"). The Mayo College is comprised of five distinct medical schools that offer M.Ds., Ph.Ds., and other degrees, as well as residencies, fellowships, and continuing medical education: (1) Mayo Clinic Graduate School of Biomedical Sciences; (2) Mayo Clinic School of Graduate Medical Education; (3) Mayo Clinic Alix School of Medicine; (4) Mayo Clinic School of Health Sciences; and (5) Mayo Clinic School of Continuing Professional Development. The medical

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schools comprising the Mayo College are all operating divisions of Mayo — not separately incorporated entities — so that their activities and operations are a component part of Mayo.

On its Form 990, Schedule A ("Public Charity Status and Public Support"), Mayo indicates that it is classified as a public charity because it meets the public support test of Section 509(a)(2), generally requiring that an organization receive (1) more than 33.3 percent of its support from contributions, membership fees, and gross receipts from activities related to its exempt functions and (2) no more than 33.3 percent of its support from gross investment income and UBTI.[4] On Part IV, line 13, of its Form 990 ("Checklist of Required Schedules"), Mayo checks "yes" to the question, "Is the organization a school described in section 170(b)(1)(A)(ii)?" It then attaches Schedule E ("School") to its Form 990.

During the tax years at issue, Mayo made investments in partnerships that had "acquisition indebtedness" with respect to real property, thereby causing the income from the partnership to constitute "debt-financed income" under Section 514(b)(1) and, accordingly, to be classified as UBTI subject to the tax under Section 511(a)(1). Under a special exception to the debt-financed income rules under Section 514(c)(9)(A), however, acquisition indebtedness does not include indebtedness incurred by a "qualified organization" in acquiring or improving real property, and a "qualified organization" for this purpose includes an educational organization described in Section 170(b)(1)(A)(ii).[5] Based upon it qualifying as an educational organization, Mayo took the position on its Form 990 that the exception to the debt-financed income rules applied and, therefore, that the partnership income was not UBTI.

In a subsequent audit, the IRS asserted that, in its view, Mayo was not an educational organization under Section 170(b)(1)(A)(ii) and, therefore, was liable for taxes on its debt-financed partnership income. Mayo paid the $11,501,621 of disputed taxes and, in 2016, filed a lawsuit in Federal District Court seeking a refund on the basis that it met the definition of an "educational organization" as specifically prescribed in the statute.

Meaning of "educational organization"

Under Section 170(b)(1)(A)(ii), an "educational organization" is defined as an organization "which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on."[6] Under this statutory language, there are four basic requirements to qualify as an "educational organization": (i) a faculty, (ii) a curriculum, (iii) students, and (iv) a place where educational activities are regularly carried on. Unlike the definition of a "hospital" under Section 170(b)(1)(A)(iii), which specifically includes a "principal purpose" requirement,[7] there is no such "principal purpose" requirement under Section 170(b)(1)(A)(ii) such that, on its face, Section 170(b)(1)(A)(ii) does not require an organization to have education as its "principal purpose" in order to be classified as an "educational organization."

Under this regulation, an organization that otherwise may be an "educational organization" by virtue of maintaining a regular faculty and curriculum and having a regularly enrolled student body in attendance at a school facility, as prescribed under the statute, will not qualify as an "educational organization" under Section 170(b)(1)(A)(ii) unless (1) its primary function is educational and (2) any noneducational activities are merely incidental to the educational activities.

In addition to the statutory requirements for constituting an "education organizational," Reg. 1.170A-9(c)(1) includes two additional requirements that do not appear explicitly in the statute, whereby an "educational organization" will only be described in Section 170(b)(1)(A)(ii) if its "primary function is the presentation of formal instruction" and its noneducational activities "are merely incidental to the educational activities."[8] With respect to the "merely incidental requirement," the regulation provides the following example:

1 *Mayo Clinic v. United States* 412 F.Supp.3d 1038, 1057, 124 AFTR 2d 2019-5448 (D. Minn. 2019), rev'd and rem'd, 997 F.3d 789, 127 AFTR 2d 2021-2013 (8th Cir. 2021).

2 The tax on UBTI is imposed under Section 511(a)(1).

3 2021-49 IRB 725 (Dec 3, 2021).

4 The public support test of Section 509(a)(2) is addressed in detail in Reg. 1.509(a)-3.

5 Section 514(c)(9)(C)(i).

6 Section 170(b)(1)(A)(ii).

7 The language of Section 170(b)(1)(A)(iii) specifically requires the "principal purpose" to be the provision of medical or hospital care, among other health-care functions.

8 Reg. 1.170A-9(c)(1).

> A recognized university which incidentally operates a museum or sponsors concerts is an educational organization within the meaning of section 170(b)(1)(A)(ii). However, the operation of a school by a museum does not necessarily qualify the museum as an educational organization within the meaning of this subparagraph.[9]

Under this regulation, an organization that otherwise may be an "educational organization" by virtue of maintaining a regular faculty and curriculum and having a regularly enrolled student body in attendance at a school facility, as prescribed under the statute, will not qualify as an "educational organization" under Section 170(b)(1)(A)(ii) unless (1) its primary function is educational and (2) any noneducational activities are merely incidental to the educational activities.

The Federal District Court invalidates regulation requiring education as primary purpose

In the Federal District Court case, the government conceded that during the tax years at issue and today, Mayo "normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on," thereby meeting the statutory definition of an "educational organization" under Section 170(b)(1)(A)(ii). Thus, as the government put it, "the United States does not dispute that Mayo Clinic, by virtue of its schools, satisfies the requirements relating to faculty, curriculum, students, and place."[10]

The government nonetheless argued that Mayo was not an "educational organization" because it did not meet the "primary function" and "merely incidental" requirements of Reg. 1.170A-9(c)(1). In this regard, the government argued that Mayo's primary function was health care, not education, and even if that were not so, Mayo's health-care activities were not merely incidental to its educational activities.[11] Mayo described its educational and patient-care activities as essential to each other and inextricable and asserted that the Treasury Department exceeded the bounds of its statutory authority when it promulgated Reg. 1.170A-9(c)(1).

In determining that it would not simply defer to the Treasury Regulation in interpreting the meaning of an "educational organization," the Federal District Court, citing the Supreme Court precedent,[12] stated that Congress unambiguously chose not to include a primary function and merely incidental requirement in Section 170(b)(1)(A)(ii). As such, the Court stated that the statute must be interpreted in the light of its surrounding provisions.

Here, the Court noted that the Section 170(b)(1)(A)(ii) "contains no explicit primary-function requirement, but the equivalent of that very requirement appears in the very next subsection of the statute, Section170(b)(1)(A)(iii). In this situation — that is, when Congress imposes a particular requirement in one subsection of a statute but not in another — settled rules of statutory construction say that the absence of the requirement is generally to be considered a deliberate omission that must be respected."[13] Accordingly, the District Court held that the Treasury Department exceeded the bounds of its statutory authority when it promulgated the primary function requirement in Reg. 1.170A-9(c)(1). With respect to the merely incidental requirement, the Court stated that the "corollary of determining that Congress unambiguously did not include a primary-function requirement in Section 170(b)(1)(A)(ii) is that Congress also must be understood to have decided not to include a merely-incidental test in this statute, at least as that test is described in the corresponding regulation."[14]

Thus, under the District Court's holding, an organization that engages in activities meeting the statutory requirements under Section 170(b)(1)(A)(ii) relating to faculty, curriculum, students, and place can qualify as an "educational organization," although such activities may not constitute the primary function of the organization, and other activities are not merely incidental to the educational activities. Thus, the government's position that Mayo was not entitled to the refunds it sought was premised only on Mayo's inability to meet the primary function and merely incidental requirements contained in Reg. 1.170A-9(c)(1), a regulation the Court found to be invalid. The government conceded that Mayo normally maintained a regular faculty and curriculum and normally had a regularly enrolled body of pupils or students in attendance at the place where its educational activities were regularly carried on. The Court therefore held that "there is no genuine issue of material fact that Mayo qualifies as an "educational organization" under IRC Section 170(b)(1)(A)(ii) and was entitled to summary judgment on its refund claims."[15]

In its conclusion, the Court noted that how to measure educational activity as opposed to noneducational activity, as well as the degree to which education must be Mayo's primary purpose, were disputed.

The 8th Circuit reverses the District Court but holds that presentation of formal instruction need not be primary function

After an extensive review of the history of expressed congressional intent as it related to the definition of a charitable organization, the Court of Appeals for the 8th Circuit, in reversing the Federal District

9 *Ibid.*

10 *Op. cit.* note 1.

11 The Court noted in this context that the IRS had issued a Technical Advice Memorandum (TAM 201407024) confirming its position that Mayo did not qualify as an "educational organization."

12 *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984); *K Mart Corp. v. Cartier, Inc.*, 486 U.S. 281, 291 (1988).

13 The Court noted that Section 170(b)(1)(A)(iii) contains the words "principal" and "purpose" but stated that the statutory and regularly framework suggest that "primary" and "principal," as well as "function" and "purpose," are interchangeable.

14 *Op. cit.* note 1.

15 It is interesting that in its analysis, the Court noted that "[n]either § [Section] 514 nor § [Section] 170 explicitly prevent an organization from qualifying under multiple subparagraphs of (b)(1)(A), and the government identifies no part of the statute that might accomplish this result implicitly. IRS revenue rulings also support this interpretation. See Rev. Rul. 64–287 (concluding that church foundation, located on university campus, that offered courses to university students qualified as an educational organization); see also Rev. Rul. 78–95 (organization qualifying under subsection (vi) could also qualify under (i)); Rev. Rul. 76–416 (organization qualifying under subsection [iii] could also qualify under [iv])." Therefore, even if Mayo qualified under Section 170(b)(1)(A)(vi) because of its public support, it could nonetheless also be described in Section 170(b)(1)(A)(ii).

Court, found that the terms "primary function" and "merely incidental" had a valid role in interpreting the meaning of an "educational organization" under Section 170(b)(1)(A)(ii). Thus, the Court concluded that an "educational organization" in Section 170(b)(1)(A)(ii) unambiguously meant an organization whose primary purpose was broadly educational and whose noneducational activities were merely incidental to that primary purpose.

The 8th Circuit, however, agreed with the Federal District Court that Reg. 1.170A-9(c)(i) added an unreasonable condition to the statutory requirements under Section 170(b)(1)(A)(ii) by requiring that an educational organization's "primary function [must be] the presentation of formal instruction,"[16] which the appellate Court stated had no long history of congressional acceptance. Therefore, according to the 8th Circuit, an organization could qualify under Section 170(b)(1)(A)(ii), although its primary function is not the presentation of formal instruction provided. However, it must meet the statutory criteria of faculty, curriculum, students, and place; its primary purpose must be broadly educational; and its noneducational activities may only be merely incidental to that primary purpose.

In its conclusion, the Court noted that how to measure educational activity as opposed to noneducational activity, as well as the degree to which education must be Mayo's primary purpose, were disputed. The government relied on expenses and revenue disclosed on Mayo's Forms 990, while Mayo emphasized a totality of the circumstances approach. Additionally, the government believed that education, including the operation of medical schools, must be the Section 501(c)(3) taxpayer's principal or most important purpose, while Mayo contended that it only must be substantial. Mayo also asserted that its status as an academic medical center meant that its medical and educational purposes — and the operations supporting those functions — were inextricably intertwined. According to the Appellate Court, separating out the educational from the noneducational, while difficult, was not impossible. "In these circumstances," the Court stated, "we leave these difficult and fact-intensive issues of fact and law to the district court on remand."[17]

IRS nonacquiescence

Subsequently, in Action on Decision 2021-4,[18] the IRS announced that it would not acquiesce in the 8th Circuit Court's holding, so the position of the IRS continues to be that an "educational organization" described in Section 170(b)(1)(A)(ii) must have the "presentation of formal instruction" as its primary function.

Although the IRS disagreed with the decision of the 8th Circuit with respect to the formal instruction requirement, it stated that it did "recognize the precedential effect of the decision to cases appealable to the 8th Circuit Court and will follow it for cases within the 8th Circuit Court in which the facts are not materially distinguishable. We do not, however, acquiesce to the opinion and will continue to litigate the formal instruction requirement in cases in other circuits."[19]

The IRS further stated that it would continue to apply the statutory faculty-curriculum-student-place requirement of Section 170(b)(1)(A)(ii) because this requirement was not before — and therefore not now — considered by either the District Court or the 8th Circuit Court. Furthermore, the IRS indicated that it would continue to apply the regulatory requirement expressly affirmed by the 8th Circuit Court that the term "educational organization" not include an organization "engaged in both educational and noneducational activities unless the latter are merely incidental to the educational activities."[20]

Conclusion

Mayo Clinic offers excellent insight into issues relating to the meaning of an "educational organization" under Section 170(b)(1)(A)(ii), whereby neither the Federal District Court or 8th Circuit Court of Appeals nor the IRS agreed on the definition of an "educational organization" under Section 170(b)(1)(A)(ii). According to the 8th Circuit Court, an "educational organization" must meet the statutory criteria of faculty, curriculum, students, and place. And its primary purpose must be broadly educational, and its noneducational activities should be merely incidental to that primary purpose. However, under the 8th Circuit Court opinion, the primary function of the organization need not be the presentation of formal instruction. The IRS, however, had indicated its position will continue to be that in order for an organization to qualify as an "educational organization," its primary function must be the presentation of formal instruction. ■

16 *Op. cit.* note 1.

17 *Op. cit.* note 1.

18 2021-49 IRB 725 (Dec 3, 2021). An IRS nonacquiescence is not binding on courts or taxpayers but merely reflects the position of the IRS that it disagrees with a court decision.

19 *Op. cit.* note 1.

20 *Ibid.*