

Court in Mayo Clinic v. U.S. Invalidates U.S. Treasury Regulation

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In what may be a bellwether for future challenges to existing U.S. Treasury Regulations, on August 6, 2019 the United States District Court for the District of Minnesota in *Mayo Clinic v. United States* invalidated Treasury Regulation § 1.170A-9(c) on the grounds that the Treasury Department exceeded the bounds of its statutory authority when it was promulgated.

Background

Mayo Foundation is an tax-exempt § 501(c)(3) organization that is the parent of several hospitals, clinics, and the Mayo Clinic College of Medicine and Science, which is comprised of five medical schools. In 2016, the Mayo Clinic filed suit on behalf of Mayo Foundation (“Mayo”) seeking over \$11 million in federal tax refunds. According to Mayo, the taxes were erroneously assessed because Mayo is a “qualified organization” that is not required to pay unrelated business income tax (“UBIT”) on passive income from debt-financed property. The Government contended that such passive unrelated business income was taxable because Mayo was not a “qualified organization” for purposes of the claimed UBIT exclusion.

Under Code § 170(b)(1)A(ii), an organization qualifies for the UBIT exclusion at issue in *Mayo* if it is

an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.

The Treasury Department regulation interpreting that provision—Treasury Regulation § 1.170A-9(c) (the “Treas. Reg.”)—further provides that an organization is not included in the definition of “educational organization” unless “its *primary function* is the presentation of formal instruction” and “noneducational activities . . . are *merely incidental* to the educational activities.”

The Government and Mayo agreed that Mayo would qualify as an “educational organization” under the definition set forth in the Code if the Treas. Reg. was not applicable. However, according to the Government, the Treas. Reg. expressly excluded Mayo from the definition of “educational organization” because (a) Mayo’s *primary purpose* is health care, not education, and (b) its noneducational “health care” activities are not *merely incidental* to its educational activities. Mayo challenged the Treas. Reg.’s validity, arguing that it impermissibly added a requirement—namely, the *primary function* test—that Congress did not intend to include in Code § 170(b)(1)A(ii).

Decision

The court considered Code § 170(b)(1)A(ii) and the Treas. Reg. under *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.* to determine whether the regulation was entitled to deference. Under the two-step *Chevron* framework, courts and agencies “must give effect to the unambiguously expressed intent of Congress. If the intent of Congress is clear, that is the end of the matter.” If Congress has not directly addressed the precise question at issue and the statute is silent or ambiguous, only then will a court consider whether an agency’s regulation promulgated to address the ambiguity is based on a permissible construction of the statute.

As stated by the court, “the precise question at issue [in *Mayo*] . . . [was] whether Code § 170(b)(1)(A)(ii) is silent or ambiguous with respect to the *primary-function* and *merely-incidental* requirements in the regulation.” Because the Code subsection immediately following § 170(b)(1)(A)(ii) explicitly *does* include a *primary function* requirement (it defines the *principal purpose or functions* of a qualifying medical facility), the court determined that Congress had “unambiguously chose not to include a primary-function requirement” in Code § 170(b)(1)(A)(ii). According to the court,

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.

Since it found that the Treasury Department did not have statutory authority to impose a *primary-function* requirement under the Treas. Reg., the court never even reached the second prong of the *Chevron* test (i.e., whether the Treas. Reg. was a permissible interpretation of the statute).

With the *Mayo* decision, organizations previously ineligible for the passive income UBIT exception at issue in the case may now qualify. In addition, the *Mayo* precedent has the potential to invite challenges to other existing Treasury Regulations, which could significantly impact tax administration. We will continue to monitor this case closely.

(Note: The Code § 170(b)(1)(A)(ii) at issue in *Mayo* generally describes a type of “educational organization” eligible to receive tax-deductible charitable contributions from individuals. Now that the Treas. Reg.’s *primary function* test has been invalidated, charitable contributions to such an “educational organization” are tax-deductible even if the organization’s primary purpose is not the presentation of formal instruction and noneducational activities are not merely incidental to educational activities. However, by definition, a charitable contribution may only be made to a corporation that is

organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition . . . or for the prevention of cruelty to children or animals; . . . no part of the net earnings of which inures to the benefit of any . . . individual . . .

An educational organization described in § 170(b)(1)(A)(ii) must be qualified to receive a charitable contribution as defined above, regardless of the *primary function* test.)

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