CLIENT ALERT

District Court Invalidates the "Primary Purpose" and "Merely Incidental" Requirements of Treasury Regulation Defining "Educational Organization"

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A U.S. District Court recently held that the Mayo Clinic, the parent organization of several hospitals, clinics, and the Mayo Clinic College of Medicine and Science, was a qualified educational organization described in Internal Revenue Code ("Code") section 170(b)(1). *Mayo Clinic v. United States*, No. 16-cv-03113 (ECT_KMM), 2019 WL 3574709 (D. Minn. Aug. 6, 2019). The Mayo Clinic, a Code section 501(c)(3) organization, sought a refund of approximately $11 million related to an IRS assessment for unrelated business income taxes under Code section 511. The Mayo Clinic's position was that it could exclude passive income derived from debt-financed real property from its calculation of unrelated business income taxes because it was an educational organization within the meaning of Code section 170(b)(1)(A)(ii). Only certain organizations, including educational organizations, may so exclude income derived from leveraged property. The court ultimately upheld the clinic's qualification as an educational organization and denied the government's proposed adjustment.

The court held that the "primary function" and the "merely incidental" limitations provided in Treasury Regulation § 170A-9(c)(1) exceeded Treasury's statutory authority. Treasury Regulation § 170A-9(c)(1) provides that an organization will not qualify as an educational organization unless education is the organization's primary function and all noneducational activities are merely incidental to that function. The government argued that the Mayo Clinic's primary function was health care and that the clinic's health-care activities were not merely incidental to its educational function. Mayo Clinic claimed that it qualified as an educational organization, and therefore properly excluded its passive income earned from debt-financed real property from the unrelated business income tax. The court ultimately agreed with the Mayo Clinic.

Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 104 S. Ct. 2778, 81 L. Ed. 2 d 694 (1984), provides a two-step analysis to determine the validity of a regulations. Under "step one" of the *Chevron* analysis, if Congress spoke directly to the issue, the regulation under scrutiny must follow to the statute, and there is no need to proceed to "step two." Applying "step one" of the *Chevron* framework, the *Mayo Clinic* court looked to the statute for a statement of what qualified as an educational organization under Code section 170. The court considered whether the statute in question was silent or ambiguous as to the primary-function and merely-incidental requirements provided in the regulation. The court stated, "Congress unambiguously chose not to include a primary-function requirement in 26 U.S.C. § 170(b)(1)(A)(ii), and the Treasury Department exceeded the bounds of its statutory authority when it promulgated the primary-function requirement in 26 C.F.R. § 1.170A-9(c)(1)." The court reasoned that Congress explicitly provided a primary-function requirement in an adjacent provision of the Code. Therefore, Congress knew how to include a primary-function requirement and would have included such a requirement expressly if that was its intent. The court then reasoned that "[t]he corollary of determining that Congress unambiguously did not include a primary-function requirement in § 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."

This case will almost surely be appealed to the Court of Appeals for the Eighth Circuit. The Department of Justice typically contests a lower court decision that invalidates a Treasury Regulation. In any event, a district court case is not binding inside or

outside the district at issue, although as a practical matter judges within a district look favorably upon the reasoning and rulings of their fellow judges. As such, taxpayers, particularly those outside the District of Minnesota, should not necessarily assume that the *Mayo Clinic* case can be relied on as the law.

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