

CLIENT ALERT

Eighth Circuit Partially Overturns Mayo and the Invalidation of the Primary-Function and Merely-Incidental Requirements in Treasury Regulations

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The Eighth Circuit partially overturned the district court in *Mayo Clinic v. United States*, holding that only organizations that have a primary purpose or function that is educational qualify under Section 170(b)(1)(A)(ii). *Mayo Clinic v. United States*, No. 19-3189, 2021 WL 1916000 (8th Cir. May 13, 2021). However, notably, the court agreed with the district court in part and concluded that Treasury Regulation § 1.170A-9(c)(1) unreasonably limits educational organizations to only those principally providing formal instruction.

The issue in the case was whether Mayo Clinic, the parent organization of several hospitals, clinics, and the Mayo Clinic College of Medicine and Science, was required to pay unrelated business income tax (UBIT) on its debt-financed income with respect to real estate. In general, only select Section 501(c)(3) organizations, including certain educational organizations, are relieved from the obligation to pay UBIT. In particular, Section 514(c)(9)(C)(i) exempts organizations described in Section 170(b)(1)(A)(ii) from paying UBIT on income from real estate acquired using debt. Section 170(b)(1)(A)(ii) refers to “an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance.” Originally, relying on its regulations, the IRS denied the Mayo Clinic’s exemption from UBIT as an educational organization because the Mayo Clinic’s primary function was not the presentation of formal instruction and the Mayo Clinic’s non-educational activities (i.e., medical activities) were not merely incidental to the educational activities. The district court in turn held that the primary-function and merely-incidental tests in the Treasury Regulation were invalid, thereby siding with the Mayo Clinic, because the two requirements were not included by Congress in the Code and impermissibly expanded the requirements of educational organizations.

The Eighth Circuit disagreed with the district court and upheld the Treasury Regulation, but only in part. The Eighth Circuit explained that the district court’s reliance on the *Russello* principle was improper. The *Russello* principle provides that if Congress included particular language in one section, but excluded that language in another section, then the exclusion was purposeful. See *Russello v. United States*, 464 U.S. 16 (1983). Applying this principle, the district court concluded that Congress included a primary-purpose test in Section 170(b)(1)(iii) and intentionally excluded a primary-purpose test from Section 170(b)(1)(ii). The Eighth Circuit stated, in response: “Although relevant, the *Russello* principle is not controlling, and we conclude the district court failed to give sufficient consideration to the origins of the statutory charitable exemption and the Treasury Regulation at issue, and the manner in which the current statutory provisions have been added to the IRC and modified over more than a century.”

The court then examined the history of the phrase “organized and operated exclusively for religious, charitable, or educational purposes” (found in Section 501(c)(3)) as applied to tax-exempt organizations generally and educational organizations specifically. The court asserted that a “[c]onsensus emerged [through caselaw] that the word ‘exclusively’ should not be interpreted literally if the purposes underlying income tax exemptions and charitable deductions were to be achieved, because every organization has some noncharitable activities.” As a result, the merely-incidental requirement, at issue in the case, came

about judicially and was not the product of judicial deference to agency interpretation. Moreover, then Eighth Circuit held that the “settled *judicial* interpretation” of Section 501(c)(3) looked to a primary-purpose test.

The appeals court partially agreed with the district court, however, and stated that “Treasury Regulation § 1.170A-9(c)(i) adds unreasonable conditions to the statutory requirement that a qualified educational organization is one ‘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 court then provided that although the Treasury Regulation unreasonably limits educational organizations to those principally providing formal instruction, “the terms ‘primary function’ and ‘merely incidental’ activities have a valid role in interpreting the statute.” The court noted that historically, educational organizations have included a nonprofit educational magazine and a museum dedicated to educating the public.

The court then concluded that to be excused from UBIT as an educational organization requires a determination of “(1) whether the taxpayer is ‘organized and operated exclusively’ for one or more exempt purposes; (2) whether the taxpayer is ‘organized and operated exclusively’ for educational purposes; and (3) whether the taxpayer meets the statutory criteria of faculty, curriculum, students, and place.” Here, the government conceded the first inquiry (the Mayo Clinic was organized and operated exclusively for one or more exempt purposes) and the third inquiry (the Mayo Clinic College has a faculty, curriculum, students, and a place where educational activities are carried on). The court then remanded the case to determine the second inquiry – whether the taxpayer is organized and operated exclusively for educational purposes.

To summarize, the lower court is to determine whether the Mayo Clinic’s overall purpose and operations establish that it is “organized and operated exclusively” for educational rather than other purposes. The court then cautioned that “the presence of a single non-educational purpose, if substantial in nature, will destroy the [UBIT] exemption regardless of the number or importance of truly educational purposes” and provided that “[t]he balance is educational against noneducational.”

Although it is questionable whether the balance of educational and noneducational activities will be found on remand to favor the Mayo Clinic, this holding may be useful information for educational organizations that do not *principally* provide formal instruction. Please note that it is likely that the IRS will take the position that the Eighth Circuit’s opinion is precedential only for taxpayers in that circuit.

It is also possible that either the taxpayer or the Government will seek certiorari to the U.S. Supreme Court.

For more information, please contact the professionals listed below, or your regular Crowell & Moring contact.

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