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Client Alert

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Tax-Exempt Mayo Clinic Awarded $11.5M UBIT Refund, Invalidating Treasury Regulations In the Process

In a recent taxpayer win, the United States District Court for the District of Minnesota granted summary judgment in an $11.5 million refund claim brought by the Mayo Clinic ("Mayo") on the basis that certain Treasury Regulations relied on by the IRS were invalid under a step one *Chevron* analysis.[1] This case adds a taxpayer victory to mounting litigation challenging the validity of Treasury Regulations in various contexts.[2]

At issue in the case was whether Mayo's partnership income derived from debt-financed real estate investments was subject to the unrelated business income tax ("UBIT") of the Internal Revenue Code (the "Code").[3] Generally, section 501(c)(3) tax-exempt organizations, like Mayo, are subject to UBIT on income that is derived from a trade or business that is unrelated to its tax-exempt purpose.[4] An exception exists, however, for certain income earned by a tax-exempt organization, such as dividends, interest, and rents from real property.[5] As a general rule, an exception to that exception would nonetheless subject those income items to UBIT to the extent they are derived from debt-financed property.[6] Certain section 501(c)(3) tax-exempt entities that are "qualified organizations," are given special treatment, however. They are not subject to UBIT on debt-financed income from real estate unless the real estate is held by a partnership that is not "fractions rule compliant."[7] The heart of the issue was whether Mayo was a qualified organization and, as a result, exempt from tax on its real estate partnership income.

Qualified organizations under section 514(c)(9)(C) include a section 170(b)(1)(A)(ii) organization. A qualified organization under section 170(b)(1)(A)(ii) is described in the statute as 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."[8] The regulations under section 170(b)(1)(A)(ii) further describe a qualified

organization as one that has a primarily educational function and does not include organizations engaged in both educational and noneducational activities, unless the latter are merely incidental to the educational activities.[9]

Mayo is the parent organization to several hospitals and clinics, including the Mayo Clinic College of Medicine and Science. As such, its activities include both health care services and education. In the taxpayer's view, those functions are inextricable. The government did not dispute that Mayo was an educational organization that normally maintained a regular faculty and curriculum and normally had a regularly enrolled body of pupils or students in attendance. In other words, Mayo met the literal language of section 170(b)(1)(A)(ii). Rather, the issue raised by the IRS was whether Mayo was primarily engaged in educational activities and whether its non-educational activities were merely incidental under the requirement of the regulations. The parties filed cross motions for summary judgment as to whether Mayo was required to meet the primarily educational/merely incidental standard set forth in the regulations. Mayo took the position that it was not because the regulations exceeded what was intended by Congress when it enacted section 170(b)(1)(A)(ii).

The court invoked the two-step test set forth in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984) to analyze whether the regulation at issue should be entitled to deference by the court. *Chevron* deference is appropriate only where Congress delegated authority to the agency to make rules carrying the force of law and the agency interpretation was promulgated in the exercise of that authority.[10] Step one of the *Chevron* test requires analyzing the language of the statute in light of statutory construction principles. If the statute is clear with respect to the issue before the court, and the regulation is faithful to the statute, that is the end of the matter. The regulation is invalid and step two of the *Chevron* test is irrelevant. If step one determines that the statute is silent or ambiguous, however, so that a regulation might fill a gap in the fabric of the tax law, the courts proceed to step two, asking whether the regulation is a reasonable interpretation of the statute. The court in *Mayo* determined that Congress in enacting the language of section 170(b)(1)(A)(ii) clearly defined qualified organization and it did so without a requirement that education be the sole or primary activity of the organization. Thus, the court concluded that a primarily educational/merely incidental rule as set forth in the regulations was not intended. That was evident, in the view of the court, from the very next subsection, 170(b)(1)(A)(iii), which includes on its face a primary purpose test. Well-settled rules of statutory construction provide that where Congress includes a particular requirement in one subsection of a statute but does not in another, the absence in the latter is deliberate. Here, both sections 170(b)(1)(A)(ii) and (iii) were enacted by Congress at the same time, and if it had intended to limit the definition of 170(b)(1)(A)(ii) to an organization having a primarily educational purpose with merely incidental noneducational activities, it knew how to do so. Accordingly, the court determined that the regulation exceeded what was called for by section 170(b)(1)(A)(ii) and, therefore, was unlawful. Thus, Mayo was entitled to its $11.5 million refund.

The *Mayo* case is a rare recent taxpayer victory in the wake of a general uptick in regulation invalidity claims. For example, in the closely-followed *Altera Corporation & Subsidiaries v. Commissioner*[11] case, the taxpayer ultimately lost in the Ninth Circuit with respect to claims that certain cost sharing regulations were invalid. Similarly, in *SIH Partners LLLP v. Commissioner*,[12] the taxpayer lost in the Third Circuit in its challenge to regulations promulgated under section 956(d). In *Kisor v. Wilkie*, cited in the *Mayo* decision, the Supreme Court recently grappled with a slightly different standard of deference, the kind afforded to an agency with respect to interpretations of the agency's own regulations.[13] However, concurring opinions by Chief Justice Roberts, Justice Gorsuch, and Justice Kavanaugh appear also to take aim at *Chevron* deference and allude to a veiled interest in perhaps one day overturning it entirely. If that day comes, federal agencies would be forced to defend their regulations without judicial deference weighing in their favor. Courts, in turn, would take on a larger role in interpreting the meaning and validity of those regulations, leaving the possibility of variations across jurisdictions.

The UBIT rules are complex and are an area of particular concern for many section 501(c)(3) organizations that engage in various investment activities. In particular, section 501(c)(3) organizations that engage in educational activities but have not historically met the primarily educational/not merely incidental requirements of the section 170(b)(1)(A)(ii) regulations may now be treated as qualified organizations. Accordingly, such organizations should consult with their tax advisors to determine the impact the *Mayo* decision may have on prior and future investment opportunities. Taxpayers in disputes with the IRS generally, whether tax-exempt or not, also should consult with their tax advisors to carefully consider whether challenging regulations relied on by the IRS may be a viable path to relief.

[1] *Mayo Clinic v. United States of America*, File No. 16-cv-03113 (D. Minn. Aug. 8 2019).
[2] *See e.g., Altera Corp. and Subs. v. Commissioner*, 926 F.3d 1061 (9th Cir. 2019) (upholding the validity of cost-sharing regulations promulgated under section 482); *SIH Partners, LLLP v. Commissioner*, 923 F.3d 296 (3d Cir. 2019) (upholding the validity of regulations promulgated under section 956(d)).
[3] IRC §§ 511-514.
[4] IRC §§ 511(a), 512.
[5] IRC §§ 512(b)(1), (3).
[6] IRC §§ 512(b)(4), 514.
[7] IRC § 514(c)(9)(B). The fractions rule requires that a qualified organization must not be allocated net taxable income or gain for any year in excess of its percentage share of overall partnership loss for the partnership tax year in which that percentage is the smallest. It also requires that each allocation with respect to the partnership has substantial economic effect within the meaning of section 704(b)(2). The purpose of the rule is to prevent a partnership from disproportionately allocating taxable income to tax-exempt investors while disproportionately allocating losses to taxable investors.
[8] IRC § 170(b)(1)(A)(ii).
[9] Treas. Reg. § 1.170A-9(c)(1).
[10] *Mayo Found. v. United States,* 562 U.S. 44, 57 (2011).
[11] 926 F.3d 1061 (9th Cir. 2019).
[12] 923 F.3d 296 (3d Cir. 2019).
[13] *Kisor v. Wilkie*, No. 18-15 (June 26, 2019).