XI. Mayo Clinic v. United States*: Are Tax-Exempt Academic Medical Centers "Educational Organizations" under U.S. Tax Law?*

A. Introduction

Tax law often requires interpreting words that seem clear until the right controversy comes along—and interpretation can be costly. The Internal Revenue Service (IRS) and Minnesota's Mayo Clinic recently disputed the definition of "educational organization."[1] At stake for the Mayo Clinic: an $11.5 million tax refund.[2] More broadly implicated for sophisticated tax-exempt organizations, particularly academic medical centers (AMCs),[3] are questions about what counts as an "educational organization," whether AMCs are justified in claiming the designation, and how tax-exempt organizations should self-identify if they seek to follow in the Mayo Clinic's footsteps and claim exemption from paying certain forms of unrelated business income taxes.

This article walks through the current rules under both the U.S. Internal Revenue Code (IRC) and accompanying Treasury Department (Treasury) Regulations for determining unrelated business income tax liability from debt-financed real property. It summarizes the controversy in *Mayo Clinic v. United States* and explains why the outcome matters for AMCs.[4] Finally, it suggests various ways that the impending Eighth Circuit ruling could impact sophisticated tax-exempt organizations like AMCs.

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[1] Mayo Clinic v. United States, No. 16-CV-03113, 2019 WL 3574709, at *2 (D. Minn. Aug. 8, 2019).
[2] *Id.*
[3] Jan Murray & Kathleen Burch, *Recent Trends in Academic Medical Center Mergers, Acquisitions and Affiliations*, 26 No. 3 HEALTH L. 29, 29 (2014) ("AMCs are multi-faceted healthcare organizations comprised of patient care and research facilities that also operate a medical school or are affiliated with a medical school and university. Therefore, AMCs are organized around a tripartite mission; patientcare, education and research.").
[4] *See generally* Mayo Clinic, No. 16-CV-03113, 2019 WL 3574709.

B. Tax-Exempt Organizations and UBIT

1. When Are Tax-Exempt Organizations Liable for Taxes?

Even when a non-profit organization qualifies for a "tax-exempt" status, it may still owe federal taxes.[5] Tax-exempt organizations are generally taxed for income unrelated to their charitable mission—taxes known as unrelated business income taxes (UBIT), assessed on unrelated business taxable income (UBTI).[6] The IRC defines UBTI as income from "any trade or business the conduct of which is not substantially related . . . to the exercise . . . by such organization of its charitable, educational, or other purpose."[7]

The IRS does not tax some forms of UBTI, including passively-generated UBTI, under the so-called "passive-income exclusion."[8] Dividends on endowments, for example, are generally not taxed.[9] UBIT is generated, however, on debt-financed passive income from real property.[10] Borrowing money to purchase property creates an "acquisition indebtedness."[11] Thus, income from real property is considered debt-financed "if at any time during the tax year there was

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[5] *See generally* I.R.S., PUBL'N. 598, TAX ON UNRELATED BUSINESS INCOME (2019) (detailing when tax-exempt organizations owe taxes for unrelated business income and providing helpful examples to define "unrelated business income").

[6] I.R.C. § 512 (2018) (defining "Unrelated Business Taxable Income").

[7] I.R.C. § 513(a) (2018) ("General Rule" in "Unrelated Trade or Business"); *see also* PUBL'N 598, *supra* note 5, at 4 (illustrating income "not substantially related" to an exempt purpose through example: if an organization's exempt purpose is to foster public interest in art through cultural events and exhibits, the organization's leasing of apartments to artists does *not* contribute sufficiently to the accomplishment of the organization's exempt purpose, and the rental income will generate UBIT).

[8] I.R.C. § 512(b)(1)–(b)(5) (2018) (containing modifications to the general rule for calculating UBIT on passive income, excluding from taxation "dividends, interest, payments with respect to securities loans. . . .").

[9] *Id.* ("There shall be excluded all dividends[.]").

[10] I.R.C. § 514(b)(1) (2018) (defining debt-financed real property as "any property 1) held to produce income, and 2) with acquisition indebtedness at any time during the tax year . . ."); I.R.C. § 514(c)(1)(A-C) (defining "acquisition indebtedness").

[11] I.R.S., CPE for FY 1986, N. I.R.C. 514 – Unrelated Debt-Financed Income (1986) (defining acquisition indebtedness).

acquisition indebtedness outstanding for the property."[12] Under Section 514(c)(9)(C) of the IRC, "qualified organizations" are *exempt* from paying UBIT on such debt-financed passive income from real property (Section 514(c) Income).[13] "Qualified organizations" include "educational organizations," so educational organizations are not liable for UBIT on Section 514(c) Income.[14]

2. Why Must Tax-Exempt Organizations Pay Taxes?

UBTI is taxable as a matter of policy because it aims to prevent "unfair competition" between tax-exempt and non-exempt entities.[15] Congress passed the Revenue Act of 1950 in response to an outcry from small business owners and others against tax-exempt organizations using their tax-exempt status to gain a competitive financial edge—particularly through "leaseback transactions."[16] The thrust of these transactions involved tax-exempt organizations borrowing funds to purchase real estate, leasing the property back often to the seller, and using tax-free rental income to pay off the debt (ultimately coming out ahead).[17] These arrangements were deemed unfair because

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[12] I.R.S., 2018 Instructions for the Form 990-T, 24, https://www.irs.gov/pub/irs-dft/i990t--dft.pdf.

[13] I.R.C. § 514(c)(9)(C) (2018) ("containing the definition of "Qualified Organization").

[14] *Id.* ([T]he term 'qualified organization' means an organization described in section 170(b)(1)(A)(ii)[.]") (internal quotations and punctuations omitted).

[15] *See* H. R. REP. NO. 81-2319, at 36 (1950) ("The problem at which the tax on unrelated business income is directed here primarily that of unfair competition."); United States v. Am. Coll. of Physicians, 475 U.S. 834, 837 (1986) ("[t]he statute was enacted in response to perceived abuses of the tax laws by tax-exempt organizations that engaged in profit-making activities."); James K. Hasson, Jr. & Suzanne Ross McDowell, *Unrelated Business Tax Income (UBIT): Pushing the Boundaries of Section 512(B)*, 2011 A.L.I. 351, 353 ("First enacted in 1950, the purpose of the unrelated business income tax ("UBIT") is to eliminate any unfair competitive advantage that exempt organizations may have over their for-profit counterparts by imposing a tax on business activities that not related to their exempt purposes.").

[16] Kenneth Liles & Cynthia Blum, *Development of the Federal Tax Treatment of Charities*, 39 LAW & CONTEMP. PROBS. 4, 45 (1975).

[17] *Id.* (pointing to several controversial examples of purchase & lease-back transactions by tax-exempt entities); *see also* Revenue Act of 1950, Pub. L. No. 64-814, §§ 301, 331, 64 Stat. 906, 947, 957 (codified as amended at

a tax-exempt organization could avoid investing any of its own money in the transaction and could give buyers better terms than for-profit entities could offer.[18] As such, current tax law requires that tax-exempt organizations pay taxes on income unrelated to the organization's charitable purpose.[19]

As a policy matter, however, other forms of passive income including dividends and endowment growth remain tax-exempt because Congress deemed them "proper" for charitable organizations.[20] Originally, "qualified retirement funds" were exempted from paying UBIT on debt-financed property because the exemption was deemed "an essential tax incentive . . . provided to tax-qualified plans in order to enable them to accumulate funds to satisfy their exempt purposes — the payment of employee benefits."[21] That exemption was widened in 1984[22] to include "educational organizations" as defined in Section 170(b)(1)(A)(ii) of the IRC.[23] Today's IRC exempts several categories of "qualified" tax-exempt organizations from passive income on debt-financed real property in some circumstances.[24] The original policy concerns addressed in exempting qualified retirement funds from paying Section 514(c) Income seem less relevant for these

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I.R.C. §§ 502-514 (1954)) (defining "unrelated business net income" and providing for its taxation); *Revenue Revision of 1950: Hearings Before the H. Comm. on Ways and Means*, 81st Cong. 579–80 (1950) (discussing the notorious example of a purchase and lease-back of a private spaghetti factory by New York University).

[18] Liles & Blum, *supra* note 16, at 47 (describing Congress's aversion to a tax-exempt organization involved in a leaseback transaction "trading on its exemption"); *see also* Diane L. Fahey, *Taxing Nonprofits Out of Business*, 62 WASH & LEE L. REV. 547, 549 (2005) (discussing the competitive advantage that tax-exempt organizations had in commercial transactions).

[19] I.R.C. § 514(c)(9) (2018) (describing treatment of debt incurred in acquisition or improvement of real property by a qualified organization).

[20] H.R. REP. NO. 81-2319, at 38 (1950) ("Your committee believes that such 'passive' income should not be taxed where it is used for exempt purposes because investments producing income of these types have long been recognized as proper for educational and charitable organizations.").

[21] S. REP. NO. 96-1036, at 29 (1980).

[22] Deficit Reduction Act of 1984, Pub. L. No. 98-396 § 1034, 98 Stat. 494 (1984).

[23] I.R.C. § 170(b)(1)(A)(i–ii) (2018) (defining "educational organization").

[24] PUBL'N 598, *supra* note 5 (enumerating qualified organization requirements).

organizations as they exist today, but that is the current state of the law.[25]

Tax-exempt organizations rely on both the IRC itself and the Treasury's clarifying regulations to navigate the complex labyrinth of exemptions, exceptions, and exceptions to exceptions.[26] To provide taxpayers the necessary information for meeting their tax responsibilities, the IRS promulgates regulations to "find the proper interpretation of the statutory provision and not to adopt a strained construction in the belief that he or she is 'protecting the revenue.'"[27] One type of regulation promulgated is the interpretative regulation.[28] This type of regulation "advise[s] the public of the agency's construction of the statutes it administers"[29] when Congress has provided specific rules but has left gaps for the IRS to fill.[30]

C. The Mayo Clinic and UBIT

1. Mayo Clinic v. United States

The Mayo Clinic (Mayo) is a tax-exempt, non-profit organization in Minnesota.[31] This means that Mayo is organized and operated

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[25] *See* David O. Kahn, *Help with Fractions: A Fractions Rule Primer*, TAX NOTES 953, 954 (2010) ("The subsequent extension of this benefit over time to a limited subset of other tax-exempt organizations is more difficult to justify from a policy perspective, but, justified or not, the four classes of [qualified] organization[s] . . . may today incur acquisition indebtedness to acquire or improve real property without causing the income produced by that investment to be subject to tax as debt-financed UBTI.").

[26] I.R.S., *Understanding IRS Guidance—A Brief Primer* (June 28, 2019), https://www.irs.gov/newsroom/understanding-irs-guidance-a-brief-primer ("[a] regulation is issued by the Internal Revenue Service and Treasury Department to provide guidance for new legislation or to address issues that arise with respect to existing Internal Revenue Code sections.").

[27] IRM 32.1.1.2 (Aug. 2, 2018), https://www.irs.gov/irm/part32/irm_32-001-001 ("Part 32: Published Guidance and other Guidance to Taxpayers, Ch. 1 § 1").

[28] IRM 32.1.1.2.6 (Sept. 23, 2011) (defining "interpretative regulations").

[29] *Id*.

[30] IRM 32.1.1.2.8 (Aug. 2, 2018) ("How to Determine if a Rule is Interpretative or Legislative").

[31] "Tax-exempt" status refers to an organization's designation according to the IRS, while "non-profit," interchangeable with "charity," is a descriptive designation to indicate that an organization operates for a charitable purpose. I.R.S.,

exclusively for an exempt purpose under Section 501(c)(3) of the IRC, which includes "religious, charitable, scientific, testing for public safety, literary, or educational purposes."[32] Under that section, "substantially all" of the organization's activities must be directed at the exempt purpose.[33] Additionally, a tax-exempt organization may not use net earnings to the benefit of any private shareholder or individual.[34] Mayo qualifies for tax-exempt status because its purpose is to "provide the best care to every patient through integrated clinical practice, research, and education," which qualifies as an exempt purpose.[35]

Importantly for Mayo, the parent entity of several medical schools, "educational organizations" are among the list of qualified organizations.[36] If Mayo properly self-identifies as an educational organization, it would be exempt from paying $11.5 million in taxes generated through debt-financed passive income during tax years 2003, 2005–2007, and 2010–2012.[37] The IRS informed Mayo in 2013 that it did not consider Mayo an "educational organization."[38] Mayo

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Frequently Asked Questions About Applying for Tax Exemption (Sept. 25, 2019), https://www.irs.gov/charities-non-profits/frequently-asked-questions-about-applying-for-tax-exemption ("Nonprofit status is a state law concept. Nonprofit status may make an organization eligible for certain benefits, such as state sales, property and income tax exemptions . . . [but] organizing as a nonprofit organization at the state level does not automatically grant the organization exemption from federal income tax. To qualify as exempt from federal income tax, an organization must meet requirements set forth in the Internal Revenue Code.").

[32] I.R.C. § 501(c)(3) (2018) (providing a list of organizations that qualify for tax-exempt status).

[33] *See, e.g.*, I.R.S. Priv. Ltr. Rul. 201907011 (Feb. 15, 2019) (notifying an organization that it does not qualify for tax-exempt status because "substantially all" of its activities were directed at furthering the common business purposes of its members, rather than a permissible exempt purpose).

[34] *Id.* (describing § 501(c)(3) requirements for exemption).

[35] Mayo Clinic, I.R.S. Form-990 (2008).

[36] I.R.C. § 512(c)(9)(C) (2018) (referencing as exempt from debt-financed passive income those "qualified organizations" further described in I.R.C. § 170(b)(1)(A)(ii), including "educational organizations.").

[37] Mayo Clinic, No. 16-CV-03113**,** 2019 WL 3574709, at *1 (D. Minn. Aug. 8, 2019) ("Mayo Clinic brought this case to obtain $11,501,621 in tax refunds.").

[38] *Id.* at 2 ("In 2013, the IRS issued a Technical Advice Memorandum confirming its position that Mayo did not qualify as an "educational organization.").

sued in 2016 to recover the taxes it had paid on its Section 514(c) Income.[39]

2. What Is an "Educational Organization"?

The major controversy in *Mayo Clinic*—whether Mayo was on the hook for $11.5 million in UBIT—arose because tax-exempt organizations can point to two discrete places to guide the meaning of "educational organization."[40] The first comes from an IRC section passed in 1954, Section 170(b)(1)(A)(ii) (the Statute), that establishes a four-part definition for "educational organization."[41] Mayo argued that this definition should be controlling.[42] The second comes from an interpretative regulation promulgated in 1973 by the Treasury intended to clarify the IRC's definition of "educational organization" (the Regulation).[43] The Regulation added two additional prongs to the Statute's four-part definition.[44] The IRS contended that the Regulation's clarifications were crucial to understanding "educational organization," and that Mayo failed to meet the definition.[45]

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[39] Mayo Clinic v. United States, No. 0:16-CV-03113-JNE-KMM, 2017 U.S. Dist. LEXIS 219873 (D. Minn. Dec. 15, 2017).

[40] Mayo Clinic, No. 16-CV-03113**,** 2019 WL 3574709 at *2 (describing the government's argument that the regulatory definition should control).

[41] I.R.C. § 170(b)(1)(A)(ii) (2018); referenced in I.R.C. § 514(c)(9)(C) ("for the purposes of this paragraph, the term 'qualified organization' means . . . an organization described in section 170(b)(1)(A)(ii)").

[42] Mayo Clinic, No. 16-CV-03113, 2019 WL 3574709 at *1 (setting forth the statutory definition); *see also* Mayo Clinic, No. 0:16–CV–03113–JNE–KMM, 2017 WL 8676991, at *1 (articulating Mayo's argument in the alternative that it satisfies the Treasury Regulation's definition because it "integrates patient care with medical education, has been providing graduate medical education for many years, and references education among its purposes in the organization's Articles of Incorporation and Bylaws.").

[43] Treas. Reg. § 1.70A-9(c)(1) (1973) (26 C.F.R. § 1.170A-9(c)(1)) (defining "educational organization" as referenced in I.R.C. § 170(b)(1)(A)(ii) (2018)).

[44] *Id.* ("[The definition] does not include organizations engaged in both education and noneducational activities unless the latter are merely incidental to the educational activities.").

[45] Defendant's Memorandum of Law in Support of Its Summary Judgment Motion at 24–25, Mayo Clinic v. United States, 2019 WL 3574709 (D. Minn. Aug. 8, 2019) (No. 16-CV-03113) (arguing that the Regulation's additional criteria for "educational organizations" necessary because the Statute does not define "educational organization" outright).

The IRC does not explicitly define "educational organization."[46] Instead, four factors provide a test.[47] To be considered an "educational organization" under the Statute, organizations must satisfy the "faculty-curriculum-student-place" definition: (1) to "normally maintain[] a regular faculty" (2) "and curriculum and" (3) to "normally ha[ve] a regularly enrolled body of pupils or students in attendance" (4) "at the place where its educational activities are regularly carried on."[48] Mayo contended that it "easily met" the Statute's definition of "educational organization."[49] Mayo is a parent organization to five degree-granting medical schools.[50] It oversees the schools, expects "all physicians" to serve as faculty at the schools, and provides "resources necessary" to support graduate education at the schools.[51] The schools have established curricula and reach thousands of students each year, who study in classrooms and clinics.[52] Thus, the "faculty-curriculum-student-place" requirements were fulfilled, according to Mayo.[53]

The United States conceded that Mayo fulfills the Statute's four requirements, but contended that the Regulation adds two mandatory requirements to the "faculty-curriculum-student-place" definition: (1) that education is the organization's primary function,

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[46] *See* I.R.C. § 170(b)(1)(A)(ii) (2018); *see also, generally*, I.R.C. §§ 1–9834 (2018).

[47] *Id.* (stating the four statutory elements of the test).

[48] *Id.*

[49] Plaintiff's Memorandum of Law in Support of Its Summary Judgment Motion at 25, Mayo Clinic v. United States, 2019 WL 3574709. (D. Minn Aug. 8, 2019) (No. 16-CV-03113) [hereinafter Plaintiff's Memorandum of Law] ("If the Court agrees that Mayo's administrative activities are "educational," the test is easily met").

[50] Mayo Clinic, No. 16-CV-03113, 2019 WL 3574709, at *3. ("The College is comprised of five distinct medical schools that offer M.D., Ph.D., and other degrees, as well as residencies, fellowships, and continuing medical education[.]").

[51] Plaintiff's Memorandum of Law, *supra* note 49, at 9. ("Mayo enabled faculty members . . . by providing the resources necessary to support graduate medical education . . . Mayo expected all physicians to serve as faculty at the Schools[.]").

[52] *Id.* at 10 ("Mayo normally maintained a curriculum during the Refund Years. . . . From 2003–2012, total enrollment at the Schools ranged from 2,584 to 3,579 . . . Educational activities were regularly carried out in Mayo's hospitals, clinics, laboratories, classrooms, computer labs, simulation centers, and conference rooms.").

[53] *Id.* at 11 ("Accordingly, Mayo meets the statute's definition of an 'educational organization' and is entitled to a tax exemption.").

and (2) for an organization engaged in both education and non-educational activities, that those non-educational activities are "merely incidental to the educational activities."[54] The IRS contended that Mayo's *primary* exempt purpose was healthcare—not education—and that Mayo's patient services were not "merely incidental" to its educational activities.[55] The United States argued that Mayo "consistently and candidly admitted that it is a hybrid organization whose primary purpose is to provide healthcare."[56] The United States pointed to statements from Mayo CEOs, among other sources, to argue that Mayo is more of a holding company providing "back door functions" for its operating subsidiaries, including non-exempt subsidiaries.[57] As such, Mayo was outside of the regulation's definition because its primary function was patient care, rather than education, and because Mayo's non-educational purposes were far from "merely incidental" to its educational activities.[58]

Both parties quibbled about the definition of "primary" in the Regulation. Mayo argued that one dictionary definition of "primary" is "essential" or "fundamental"—a "substantial function"—and that under that definition, Mayo's educational activities easily qualified as "primary" under the Regulation.[59] The United States relied on an understanding of "primary" as "particular . . . single, distinct, or

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[54] I.R.C. § 170(b)(1)(A)(ii) (2018) (setting out four factors required for an educational organization).

[55] Defendant's Memorandum of Law, *supra* note 45, at 25 ("[Mayo] cannot establish that its primary function is to provide formal instruction or that its noneducational activities are merely incidental to its educational activities.").

[56] *Id.* at 26.

[57] *Id.* at 11–12, 14 (pointing to several factors to argue that Mayo was not primarily an education organization, including a former Mayo CEO's statement that Mayo was "an integrated practice of medicine that has a research arm and an educational arm;" approximately 90% of Mayo's revenue was from support/shared services, while under 8% was from education; and Mayo's logo included three shields to demonstrate three purposes: education, research, patient care (the largest shield)).

[58] *Id.* at 25–26 ("Mayo Clinic's primary function is not to provide formal instruction, and its noneducational activities are anything but "merely incidental" to its educational activities.").

[59] Plaintiff's Memorandum of Law, *supra*, note 49, at 20–21 ("For other accepted and common meanings of 'primary' are 'essentially . . . or 'fundamentally'[.]") (quoting from Bd. of Governors of Fed. Reserve Sys. v. Agnew, 329 U.S. 441, 446 (1947)).

specific."[60] Mayo's obvious "tripartite [commitment to] education, patient care, and research" meant that it could not reasonably claim "education" as its singular purpose.[61]

Mayo also consulted a dictionary when interpreting the requirement that all non-educational activities be "merely incidental to the educational activities."[62] To avoid the outcome that patient care and research were "merely incidental" to formal teaching, Mayo defined "non-educational activities" as anything *not related* to education, while "educational" activities encompassed anything "at minimum, related to education."[63] Since patient care and research are related to, and in fact further, Mayo's educational purposes, Mayo argued that its activities met the Regulation's requirement.[64] The United States did not define "merely incidental," but instead argued that Mayo's noneducational activities were "anything but 'merely incidental' to the educational activities . . ." and argued that instead, "[i]t's the reverse."[65]

The court applied the two-part test of *Chevron U.S.A. v. Natural Resources Defense Council, Inc.*,[66] to determine whether it should defer to the Regulation's definition of "educational organization."[67] Courts use the *Chevron* analysis when "it appears that Congress delegated the authority to the agency generally to make rules carrying the force of law," and an agency has exercised that authority.[68] The first step of the analysis asks "whether Congress has directly spoken to the precise question at issue."[69] If the "intent of Congress is

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[60] Defendant's Memorandum of Law, *supra* note 45, at 9–10 ("An organization's particular purpose . . . refer[s] to the organization's single, distinct, or specific purpose.").

[61] *Id.* at 10 (enumerating Mayo's other noneducational activities).

[62] Treas. Reg. § 1.70A-9(c)(1) (1973) (26 C.F.R. § 1.170A-9(c)(1)).

[63] Plaintiff's Memorandum of Law, *supra* note 49, at 25 ("Thus, 'noneducational' means 'not of or related to education.'").

[64] *Id.* ("The facts and case law show that Mayo's patient care and research activities are, at minimum, related to education.").

[65] Defendant's Memorandum of Law, *supra* note 45, at 26.

[66] 467 U.S. 837 (1984).

[67] In 2011, the Supreme Court held in *Mayo Found. for Med. Educ. & Research v. United States*, 56 U.S. 44, 55–56 (2011), that *Chevron* applied in full force in the tax context.

[68] United States v. Mead Corp., 533 U.S. 218, 226–27 (2001).

[69] Chevron, U.S.A. v. Nat. Res. Def. Council, Inc., et al., 467 U.S. 837, 842–43 (1984).

clear," the statute wins over a competing agency promulgation.[70] If the statute is silent or ambiguous, the *Chevron* analysis proceeds and asks "whether an agency's answer is based on a permissible construction of the statute," and if it is, the court will defer to the promulgation unless it is "arbitrary, capricious, or manifestly contrary to the statute."[71]

Framing the precise question at issue thus becomes centrally important in a *Chevron* analysis. Here, the court articulated that question as "whether [the Statute] is silent or ambiguous with respect to the primary-function and merely-incidental requirements in the regulation."[72] But, ambiguity does not arise simply when the parties' interpretations fail to align and the court finds both interpretations reasonable.[73] Context—including statutory text, structure, purpose, and history—guides courts in answering whether true ambiguity exists and the *Chevron* analysis proceeds to the second step.[74] The court thus looked at the statutory construction of the Statute in light of related provisions in the text[75] and found that the "primary-function" and "merely-incidental" requirements in the Regulation exceeded the bounds of the Treasury's statutory authority.[76] Specifically, the court highlighted the *inclusion* of an explicit "primary-function" requirement in a related IRC section passed at the same time[77] as the Statute, Section 170(b)(1)(A)(iii) of the IRC which defines another type of qualified organization.[78] Under principles of statutory construction, the

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[70] *Id.*
[71] *Id.*
[72] Mayo Clinic, No. 16-CV-03113, 2019 WL 3574709, at *4 (D. Minn. Aug. 8, 2019).
[73] *See* Mayo Clinic, 2019 WL 3574709, at *4 ("It is not enough, as the [Federal Circuit] did here, that '[b]oth parties insist that the plain regulatory language supports their case and neither party's position strikes us as unreasonable.'") (quoting Kisor v. Wilkie, 139 S. Ct. 2400, 2423 (2019)).
[74] Kisor v. Wilkie, 139 S. Ct. 2400, 2415 (2019) at 2415 (concluding that courts must look to context to resolve ambiguity).
[75] *See* Chevron, 467 U.S. at 842–43 ("[T]he goal of statutory analysis, of course, is to give effect to the Congressional intent behind the statute's enactment[.]").
[76] Mayo Clinic, No. 16-CV-03113, 2019 WL 3574709, at *23 ("Treasury Department exceeded the bounds of its statutory authority when it promulgated the primary-function requirement and merely-incidental test[.]").
[77] 1954 Internal Revenue Code, as enacted by Pub. L. No. 83-591 (codified at I.R.C. § 170).
[78] I.R.C. § 170(b)(1)(A)(iii) (defining another type of qualified organization's requirements as "an organization the *principal purpose* or functions of which

court contended, inclusion of text in part (iii) of this section of the IRC but not in the Statute demonstrated intent to omit that text from part (ii).[79] As for the "merely-incidental" requirement, the court characterized the requirement as "opposing expressions of the same test," and disposed of that requirement under the same principles of statutory interpretation.[80]

The upshot of the court's analysis is that Congress spoke clearly when it omitted from one section, but not other related sections, primary-function and merely-incidental requirements in the Statute's definition of "educational organization."[81] If Congress intended to include those additional prongs, found in the Regulation, it would have done so.[82] As a result, the court granted Mayo's motion for summary judgment on its refund claims of $11.5 million and held that the Regulation's primary-function and merely-incidental requirements are unlawful because they exceed the Treasury's authority.[83]

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are the providing of medical or hospital care or medical education or medical research. . . .") (emphasis added).

[79] Mayo Clinic, No. 16-CV-03113, 2019 WL 3574709, at *18–19 ("Romanette (ii) should not be understood implicitly to contain the very same requirement that is explicit in romanette (iii).").

[80] *See id.* at *20 ("The Parties seem to understand the primary-function requirement and merely-incidental test as opposing expressions of the same test); *see also* Plaintiff's Memorandum of Law, *supra* note 49, at 24 ("Because Mayo's 'primary' function is educational, it necessarily meets this [merely-incidental] prong of the regulation's test, too. (Other functions of an organization would inherently be 'incidental' to the organization's 'primary' function)."); Defendant's Reply Brief in Support of Its Summary Judgment Motion and Response to Plaintiff's Summary Judgment Motion at 36–37, Mayo Clinic v. United States, 2019 WL 3574709 (D. Minn. Aug. 8, 2019) (No. 16-cv-03113) (arguing that the regulation's merely-incidental language "demonstrate[s] that an 'educational' organization's principal function must be the presentation of formal instruction . . . with all other activities being incidental to that activity").

[81] Mayo Clinic, 2019 WL 3574709, at *33 ("The conclusion that a primary-function or merely-incidental requirement is inconsistent with § 170(b)(1)(A)(ii) is based primarily on the explicit presence of a primary-purpose test in the next subsection of the same statute, § 170(b)(1)(A)(iii).").

[82] *Id.* at *15 ("W]hen Congress includes particular language in one section of a statute but omits it in another—let alone in the very next provision—this Court presume[s] that Congress intended a difference in meaning.") (quoting from Loughrin v. United States, 573 U.S. 351, 358 (2014)).

[83] *Id.* at *3 (discussing the holding of the case).

D. Ramifications for Tax-Exempt Organizations

1. Can AMCs Overcome "Primary Purpose" and "Merely Incidental" Requirements?

Many large non-profit organizations, particularly those with multiple charitable purposes, anxiously tracked the *Mayo Clinic* case.[84] At least 120 large tax-exempt organizations in the U.S. describe themselves as AMCs that provide patient services *and* education.[85] Some estimates point to around 400 total AMCs in the U.S.[86] AMCs have both hospital beds and classrooms, and have been defined as "hospitals and health systems with a close affiliation with a medical school."[87] AMCs' organizational configurations and assets can be complex—often including real property that generates Section 514(c) Income.[88] AMCs are large, particularly by tax-exempt standards: an average AMC's medical education budget contains anywhere from $140 million to $1.7 billion in annual funding.[89] AMCs graduate tens

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[84] *See, e.g.*, Ayla Ellison, *Mayo Clinic, IRS Face Off in Federal Court*, BECKER'S HOSP. CFO REP. (July 2, 2019), https://www.beckershospitalreview.com/finance/mayo-clinic-irs-face-off-in-federal-court.html; Michael L. Wyland, *Mayo Clinic's Primary Activity Could Cost It Millions in Taxes*, THE NONPROFIT Q. (June 20, 2018), https://nonprofitquarterly.org/mayo-clinics-primary-activity-could-cost-it-millions-in-taxes/ (both discussing the disposition of the case).

[85] Melissa Korn, *Once Cash Cows, University Hospitals Now Source of Worry for Schools*, WALL ST. J. (Apr 22, 2015), https://www.wsj.com/articles/universities-get-second-opinion-on-their-hospitals-1429725107 (citing the Association of American Medical College's finding of about 120 AMCs in the United States as of 2015).

[86] Webinar: Financing the Academic Mission, ASS'N OF AM. MED. COLLS. (Jan. 27, 2015) https://www.aamc.org/professional-development/affinity-groups/gba/webinar-financing-academic-mission (citing around 400 teaching hospitals and 310 Council of Teaching Hospitals (COTH) membership hospitals).

[87] *Id.*

[88] *Id.*

[89] *See id.* (citing the median budgets for research-based and community-based medical school, which place less focus on research than do other types of medical schools); *see also* Kerstin Frailey, *What Does the Nonprofit Sector Really Look Like?* GUIDESTAR BLOG (Jan. 6, 2017, 8:00 AM), https://trust.guidestar.org/what-does-the-nonprofit-sector-really-look-like (finding that the 66% of all nonprofits have annual budgets under $1M).

of thousands of medical students each year, and their faculties often focus on innovative medical research, providing students with unique clinical opportunities.[90] These factors demonstrate that education is a fundamental part of an AMC's work—but they also suggest that education is not the *primary* purpose of an AMC's work under a commonsense understanding of the word "primary."[91] Moreover, finding non-educational activities (like patient care) "merely incidental" to an AMC's education mission seems inaccurate.

AMCs share "a tripartite mission: patient care, education, and research."[92] The three strands of an AMC's work "[define] academic medicine."[93] Many AMCs thus rejoiced when the court ruled in Mayo's favor and invalidated the primary-function and merely-incidental requirements in the Regulation.[94] Had the court upheld the Regulation's additional requirements, tax-exempt AMCs like Mayo

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[90] PWC, Report, *The Future of the Academic Medical Center: Strategies to Avoid a Margin Meltdown*, HEALTH RESEARCH INSTITUTE (2012) https://uofuhealth.utah.edu/hcr/2012/resources/the-future-of-academic-medical-centers.pdf ("AMCs graduate nearly 17,000 MDs every year[.]"); *see also* Webinar, *supra* note 86 **(**estimating 17,000 medical students graduate per year).

[91] Webster's Dictionary defines "primary" as "of first rank, importance, or value." *Primary*, MERRIAM-WEBSTER DICTIONARY ONLINE, https://www.merriam-webster.com/dictionary/primary?src=search-dict-hed (last visited Nov. 10, 2019).

[92] Recent Trends, *supra* note 3, at 29 ("AMCs are organized around a tripartite mission; patient care, education and research."); *see also* PWC, Report, *supra* note 90, at 5 ("AMCs, with their tripartite mission of patient care, teaching, and research, have thrived for many years.").

[93] ASS'N OF AM. MED. COLLS., *Careers in Medicine*, https://www.aamc.org/cim/career/practice/teaching/ (referencing AMCs' "tripartite mission of teaching, research, and clinical care").

[94] *See, e.g.*, Sean Baker, *Court Sides with Mayo Clinic in $11.5 million IRS Dispute*, MEDCITYBEAT (Aug. 8, 2019), https://www.medcitybeat.com/news-blog/2019/mayo-wins-irs-ruling; Daryll K. Jones, *Minnesota Federal District Court Invalidates Treas. Reg. 1.170A-9(c)(1) (defining "educational organization") based on* Chevron *Analysis*, NONPROFIT L. PROF BLOG (Aug. 7, 2019), https://lawprofessors.typepad.com/nonprofit/2019/08/minnesota-federal-district-court-invalidates-treas-reg-1170a- 9c1-defining-educational-organization-b.html; James R. Malone, Jr., *UBIT and Educational Organizations: the IRS Gets Schooled on* 'Chevron', TAX CONTROVERSY POSTS (Aug. 19, 2019), http://taxcontroversyposts.postschell.com/ubit-and-educational-organizations-the-irs-gets-schooled-on-chevron/ (both discussing the district court opinion).

would be forced either to claim that education serves as their *primary* exempt purpose or to argue for a contorted understanding of "primary."[95] As discussed above, both Mayo and the United States turned to the dictionary to define "primary"—and, while Mayo proposed an acceptable definition of primary as "fundamental" to demonstrate compliance with the primary purpose requirement, this seems like a stretch.[96] Clever definitional acrobatics can also bring AMCs into compliance with the "merely incidental" test, but it would be far cleaner to assess whether AMCs qualify as "educational organizations" under the Statute alone.

2. Is It Fair to Tax AMCs for Section 514(c) Income?

Congress and the Treasury have long wrestled with the difficult balance between promoting tax-exempt organizations' many public benefits and limiting abuse of their special designation.[97] To choose one example, the director of the National Federation of Independent Businesses came before Congress in 1987 to bring complaints that non-profit hospitals were unfairly benefitting from tax-exemption by expanding their real estate footprint for lower costs than for-profit entities had to bear.[98] Perhaps small business—or for-profit hospitals—will again contend that AMCs and other sophisticated organizations have an unfair advantage, and will argue in favor of the Regulation's strict enforcement.

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[95] *See* Defendant's Reply Brief *supra* note 80, at 35 (decrying Mayo's unusual definition of "primary" and instead defining "primary" according to Oxford English Dictionary as that which is "of the highest rank or importance; principal, chief.").

[96] *See* Plaintiff's Memorandum of Law *supra* note 49, at 19–20; Defendant's Memorandum of Law, *supra* note 45, at 8 (both discussing various dictionary definitions of 'primary').

[97] Jeremy J. Schirra, *A Veil of Tax Exemption?: A Proposal for the Continuation of Federal Tax-Exempt Status For "Nonprofit" Hospitals*, 21 HEALTH MATRIX 231, 242–46 (2011) (discussing history of hospitals' tax-exempt status).

[98] *Unrelated Business Income Taxation: Hearing Before the Subcomm. on Oversight of the H. Comm. of Ways and Means*, 100th Congress 1 (1985) (statement of John H. Motley III, Director of the National Federation of Independent Businesses) ("[C]urrent law does indeed give nonprofits a competitive advantage in the marketplace where they choose to compete with for-profit businesses.").

As noted, Congress's original intent in exempting Section 514(c) Income from taxation for qualified organizations was to balance assisting tax-exempt organizations and reigning in abuse from their special tax status.[99] Though hospitals originated from "very modest means," AMCs today share little resemblance to those humble origins.[100] The sheer size, number, and capital of many AMCs has led some commentators to question whether AMCs deserve the assistance.[101] "A simmering issue underneath various tax conflicts," writes Jon Pratt, executive director of the Minnesota Council of Nonprofits, "is the sheer size and growth of the medical and higher education sectors."[102] These sophisticated nonprofits "do not look like charity cases," and have morphed significantly from their humble early-1800s roots and modest sizes.[103] Courts hearing future claims similar to *Mayo Clinic* may determine that AMCs too closely resemble the institutions in the 1950s that led to UBIT in the first place, and that AMCs should not be considered "educational organizations" as a matter of policy.

Courts may also decide that AMCs and other sophisticated tax-exempt organizations are not "educational organizations" for fear of diminishing the tax base—one of the original concerns that led to general UBIT taxation.[104] Broadly, UBIT liability over the past decade

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[99] *See* Liles & Blum, *supra* note 16, at 15 ("Your committee does not question the contention that some organizations are abusing their tax-exempt privilege by undesirable accumulations of income . . . [h]owever . . . the measure passed by the House was too inflexible and as a result would seriously injure many worthwhile educational and charitable projects) (quoting from S. Rep. No. 2375, 81st Cong. 34 (1950)).

[100] Schirra, *supra* note 97, at 247–50 (listing several commonly-identified justifications for tax-exempt organization's special tax status).

[101] *See, e.g.*, Melvin Horwitz, *Corporate Reorganization: The Last Gasp or Last Clear Chance for the Tax-Exempt, Nonprofit Hospital?*, 13 AM J.L. & MED. 527, 530–34 (1988) (discussing several scholarly critiques of nonprofit hospitals); David A. Hyman, *The Conundrum of Charitability: Reassessing Tax Exemption For Hospitals*, 16 AM. J.L. & MED. 327 (1990) (analyzing the appropriateness of tax-exempt status for hospitals).

[102] John Pratt, *The True Story of Nonprofits and Taxes*, NONPROFIT Q. (2019), https://nonprofitquarterly.org/the-true-story-of-nonprofits-and-taxes/.

[103] *Id.*

[104] Liles & Blum, *supra* note 16, at 44 (describing unrelated business income's "double threat:" 1) narrowing the revenue base and 2) conferring unfair business advantage on tax-exempt organizations).

has been substantial.[105] In 2010, tax-exempt organizations paid $341 million in UBIT, a 28% increase from 2009,[106] and in 2015, tax-exempt organizations likely paid around $319 million.[107] The potential of exempting AMCs from paying taxes on Section 514(c) Income to shrink the tax base also means that sophisticated tax-exempt organizations (and their tax attorneys) would benefit, as did Mayo, from courts' invalidation of the Regulation.[108] The ruling provides "a very easy backdoor way for any organization to claim that it is a public charity," commented Philip Hackney of University of Pittsburgh School of Law.[109]

3. What Additional Challenges Lie Ahead for the Regulation?

It is possible to overestimate the impact of the District Court's decision as it currently stands. The District Court's invalidation of the Regulation in the District of Minnesota does not necessarily carry much weight.[110] Moreover, on October 4, 2019, the United States filed

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[105] Internal Revenue Service, *Unrelated Business Income Tax, 2012*, STATISTICS OF INCOME BULLETIN (2012), https://www.irs.gov/statistics/soi-tax-stats-exempt-organizations-unrelated-business-income-ubi-tax-statistics#2 (summarizing UBIT tax liability from 2002-2012).

[106] Jael Jackson, *Unrelated Business Income Tax Returns, 2010*, STATISTICS OF INCOME BULLETIN, at 1 (2014) (reporting total UBIT liability for 2010 and the percentage of liability increase from 2009).

[107] *See* Pratt, *supra* note 102, at 4 n.19 ("[t]he 2015 unrelated business income tax (UBIT) payments by 501(c)(3) organizations were extrapolated by the author projecting 4 percent growth from 2013 tax payments (IRS Statistics on Income, Unrelated Business Taxable Income [Less Deficit], Unrelated Business Taxable Income, and Total Tax, by Type of Tax-Exempt Organization, Tax Year 2013)").

[108] *See* Sam McQuillan, *Mayo Tax Fight Results May Be Savings for Major Hospitals*, BLOOMBERG TAX (Oct. 9, 2019), https://news.bloombergtax.com/daily-tax-report/mayo-clinic-tax-fight-result-may-be-savings-for-major-hospitals ("More hospitals may shift property investments to their academic centers in order to take advantage of the Section 514 treatment[.]").

[109] *Id.*

[110] Joseph Mead, *Stare Decisis in the Inferior Courts of the United States*, 12 NEV. L.J. 787, 789 (2012) ("[T]he practice among federal district courts is more varied and uncertain, but routinely involves little or no deference to the prior precedent of that same district court. Deprived of any significant stare decisis effect, district court decisions adjudicate present controversies but do not create law for future cases.").

a Notice of Appeal to the Court of Appeals for the Eighth Circuit.[111] The Eighth Circuit may reverse the District Court's decision and re-validate the Regulation for that Circuit. That reversal might simply maintain the status quo. "Most hospitals with affiliated programs likely don't invest to the degree the Mayo Clinic does," suggested Lloyd Hitoshi Mayer, Professor of Law at Notre Dame Law School, though "that could change."[112] As such, a reversal may not alter tax liabilities except for a few select tax-exempt organizations.

If the Eighth Circuit affirms the District Court's decision to invalidate the Regulation, ramifications will again depend on the number of tax-exempt organizations currently claiming status as an "educational organization" in order to avoid UBIT on Section 514(c) Income. Though UBIT liability from real property is significant, it is not clear exactly how many AMCs and other tax-exempt organizations would change investment strategies to minimize federal taxes. An Eighth Circuit affirmation may send a message to other federal districts to rule against AMCs and other organizations that bring claims similar to *Mayo Clinic*. This trend could make tax filings more painful for AMCs and other tax-exempt organizations that serve educational purposes alongside other charitable goals.

Regardless of the Eighth Circuit's decision, the outcome of *Mayo Clinic* may open the door for further challenges to the Regulation in other federal districts and appellate circuits. Most AMCs reference "education" in their mission statements.[113] The Cleveland Clinic, for example, describes its charitable purpose as providing "better care for the sick, investigation of their problems, and further education of those who serve."[114] New York University's Langone Health describes its mission as "making world-class contributions that place service to human health at the center of an academic culture devoted to excellence in research, patient care and education."[115] And while the Cleveland Clinic's 2017 Form-990 lists no net UBIT, Langone Health reports $5,790,250.[116] Many AMCs likely stand to

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[111] Mayo Clinic v. United States, No. 16-cv-3113-ECT-KMM (D. Minn. filed Oct. 4, 2019).

[112] McQuillan, *supra* note 108 (highlighting the recent *Mayo Clinic* decision and discussing broad-stroke concerns for tax-exempt organizations).

[113] Recent Trends, *supra* note 3, at 29 (discussing AMC's common mission of education).

[114] Cleveland Clinic, I.R.S. Form 990, at 2 (2017).

[115] NYU Langone Health, I.R.S. Form 990, at 1 (2016).

[116] *Id.* (reporting 2016 UBIT); Cleveland Clinic, I.R.S. Form 990, at 2 (2017).

lose or gain significant amounts of money depending on whether or not "educational organizations" must adhere to the Regulation's primary-function and merely-incidental requirements.[117]

Similarly, the District Court's decision and future litigation may have implications for other tax-exempt organizations with multi-pronged missions where one prong satisfies the Code's four-part definition of "educational organization." Some, like Professor Ge Bai of Johns Hopkins, see general implications for tax-exempt organizations: "an opening to create more money—that was the message this lawsuit cast into the market."[118] Since courts as recently as 2017 have relied on the Regulation to assess whether hospitals were "educational organizations," a decision to invalidate the regulation in those jurisdictions would certainly create such an opportunity.[119]

E. Conclusion

Mayo Clinic v. United States currently raises more questions than it answers. Sophisticated tax-exempt organizations stand to gain or lose millions of tax dollars depending on how far the litigation goes and whether the Supreme Court or Congress ultimately weigh in. For practitioners in the tax-exempt space, this will be a case to watch.

Ainsley Tucker[120]

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[117] *See* McQuillan, *supra* note 108 ("The implication is not just for Mayo. It's for other nonprofits . . . [t]here is an opening to create more money[.]").
[118] *Id.*
[119] *See, e.g.*, Klubo-Gwiezdzinska v. Comm'r, T.C. Summ. Op. 2017-45 at *19 (2017) (finding "insufficient evidence to conclude that Washington Hospital Center is a 'recognized educational institution' because patient care 'is not 'merely incidental to the educational activities.'"); Proskey v. Comm'r, 51 T.C. 918, 923 (1969) (referencing the definition of 'educational organization' in the context of taxation of a fellowship grant); Bayley v. Comm'r, 35 T.C. 288, 293–94 (1960) (analyzing whether a medical student was a dependent student by looking to the regulatory definition of 'educational organization').
[120] Student, Boston University School of Law (J.D. 2021).