



TaxNewsFlash

Exempt Organization

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District court finds taxpayer was “educational organization”

A federal district court yesterday found that a taxpayer was entitled to an \$11.5 million refund of unrelated business income tax (UBIT) because during the tax years at issue, the taxpayer was organized and operated exclusively for educational purposes and had no noneducational purpose that was substantial in the relevant sense.

The case is: *Mayo Clinic v. United States*, No. 16-cv-03113 (ECT/ECW) (D. Minn.)

Read the district court’s [decision](#) [PDF 869 KB]

Background

The taxpayer is a Minnesota nonprofit corporation and tax-exempt organization that is the parent organization of several hospitals, clinics, and a college of medicine and science. After conducting an audit, the IRS asserted in 2009 that the taxpayer owed tax on certain income it received from partnerships because it was not an “educational organization” described in section 170(b)(1)(A)(ii) and therefore was not entitled to an exception in the unrelated debt-financed income rules available to those “qualified organizations.” Specifically, applying two tests from the applicable regulation, the IRS determined that (1) the taxpayer’s primary function was not the presentation of formal instruction, and (2) its noneducational activities were more than merely incidental to its educational activities.

The taxpayer filed an action in federal district court, and in August 2019 the district court granted summary judgment for the taxpayer, finding that the taxpayer was an “educational organization” and therefore qualified for an exception in the unrelated debt-financed income rules and was entitled to an \$11.5 million refund of UBIT paid in prior years. The district court further concluded that because Congress did not include a primary-function requirement in the relevant statute, Treasury exceeded its authority by including such a requirement in the regulations. Read [TaxNewsFlash](#).

The IRS appealed to the U.S. Court of Appeals for the Eighth Circuit which reversed and remanded the district court's decision, concluding that the regulations were valid, but only in part, and that application of the statute as reasonably construed by the regulations to the taxpayer's tax years could not be determined as a matter of law by summary judgment. The Eighth Circuit agreed with the district court that Treas. Reg. § 1.170A-9(c)(1) "adds unreasonable conditions to the statutory requirement," but only by limiting "educational organizations" to those principally providing "formal instruction." By contrast, the terms "primary function" and "merely incidental" activities in the regulation "have a valid role in interpreting the statute," the Eighth Circuit concluded. More specifically, the appeals court noted that, to qualify as an "educational organization" within the meaning of section 170(b)(1)(A)(ii), an organization's primary purpose must be "educational" and its noneducational activities must be merely incidental to that primary purpose. Read [TaxNewsFlash](#)

The IRS nonacquiesced to the Eighth Circuit's decision last November. Read [TaxNewsFlash](#)

Following a bench trial conducted from April 25 – 29, 2022, the district court found that the better answer on the trial record was that, during the tax years at issue, the taxpayer was organized and operated exclusively for educational purposes and had no noneducational purpose that was substantial in the relevant sense.

For more information, contact a tax professional with KPMG's Washington National Tax practice:

Ruth Madrigal | ruthmadrigal@kpmg.com

Preston Quesenberry | pquesenberry@kpmg.com

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