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Recent Court Cases: Philanthropy-Related

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The "eds and meds" is a popular shorthand phrase for two types of powerhouse community institutions: higher education and medical centers. They are generally the biggest employers in a particular locale and strongly influence the economic vitality of a region.

Most – though not all – are nonprofit organizations exempt from tax under Internal Revenue Code section 501(c)(3).

It's been awhile since we've highlighted interesting court cases directly involving or related to the philanthropy sector. So here are three recent ones about eds and meds.

The first of these cases is about prestigious Harvard University. The second relates to a huge healthcare conglomerate in Northern California: Sutter Health.

The third of these cases is a hybrid – an "ed" *and* a "med" – or at least that's what the Mayo Clinic claims. It's precisely the question that a federal district court recently had to decide. Is it enough of an "ed" to take advantage of a special exception to the debt-financed income part of the unrelated business income tax rules? That special "get-out-of-UBI-tax-free" status applies *only* – and here's the rub – if an organization fits within a Treasury regulation's definition of "educational."

But in *Mayo Clinic v. U.S.* August 30, 2019, (Dist. MN), Civ. No. 16-cv-3113-ECT-KMM, a federal judge took issue with that definition in the regulation. The court ruling involved excruciating parsing of statutory language and interpretation. Dictionaries were key evidence. Who says careful writing doesn't matter?

Case 1: Harvard: ("Ed")

For over 50 years, courts and educational institutions around the United States have grappled with affirmative action as a remedy to lessen hundreds of years of racial inequality.

The struggle to come up with a fair and workable solution to this intractable problem continues to this day. On September 30, 2019, federal judge Allison D. Burroughs issued her decision in "... one of the most closely watched

lawsuits concerning affirmative action and higher education" in recent years. In 2014, a group of Asian-American college applicants filed a lawsuit: *Students for Fair Admissions, Inc. v. President and Fellows of Harvard College (Harvard Corporation)*, Civil Action No. 14- cv -14176 -ADB. "The case … puts Asian-Americans front and center in the latest stage of the affirmative action debate. The issue is whether there has been discrimination against Asian-Americans in the name of creating a diverse student body." In other words, does the Harvard admissions process "… discriminate against Asian-Americans in admissions and give preferences to other racial minorities?" More specifically, in this case, the plaintiffs made four key claims: "that Harvard had intentionally discriminated against Asian-Americans, used race as a predominant factor in admissions decisions, used racial balancing and considered the race of applicants without first exhausting race-neutral alternatives."

In 2018, Harvard – which has continued to deny it discriminated against any group of applicants – instituted certain changes in its policy which addressed some of the concerns mentioned by the plaintiffs. There was a trial in late 2018, continuing into early 2019.

Noting these reforms, but without basing her decision on them, Judge Burroughs ruled in favor of Harvard and against the Asian-American plaintiffs in a 130-page ruling, *Findings of Fact and Conclusions of Law*. The bottom line is that Harvard can continue to use its current admissions evaluation procedures, particularly as changed by the 2018 modifications. The judge concluded that Harvard's admission process was "committed to attracting applicants "'who are exceptional across multiple dimensions.'" Moreover, "an applicant's race was 'never viewed as a negative.'"

"The process could be better, the judge said, but that was no reason to ' dismantle a very fine admissions program.'"

Case 2: Sutter Health: ("Med")

It's much more expensive to have a heart attack in Northern California than in Southern California. For that matter, the same kind of significant cost differential applies to people seeking treatment for common-cold symptoms in those two regions.

Sutter Health is a massive Northern California healthcare system of some 24 hospitals and over 5,000 physicians. It's total annual revenue is about $13 billion. "Sutter has effectively linked together a number of hospitals, doctors, and other medical service providers to create a powerful, integrated network. "

In March of 2018, California Attorney General Xavier Becerra joined an ongoing class-action lawsuit against Sutter. These plaintiffs alleged that that " Sutter's business model has led to these [… cost …] disparities" between

Northern and Southern California. According to allegations in the 49-page Complaint, "Sutter violated antitrust laws by using its market power to illegally drive up prices in Northern California, where those prices are 20 to 30 percent higher than in Southern California to begin with."

For its part, Sutter Health has vigorously denied any wrongdoing, asserting it is "focused on benefiting the community it serves." Sutter takes "pride in the services they provide to low-income patients and their support of medical research designed to improve the quality of care." Sutter's position in this lawsuit is that its business model is a good thing because it facilitates progress and reduces inefficiencies that greatly benefit the community's citizens.

It's not uncommon for lawsuits to be settled on the proverbial courthouse steps on the eve of trial. That's what happened here in mid-October 2019; Sutter Health reached a tentative agreement to settle the case, on as-yet-undisclosed terms.

"Those details, according to the judge, are not likely to be made public before February or March, when approval hearings will be held." But California Attorney General Xavier Becerra hinted – before the lawsuit was settled – that he "expected Sutter to face damages of up to $2.7 billion."

This case has been closely watched by other hospitals as well as by regulators including state attorneys general. Lots of nervous healthcare institutions and chains will wait and see how much Sutter Health has to cough up.

Case 3: Mayo Clinic (Hybrid "Ed"/"Med")

Minnesota's world-renowned Mayo Clinic is the parent 501(c)(3) of "several hospitals, clinics, and the Mayo Clinic College of Medicine and Science." The college, in turn, has five distinct medical schools that offer degrees and continuing medical education."

The Mayo Clinic receives income from many sources including substantial revenue from certain investments in real estate partnerships, some of which "use debt to finance their own operations and businesses."

Under a set of extraordinarily complex (even by Internal Revenue Code standards) rules, exceptions, and exceptions to the exceptions, this "debt-financed income" is generally – but not always – taxed under the unrelated business income (UBI) tax provisions of section 512. (There's more information about this down-the-rabbit-hole experience here and here, for instance.)

In order to pay as little UBI tax as legitimately possible, the Mayo Clinic claimed the exception-within-an-exception status as an "educational organization." There is a statute in the Internal Revenue Code that defines this term. There is also a Treasury regulation that expands that definition a bit.

It's the "a bit" part that Mayo Clinic boldly challenged. The IRS took the position that Mayo owes the tax because – under the regulation – Mayo Clinic's "*primary* function" is not "formal instruction." Mayo Clinic argues that the "primary function" test of the regulation in question [section 1.170A-9(c)(1)] is an unauthorized expansion of the definition contained in the relevant statute, that is, section 170(b)(1)(A)(ii).

It's a big deal to challenge an officially promulgated Treasury regulation. Ordinarily, the courts give "deference" to an administrative agency's interpretation and application of a statute.

But, in this case, the federal district court in Minnesota accepted the Mayo Clinic's position that the regulation goes too far beyond the express language of the statute. The bottom line is a fine-point matter of grammar and statutory interpretation. There were, indeed, dictionaries involved in the final parsing.

The court ruled that if Congress wanted to include the Treasury's interpretation – adding a "primary function" test – to the statutory "educational organizational" language, it could and would have done so. But it didn't. So out goes 26 Code of Federal Regulations 1.170A-9(c)(1) purportedly interpreting the Internal Revenue Code section 170(b)(1)(A) definition of "educational organization." At least for now – temporarily – in the Eighth Circuit.

The government has formally appealed this August 2019 lower-court ruling.

Conclusion

Stay tuned. We'll follow along with any and all appeals of the two cases that have not settled.

— Linda J. Rosenthal, J.D., FPLG Information & Research Director