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Creating Complex Monsters: Joint Operating Agreements and The Logical Invalidity of Treasury Regulation 1.502-1(b)

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for McKenzie

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I. INTRODUCTION

A familiar mathematical axiom holds that the shortest distance between two points is a straight line.¹ Indeed, in most any human endeavor simplicity should be encouraged and complexity discouraged. Modern armies, for example, adhere to acronyms² intended to remind leaders and followers alike to strive for simplicity in an effort to conserve energy and avoid misunderstandings. It can be stated intuitively that complexity inevitably excludes understanding in a certain portion of the intended audience. Those who engineer complexity understand it best, but understanding decreases as one moves farther from the source until the thing engineered is not understood at all.³ More importantly, complexity causes unnecessary expense, it results in a diversion of resources, and, by the weight of its own process, obscures the original goal to the ultimate extent that the goal is deemed unworthy of achievement.⁴

1. Arthur F. Coxford & Zalman P. Usiskin, *Geometry: A Transformation Approach* 403 (1971).

2. For example "KISS" means "Keep It Simple, Stupid." It is a "catchphrase used by the military to remind commanders that complex military plans seldom work in wartime conditions, and that it's best to keep tactics and strategies as simple as possible." S.F. Tomajczyk, *Dictionary of the Modern United States Military* 336 (1996).

3. The idea that drafters intentionally make tax laws and regulations complex is cynical, but one which has been expressed from time to time:

[T]here is a perverse incentive for the draftsmen of Treasury Regulations to write the regulations as long and complex as possible. The draftsmen know that they will probably soon be entering private practice, where they can make a lucrative living pontificating on their own regulations. It has become common for draftsmen to leave Treasury shortly after the regulations are issued, in many cases, no doubt, lured by the potential to make a buck off their own regulations. Several prior draftsmen now give speaking tours around the country. Others have profited by writing books. Thus, there is a tremendous economic incentive for the draftsmen to write regulations that are as obscure, complex, and arcane as possible.

Schuyler M. Moore, *A Proposal to Reduce The Complexity of Tax Regulations*, 37 *Tax Notes* 1167 (1987).

4. The problem of complexity in tax law is an old one and is explored in great detail in various articles. See generally James S. Eustice, *Tax Complexity and the Tax Practitioner*, 45 *Tax L. Rev.* 7 (1989); Farley P. Katz, *The Infernal Revenue Code*, 50 *Tax Law.* 617 (1997); Sheldon D. Pollock, *Tax Complexity, Reform, and the Illusions of Tax Simplification*, 2 *Geo. Mason. Indep. L. Rev.* 319 (1994); Sidney I. Roberts et al., *A Report on Complexity and The Income Tax*, 27 *Tax L. Rev.* 325 (1972); Adrian J. Sawyer, *Why Are Taxes So Complex and Who Benefits?* 73 *Tax Notes* 1337 (1996); Stanley S. Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 *Law & Contemp. Probs.* 673 (1969); Michelle J. White, *Why Are Taxes So Complex and Who Benefits?* 47 *Tax Notes* 341 (1990).

The Internal Revenue Code has never been hailed as an example of the mathematical axiom concerning the shortest distance between the status quo and a desirable result. In fairness though, complexity in the Code is often in response to other factors, including complexity in financial transactions.⁵ The latter complexity is not necessarily without purpose. It is often employed, for example, to provide assurances between trading partners who do not trust one another or, as is the wont of lawyers, in an exercise in overkill designed to anticipate every possible contingency. Complexity is also sometimes used in an effort to shield, hide, or recharacterize the nature of income generated by a particular transaction. Thus, in its own complexity, the Code is often necessarily designed to root out the true character of a given transaction.⁶ Sometimes the Code is designed to allow a narrow way to achieve a desirable goal and simultaneously avoid undesirable side effects.⁷ All of this, in simple terms, is only to say that whenever a particular provision or regulatory requirement is characterized by, fosters, encourages, or condones complexity, there ought to be an apparent and sound justification.

This conclusion, that complexity ought to be purposeful and not gratuitous, is demonstrated by the emergence of joint operating agreements. Also known as “virtual mergers,”⁸ joint operating agreements are the Internal Revenue Service (“Service”)-approved mechanisms⁹ by which unrelated tax

5. One commentator, however, argues that tax complexity is not only a result of complexity in business transactions but also a cause of such complexity. Pollock, *supra* note 4, at 338 (“The rise in complexity of the tax laws cannot be attributed solely to an increasingly complex economy and business world. Rather, the tax laws themselves contributed to the complexity in the business world.”) Resolving the debate is like trying to determine whether the chicken preceded the egg.

6. The passive activity limitation rules are favorite examples of complex anti-abuse provisions. IRC § 469. But other provisions rival the passive activity rules for complexity. See, e.g., IRC §§ 1272-1275, 7872 (pertaining to imputed interest), 1311. See generally H. Stewart Dunn, *Improved Development of Complex Tax Legislation*, 10 *Am. J. Tax Pol’y* 307, 313-20 (1992).

7. IRC § 501(h), for example, provides tax exempt organizations with an objective measure of how much propaganda and legislative activity in which they may engage without jeopardizing their tax exempt status under IRC § 501(c)(3) (which prohibits tax exempt organizations from making such activities a “substantial” part of their operations). The process of applying IRC § 501(h) is painfully complex and involved, but is probably justified because it allows exempt organizations to safely engage in a certain level of propaganda and legislative advocacy with the assurance that they will not lose their tax exemptions.

8. Michael W. Peregrine & Robert L. Capizzi, *New Developments In Tax Planning for Joint Operating Company Arrangements*, 14 *Exempt Org. Tax Rev.* 101 (1996); Roderick Darling & Marvin Friedlander, *Internal Revenue Service, Virtual Mergers—Hospital Joint Operating Agreement Affiliations*, in 1996 *Exempt Organizations Continuing Professional Education Technical Instruction Program Textbook* 131, 132 (1996).

9. The Service has not issued regulations or any other guidance upon which taxpayers may rely regarding joint operating agreements. Instead, it has expressed its approval

exempt organizations may pool resources to obtain goods and services necessary to the accomplishment of their common goal without diverting the charitable fund to waste, profit-taking by other individuals or entities, or taxation by the government. Virtual mergers are so-called because they involve detailed contractual undertakings, not amounting to legal merger under state law,¹⁰ but creating sufficient governance, management, and financial connections between several entities such that the previously unrelated parties are treated as a single entity for purposes of Regulations section 1.502-1(b).¹¹ As a result the several entities are allowed to consolidate the performance of their activities by use of a newly created exempt

of joint operating agreements through a series of private letter rulings. See Priv. Ltr. Rul. 97-22-042 (Mar. 3, 1997); Priv. Ltr. Rul. 97-21-031 (Feb. 26, 1997); Priv. Ltr. Rul. 97-16-021 (Jan. 17, 1997); Priv. Ltr. Rul. 97-14-011 (Dec. 24, 1996); Priv. Ltr. Rul. 96-51-047 (Sept. 24, 1996); Priv. Ltr. Rul. 96-23-011 (Feb. 29, 1996); Priv. Ltr. Rul. 96-09-011 (Nov. 22, 1995). The legal standards applied in each of the rulings are essentially identical. Private Letter Rulings may not be used or cited as precedent unless the Secretary of Treasury determines otherwise. IRC § 6110(j)(3).

10. Darling & Friedlander, *supra* note 8, at 132. ("Because a joint operating agreement affiliation is not a true merger, it has come to be called a "virtual merger."").

11. Regs. § 1.502-1(b) provides:

If a subsidiary organization of a tax-exempt organization would itself be exempt on the ground that its activities are an integral part of the exempt activities of the parent organization, its exemption will not be lost because, as a matter of accounting between two organizations, the subsidiary derives a profit from its dealings with its parent organization, for example, a subsidiary organization which is operated for the sole purpose of furnishing electric power used by its parent organization, a tax exempt educational organization, in carrying on its educational activities. However, the subsidiary organization is not exempt from tax if it is operated for the primary purpose of carrying on a trade or business which would be an unrelated trade or business (that is, unrelated to exempt activities) if regularly carried on by the parent organization. For example, if a subsidiary organization is operated primarily for the purpose of furnishing electric power to consumers other than its parent organization (and the parent's tax exempt subsidiary organizations), it is not exempt since such business would be an unrelated trade or business if regularly carried on by the parent organization. Similarly, if the organization is owned by several unrelated exempt organizations, and is operated for the purpose of furnishing electric power to each of them, it is not exempt since such business would be an unrelated trade or business if regularly carried on by any one of the tax-exempt organizations. For purposes of this paragraph, organizations are related only if they consist of: (1) A parent organization and one or more of its subsidiary organizations; or (2) Subsidiary organizations having a common parent organization. An exempt organization is not related to another exempt organization merely because they both engage in the same type of exempt activities.

entity without engaging in unrelated business activity or otherwise jeopardizing their separate tax exempt statuses.

Using the mathematical analogy to illustrate, point A is the status quo at which the unrelated parties have a common need which must be met if they are to achieve a commonly-held goal. For example, five tax exempt hospitals in a given locale, although unrelated, might share a common need for a specialized medical diagnosis procedure. Point B is the later point at which the exempt organizations are able to obtain necessary goods and services at cost and without wasting charitable funds or diverting them to personal profit or taxation. To remain with the above example, the five hospitals might each establish a captive subsidiary to provide the diagnostic procedure at cost, or they might each establish an in-house facility. Each exempt hospital would then be able to obtain the necessary service without the diversion of the charitable fisc to personal profit or taxation.¹² Still, neither option would constitute the shortest distance as it relates to all the hospitals because the five-fold duplication creates waste and a combined capacity which outweighs overall demand. The shortest, i.e., least complex, distance from point A to point B would be to allow the exempt organizations to share access to a single facility which would provide all five organizations with diagnostic services at cost and on a consolidated basis, thereby achieving a certain self-contained economy based on charity rather than profit and ultimately working to the advantage of common charitable beneficiaries. However, this option would not get the hospitals entirely to point B because the resulting "consolidated" entity would be taxable under present law.¹³ Neither could any one hospital provide the diagnostic service to the four other hospitals on a consolidated basis without engaging in an unrelated business activity.¹⁴ To gain tax exempt status, avoid the imposition of the unrelated business income tax, and remain in compliance with Regulations section 1.502-1(b), the exempt organizations must actually merge or engage in a complex transaction resulting in a virtual merger. The tax free consolidation of services is thereby finally achieved but the process is much more expensive and complex than if the unrelated parent organizations were permitted to create a single mutually-owned subsidiary or designate one of their five to provide the service for the entire group.

12. Regulations section 1.502-1(b) would shield the hospitals from taxation in either case.

13. "If the organization is owned by several unrelated exempt organizations and is operated for the purpose of furnishing electric power to each of them, it is not exempt since such business would be an unrelated trade or business if regularly carried on by any one of the exempt organizations." Reg. § 1.502-1(b).

14. *Id.*

Since the goal, consolidation, is manifestly desirable and complexity is to be avoided when possible, it is appropriate to ask what purpose is served by Regulations section 1.502-1(b)'s insistence upon virtual mergers as a means to achieve the goal rather than opting for the easier approach of allowing unrelated exempt organizations to create a single exempt subsidiary or allowing one exempt entity to serve similarly situated entities. Why should the exempt organizations be required to "reinvent the wheel?" After all, Regulations section 1.502-1(b) presently allows the five unrelated exempt organizations, for example, to establish five separate exempt subsidiaries without taxation so long as each of the five subsidiaries provides goods or services solely to its single parent. What purpose is served, then, by taxing five unrelated exempt organizations who establish one mutual subsidiary but not taxing those organizations when they collectively establish five separate subsidiaries? How does the imposition of the joint operating agreement requirement make the former option less objectionable than it is already deemed to be?

The primary focus of Regulations section 1.502-1(b) is preventing exempt organizations from engaging in unfair competition.¹⁵ Thus, to prevent the competitive disadvantages to taxable entities resulting from exempt organizations engaging in business activity, Regulations section 1.502-1(b) requires that exempt organizations undertake an arduous process which results in a merger as a legal fiction—a virtual merger.¹⁶ The joint operating agreement is thought to bring otherwise unrelated exempt organizations within the literal meaning of Regulations section 1.502-1(b) and thereby achieves the purpose of preventing unfair competition.¹⁷ Yet from the standpoint of taxable entities, the purported beneficiaries of the requirement, the end result is identical regardless of the process by which consolidation is achieved. By whatever process, mutual subsidiary or joint operating agreement, there results a new entity which provides goods and services that might otherwise be provided by existing taxable entities, albeit at greater expense to the exempt recipient entities. The only apparent difference is that the joint operating agreement requirement is more expensive and time

15. See *Geisinger Health Plan v. Commissioner*, 30 F.3d 494, 500 (3d Cir. 1994); *Geisinger Health Plan v. Commissioner*, 100 T.C. 394, 401 (1993); *Associated Hospital Services, Inc. v. Commissioner*, 74 T.C. 213, 223-24 (1980); *Hospital Bureau of Standards and Supplies v. United States* 158 F. Supp. 560, 563-64 (Ct. Cl. 1958). The regulation was originally enacted on August 4, 1952, as Regs. § 29.101-3(b), 111.

16. *Darling & Friedlander*, *supra* note 8, at 134. ("If the hospitals establish a "super" parent to implement the joint operating agreement, and the facts and circumstances establish that the equivalent of a parent-subsidiary relationship exists, then the "super" parent will be considered to be an integral part of the subsidiaries. Thus, essential services it provides to the subsidiaries will not constitute unrelated trade or business.")

17. *Id.*

consuming. Hence, the complexity of virtual mergers and the disadvantages attendant to them—primarily diversion of resources, but also the discouragement of innovation and/or centralization of charitable services—do not appear justified by any good policy reason, unless the complexity is intended to serve as negative reinforcement of tax exempt subsidiaries.

This article questions the validity of Regulations section 1.502-1(b) and its resulting insistence upon virtual mergers. It argues that the regulation is invalid as having no basis in section 502, the statute under which it was codified. This article argues, instead, that the regulation is a logically incorrect amalgamation of two distinct judicial tax doctrines by which tax exemption may be or could have been gained vicariously: (1) the integral part doctrine which allows one organization to achieve tax exemption on the basis of another organization's charitable activities,¹⁸ and (2) the now-discarded destination of income doctrine under which tax exemption could be had on

18. The integral part doctrine did not originate with Regs. § 1.502-1(b). Instead it arose from the Ninth Circuit's decision in *Squire v. Student Books*, 191 F.2d 1018 (9th Cir. 1951). In that case, a tax exempt educational institution owned all the stock of a bookstore which sold textbooks and supplies to the college's students and faculty. The court held that the bookstore was entitled to tax exemption because its activities stood in a "close and intimate relationship to the functioning of the College itself." *Id.* at 1020. Recently, the Third Circuit Court of Appeals mistakenly traced the "genesis" of the integral part doctrine to Regs. § 1.502-1(b). *Geisinger Health Plan v. Commissioner*, 30 F.3d 494, 499 (3d Cir. 1994). As noted earlier, though, the regulation was first enacted in 1952, a year after the decision in *Squires*. See *supra* note 15. More importantly, though, the Third Circuit in *Geisinger* confused the vicarious nature of the integral part doctrine. The doctrine, as demonstrated in *Squires* and even Regs. § 1.502-1(b), grants exempt status to an organization which provides admittedly commercial goods and services exclusively to a tax exempt parent. Tax exemption is granted to the first organization because it is viewed as the second organization's alter ego, not because the first organization is otherwise engaged in a charitable activity. In *Geisinger*, though, the court stated that the organization's relationship to a tax exempt organization must "somehow enhance[] the subsidiary's own exempt character to the point that, when the boost provided by the parent is added to the contribution made by the subsidiary itself, the subsidiary would be entitled to § 501(c)(3) status." 30 F.3d 494, 501 (emphasis added). The integral part doctrine applies when the organization has no independent exempt character but is seeking to qualify vicariously through assistance to another organization's exempt activities. The "boost" characterization used in *Geisinger* would have resulted in the denial of tax exempt status to the bookstore in *Squires* because the bookstore had no exempt character separate from the College whose students and faculty it served. In a more recent case, the Tax Court did not adopt the *Geisinger* "boost" rationale but indicated that the *Squires* integral part doctrine could apply to mutual organizations such as those prohibited by Regs. § 1.502-1(b):

The cases applying this doctrine have held that where an organization (1) bears a "close and intimate relationship" to the operation of one or more tax-exempt organizations and (2) provides a "necessary and indispensable" service solely to those tax-exempt organizations, it will take on the exempt status of those organizations.

University Med. Resident Serv. v. Commissioner, 71 T.C.M. (CCH) 3130 (1996).

the sole basis that all the earnings of a corporation, however realized, were distributed to an organization directly providing charitable goods and services.¹⁹ An analysis of the two doctrines shows they are oriented toward distinct aspects of the unfair competition problem and do not simply address the same problem in different ways. Although the two doctrines may be legally and theoretically sound as separate doctrines, they are legally and theoretically unsound as a single merged doctrine resulting in the requirement of virtual mergers.

This article also argues that the abdication of judicial power with respect to Regulations section 1.502-1(b), particularly by the United States Tax Court,²⁰ contributes to unnecessary complexity. The Tax Court has essentially admitted that the regulation has no statutory or even logical support.²¹ In the end, though, the Tax Court sustained the regulation based upon a questionable application of principles of judicial deference to administrative rulemaking. Had it overturned the regulation, the Tax Court would have eliminated the needless complexity which presently unnecessarily attaches to exempt organizations' efforts to economize through consolidation. Rather, the Tax Court assumed that the complexity of the issue demanded that it take an unduly deferential approach to the regulation and thereby perpetuated the complexity of virtual mergers.²²

Finally, this article concludes that even were the regulation a valid interpretation of law, it is nevertheless incorrect as a matter of tax policy because it fosters complexity without a corresponding policy benefit. The regulation is grounded on the rejection of the self-contained charitable economic model; that is, a separate economic system comprised of direct providers of charitable goods and services which own and are served by a secondary market within the same economy. Within this self-contained economic model, the secondary market is comprised of tax exempt entities indistinguishable from ordinary commercial businesses except for their limitation of customers to their charitable parent entities, all of whom share a common charitable goal. Thus, the economy is based upon charitable need, rather than profit, as the production incentive and the system's currency remains exclusively within the exempt economy, neither taxed nor subject to profit-taking. Regulations section 1.502-1(b) unalterably deems this self-contained economy as one which results in unfair competition, apparently on the basis of the same considerations which underlie the rejection of the

19. *Roche's Beach, Inc. v. Commissioner*, 96 F.2d 776, 778-79 (2d Cir. 1938); *C.F. Mueller Co. v. Commissioner*, 190 F.2d 120, 121-22 (3d Cir. 1950).

20. *Associated Hospital Services, Inc. v. Commissioner*, 74 T.C. 213, 226-31 (1980).

21. *Id.* at 227.

22. The Tax Court termed the history behind the enactment and application of Regs. § 1.502-1(b) a "perplexing saga." *Id.* at 222.

destination of income doctrine. The drafters presume that without the regulation, the resulting self-contained economy would have a negative effect on the taxable economy in the same manner as organizations claiming exemption under the destination of income doctrine. This article argues that the premise of Regulations section 1.502-1(b) is incorrect and that the complexity engendered by the regulation, in the form of joint operating agreements, is therefore unnecessary. The solution suggested by this article is the repeal of Regulations section 1.502-1(b) and a reliance, instead, upon sections 501(c)(3)²³ and 511²⁴ of the Code, as the exclusive tools by which to prevent unfair competition. This simple solution, properly applied, would allow tax exempt organizations to get from point A to point B, without the

23. Section 501(c)(3) might have been enacted as four separate provisions since it contains (1) the identification of those organizations entitled to exempt status, (2) a prohibition against the use of tax exempt revenues for private gain, (3) a partial prohibition against activities involving propaganda or attempts to influence legislation, and (4) a total prohibition against participation in campaign activities. As it is, IRC § 501(c)(3) provides exemption for:

Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

The provision thus covers all of the basic issues relating to operation of a tax exempt organization. There are, of course, 27 other subdivisions of § 501(c)(3) which grant tax exemption on other grounds. But approximately 630,000 of the 1.5 million exempt organizations in the United States are classified as 501(c)(3) organizations. I.R.S. Fact Sheet 97-7 (Feb. 1997). Approximately 300,000 exempt organizations are churches and 140,000 organizations are 501(c)(4) organizations. *Id.* Unless otherwise specified, this article focuses on 501(c)(3) organizations.

24. The unrelated business income tax, unlike the rules regarding basic qualification, is set out in incremental statutes. Section 511 imposes a tax on "unrelated business taxable income." Section 512 defines unrelated business taxable income as income from an "unrelated trade or business." Section 513(a) defines unrelated trade or business:

The term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501

complexity of, and without sacrificing the policy interests thought to be protected by, joint operating agreements.

II. CONCEPTUALIZING JOINT OPERATING AGREEMENTS

The basic concept underlying joint operating agreements—virtual mergers—is consolidation. In its most prevalent present use, a joint operating agreement results in two or more tax exempt hospitals associating in an effort to eliminate duplicative services and thereby reduce operating expenses, gain negotiating power with third party payers or service providers, and reduce overall costs to patients.²⁵ The result of the joint operating agreement is the creation of a consolidation entity,²⁶ normally a partnership or a corporation, which governs and coordinates the activities of the participating hospitals. The consolidation entity might itself perform administrative services for all participants to the joint operating agreement or it might designate one of the participants as the central provider of particular administrative services for all other participants. From a tax standpoint, the primary concern for the participating hospitals is that the consolidation entity not be subject to corporate tax if the entity is organized as a corporation, or that the participating hospitals not be subject to the unrelated business income tax if the

25. See Steven R. Hollis, *Strategic and Economic Factors In The Hospital Conversion Process*, 16 *Health Affairs* 131, 132 (1997) (affiliations generally motivated by desire to obtain “negotiating clout” with health maintenance organizations, and to achieve “economies of scale”). Joint operating agreements have not previously been the subject of analysis from a policy perspective. The “nuts and bolts” of joint operating agreements, however, have been discussed in recent literature. See Rochelle Korman & William F. Gaske, *Joint Ventures Between Tax-Exempt and Commercial Health Care Providers*, 74 *Tax Notes* 1575 (1997) (providing an excellent overview of the nonprofit/for-profit hospital structures emerging in the last 20 years). The following articles provide insights into the more practical aspects of joint operating agreements but do not address the integral part doctrine’s validity or necessity: Leslie J. Gold, *IRS Issues Favorable Ruling on Company Coordinating Multiple Hospital Alliance*, *Daily Tax Rep.*, Dec. 6, 1996, at G-1; Gerald M. Griffith & Brad M. Tomtishen, *IRS Adopts Facts and Circumstances Approach for JOAs-Part One*, 14 *Exempt Org. Tax Rev.* 403 (1996); Gerald M. Griffith & Brad M. Tomtishen, *Exempt Hospital Affiliations: Bond and UBIT Issues—Part Two*, 13 *Exempt Org. Tax Rev.* 215 (1996); Gerald M. Griffith & Brad M. Tomtishen, *Exempt Hospital Affiliations: Bond and UBIT Issues*, 11 *Exempt Org. Tax Rev.* 709 (1995); Peregrine & Capizzi, *supra* note 8, at 101; Michael W. Peregrine et al., *New Guidance on Tax Treatment of Joint Operating Agreements*, 13 *Exempt Org. Tax Rev.* 439 (1996).

26. The resulting entity is more often called a “joint operating company” or a “super” parent. This article uses the term “consolidation entity” because it identifies the organization’s functions in the same manner that the term “feeder organization” readily identifies organizations which function only to “feed” profits to an organization exempt under IRC § 501(c)(3).

consolidation entity is a partnership.²⁷ Additionally, the hospital participants seek to avoid engaging in unrelated business activity or otherwise jeopardizing their separate tax exempt statuses by virtue of their sharing administrative burdens, such as billing or payroll activities. Once approved by the Service, the joint operating agreement will result in an exempt organization, the consolidation entity, which is owned by, takes its power and authority from, governs, and operates for the exclusive benefit of its tax exempt owners.

Although joint operating agreements are particular to the nonprofit health care industry, the concept of a tax exempt consolidation entity, i.e., an organization having as its claim to tax exemption the centralized provision of services to other tax exempt organizations, is neither foreign nor unprecedented to tax law. The Service has previously approved tax exempt status for organizations which do not directly provide a charitable service, but which provide seemingly commercial services exclusively to organizations which themselves provide charitable services. For example, in Revenue Ruling 38-51²⁸ the Service approved tax exempt status for an organization that operated a cemetery exclusively for the benefit of its member churches. In Revenue Ruling 69-572,²⁹ the Service approved tax exempt status for an organization that constructed, owned and operated a building which provided rental space exclusively for other tax exempt entities.³⁰ Likewise, Congress has granted tax exempt status to certain organizations—apparently selected

27. IRC § 512(c)(1) imposes the unrelated business tax on the partners when the unrelated activity is conducted via a partnership.

28. 1938-2 C.B. 166.

29. 1969-2 C.B. 119. Other rulings granting tax exempt status to an organization which provides services exclusively to tax exempt entities include Rev. Rul. 71-529, 1971-2 C.B. 234 (organization that provides management services for unrelated colleges' and universities' endowment funds held exempt under IRC § 501(c)(3)), and Rev. Rul. 74-614, 1974-2 C.B. 164 (organization providing computer services to several unrelated colleges and universities held exempt under IRC § 501(c)(3)).

30. Revenue Ruling 69-572, 1969-2 C.B. 119, is most significant because of its explicit recognition that a charitable purpose is manifested through the consolidation of the efforts of other exempt organizations:

Because of the close connection between [the applicant organization] and the charitable functions of the tenant-organizations, the rental of the organization's facilities at rates substantially below their fair rental value, and the operation by the organization with the intention of realizing an amount sufficient only to meet annual operating costs, the organization is dedicated to carrying out the charitable endeavors of the community chest and its member agencies.

The ruling did not discuss the potential for unfair competition.

without identifiable rhyme or reason—which provide otherwise commercial services solely to tax exempt organizations.³¹

Section 501(m) of the Code is especially noteworthy in that it specifically rejects the consolidation concept as it might apply to a company that sells “commercial-type insurance” solely to tax exempt organizations.³² Again, there is no apparent rhyme or reason to the rejection of the concept when applied to the insurance industry, but section 501(m) certainly suggests a recognition of the basic concept.³³ Hence, the idea that the definition of “charity” might include the provision of cost or below cost goods and services to unrelated tax exempt organizations which themselves directly assist a class of beneficiaries is not at all new to tax jurisprudence.

The Service’s grant of tax exempt status to consolidation entities resulting from joint operating agreements implies a further recognition of the underlying concept, but only after a good deal more refinement or perhaps regression, depending upon one’s viewpoint. Unlike joint operating agreements, in which structural form is of paramount importance, the Service granted tax exempt status in older rulings to entities serving similar or even dissimilar tax exempt entities without regard to the structure between the service entity and the tax exempt entities being served.³⁴ When the concept is recognized in various Code provisions, there is also little attention paid to the structure of the relationships between the consolidation entity and the tax exempt organizations being served or between the tax exempt organizations themselves.³⁵ Under the present incarnation of the consolidation concept, by way of joint operating agreements, the relationship between the consolidation entity and the tax exempt participants, and the relationship between the tax exempt participants themselves is absolutely dispositive.

Ultimately, approval of tax exempt status for the consolidation entity and avoidance of tax liability by the individual participants depends upon a

31. See IRC § 501(c)(12) (mutual ditch, irrigation or cooperative telephone companies); IRC § 501(c)(13) (mutual cemetery companies); IRC § 501(c)(25) (mutual real estate management company); IRC § 501(e) (hospital service organizations); IRC § 501(f) (cooperative mutual fund managers); IRC § 501(n) (charitable risk pools).

32. *Florida Hosp. Trust Fund v. Commissioner*, 103 T.C. 140 (1994), *aff’d*, 71 F.3d 808 (11th Cir. 1996) (affirmed without reaching the § 501(m) issue).

33. In addition, IRC § 501(n) creates an exception to IRC § 501(m), which might itself be viewed as an exception to IRC § 501(c)(3) and therefore an implicit recognition that mutual organizations might achieve tax exempt status under IRC § 501(c)(3). IRC § 501(n) grants tax exempt status to a limited class of captive and mutual insurance companies. I have previously discussed captive and mutual insurance companies as they relate to IRC § 501(c)(3) and Regs. § 1.502-1(b). Darryll K. Jones, *The Lingering Demise of Tax Exempt Mutual and Captive Insurance Companies*, 69 Fla. B.J. 88 (1995).

34. See *supra* note 29.

35. See *supra* note 30.

high degree of governance, managerial and financial integration between and amongst the consolidation entity and the service recipients; an actual merger is not required but a mutual association or joint venture such as is found in previous revenue rulings or in various code provisions is insufficient. Instead, the essential goal of a joint operating agreement, if it is to be approved by the Service, is the appearance of a single parent controlling one or more subsidiaries. Approval not only results in tax exempt status for the consolidation entity, but also allows any one of the subsidiaries to engage in otherwise normal business activity for the benefit of co-participants without engaging in an unrelated activity or otherwise jeopardizing their existing tax exempt status. So long as the activity is one which any one of the participating could perform for itself without incurring unrelated business income tax, and there is a sufficient degree of governance, management and financial integration, the consolidation entity will be granted tax exempt status and none of the participating entities will be considered to be engaging in an unrelated activity.

Through private correspondence³⁶ and internal agency training material,³⁷ the Service has listed several factors which it deems important to the establishment of sufficient governance, management, and financial integration. The factors are prefaced by an introductory comment which clarifies that the joint operating agreement must result in the appearance and substance of a shifting of functions and income from one department to another within a single entity, even though the agreement involves several unrelated entities.³⁸ The comment further emphasizes that no single fact or pattern of facts is required, but the totality of the facts and circumstances must demonstrate a centralized source of control over the several entities such

36. Internal Revenue Service Letter to Applicants for Hospital Joint Operating Agreements Setting Out Factors For Exemption, reprinted in *Daily Tax Rep.*, July 24, 1996, at L-2 [hereinafter, JOA Applicant Letter].

37. Darling & Friedlander, *supra* note 8, at 135-36.

38. The Service is looking for explicit manifestations of control under all the facts and circumstances of a joint operating agreement (JOA) between otherwise unrelated hospitals or hospital systems such that dealings between the hospitals (and the parts of the hospital system that are completely financially integrated) under the agreement are merely [a] matter of accounting between related organizations rather than rising to a level of unrelated trade or business activity contemplated by section 513 of the Code. . . . This is a flexible control analysis that does not rely on structural control or any one factor (although some factors are more significant than others) but, rather, a preponderance of all the facts and circumstances that demonstrate that significant control over management and financial decisions have been ceded by participating entities to a mutual governing body under a joint operating agreement.

JOA Applicant Letter, *supra* note 36.

that the several ostensibly unrelated entities function as a single multi-departmental unit.³⁹

The factors which the Service believes demonstrate the required control include whether the joint operating agreement delegates "significant management responsibility" to the consolidation entity.⁴⁰ For this factor to demonstrate the desired control, the consolidation entity must have concrete authority not only over long range plans, but also over "day-to-day" management decisions. A second factor considers the ease with which a joint operating agreement may be dissolved or a participant may withdraw from the joint operating agreement.⁴¹ The easier it is to dissolve or withdraw from

39. *Id.* The Service further instructs its field agents that:

The . . . facts and circumstances provide the basis for more flexible control analysis that does not rely strictly on the degree of structural control or any one factor. Although some factors are more significant than others, the analysis looks to a preponderance of all the facts and circumstances that demonstrates significant control over management and financial decisions which have been ceded by participating entities to a governing body under a joint operating agreement or a "super" parent organization. There may be other facts and circumstances that have not been listed and they too will be considered if raised by organizations.

Darling & Friedlander, *supra* note 8, at 134-35.

40. Elements of specific management authority include:

- (1) Authority to establish budgets. This significant aspect includes responsibility to establish overall budgets, as well as authority to approve major expenditures, debt, contracts, managed care agreements, and capital expenditures. This aspect also considers whether the JOA governing body regularly meets to establish long term and short term budgets and to implement its decisions.
- (2) Authority by the JOA governing body to monitor and audit each participating entity's compliance with its directives. This is a significant aspect.
- (3) Authority to direct services. This significant aspect considers whether the JOA governing body can direct that health care services be undertaken or not be undertaken by the participating entities. For example, whether the governing body of the JOA can direct a participating hospital to refrain from being a provider of pediatric services.
- (4) Authority to enter agreements that bind participating entities, particularly agreements with managed care providers.
- (5) Authority to hire and fire personnel.
- (6) Authority to grant hospital staff privileges.
- (7) Authority to set or approve fees and prices.
- (8) Authority to buy assets for and sell assets of participating entities.
- (9) Authority to re-allocate income among the participating entities to balance income and expenses to assure financial integration and to achieve mutual objectives.

Id. at 135.

41. Factors that establish a permanent arrangement include whether there are significant penalties or other hindrances to terminating the agreement, and whether

a joint operating agreement, the less logical it is to view the arrangement as a merger-in-fact. The third factor is actually a subset of the second factor and focuses on whether the joint operating agreement establishes informal dispute mechanisms.⁴² The existence of informal dispute resolution procedures, particularly binding arbitration, makes it more difficult for a participant to withdraw from the joint operating agreement and thereby provides a level of permanence coming closer to that found in an actual merger. The fourth factor listed by the Service is whether any particular participant possesses or may exercise routine veto power over decisions made by the consolidation entity.⁴³ If so, then authority really hasn't been ceded to the consolidation entity since any one party might thwart the consolidation entity's authority. Under the facts and circumstances approach, only a preponderance of these factors need be present to demonstrate an integrated governance, managerial, and financial structure. The reservation of too much veto power, however, is logically most significant since the exercise of that power could negate the existence of all other factors.

there are mechanisms such as direct negotiations and binding arbitration in place to resolve disputes among the parties. The degree to which the JOA is permanent also effects the determination whether the JOA establishes the equivalent of a parent-subsidary relationship.

Id. at 136.

42. This factor is indeed listed as part of the second factor in the training material. See id. But it is listed as a third factor in correspondence to applicants. JOA Applicant Letter, *supra* note 36.

43. A veto power is not the same as a power to initiate an action. If the authority ceded to the JOA governing body is merely the power to veto actions taken by participating hospitals, then the facts and circumstances necessary to establish the equivalent of a parent-subsidary relationship would not be present. Similarly, if actions of the JOA governing body are subject to veto by the participating hospitals, this too would negate a finding that the hospitals function as subordinates of the JOA.

If participating hospitals retain some authority, this is not necessarily determinative of whether the equivalent of a parent-subsidary relationship has been established. For example, authority over ethical or moral issues based on religious principles may be reserved by the participating entities. If all of the other surrounding facts and circumstances showed that sufficient authority had otherwise been ceded to the JOA governing body, this type of reservation would not preclude a finding that the equivalent of parent-subsidary relationship had been established.

Darling & Friedlander, *supra* note 8, at 136 (headings omitted).

Two practitioners suggest that instead of allowing a party to veto action with respect to a very significant matter, the Service prefers that the agreement not allow the action in the first place except in accordance with a supermajority voting provision. Kenneth L. Tracy & Elizabeth B. Lewis, Latest JOA Ruling Confirms Internal Revenue Service Flexibility on Parent-Subsidiary Relationship Issue, 16 Exempt Org. Tax Rev. 449, 455 (1997).

In the original series of private letter rulings approving the implementation of joint operating agreements,⁴⁴ the Service discussed the governance and managerial factors which supported its approval of the arrangements. The results in all four rulings was the creation of tax exempt consolidation entities and a determination in each ruling that an exempt participant would not derive unrelated business income from the provision of goods and services to another participant.

Although the results were identical in each ruling, the Service discussed the governance and managerial factors in much greater detail in the second and third rulings. In Private Letter Ruling 9623011, the second ruling, Corporation A owned 100% of Corporation B, Hospital A-1, Hospital A-2, and other unspecified "health care facilities." Corporation B owned 100% of Hospital B. Collectively, the several entities were referred to as Group A. A second group, referred to as Group C, contained Corporation D which owned 100% of Corporation C. Corporation C owned 100% of Hospital C-1, Hospital C-2 and also unspecified "health care facilities." Figure 1 (page 579) graphically illustrates the corporate structures of the two groups prior to entering into the joint operating agreement.

44. Priv. Ltr. Rul. 97-14-011 (Dec. 24, 1996); Priv. Ltr. Rul. 96-51-047 (Sept. 24, 1996); Priv. Ltr. Rul. 96-23-011 (Feb. 29, 1996); Priv. Ltr. Rul. 96-09-011 (Nov. 22, 1995). Since the first four rulings were issued, the Service has approved joint operating agreements with almost verbatim boilerplate language. See *supra* note 9 and the subsequent private letter rulings cited therein.

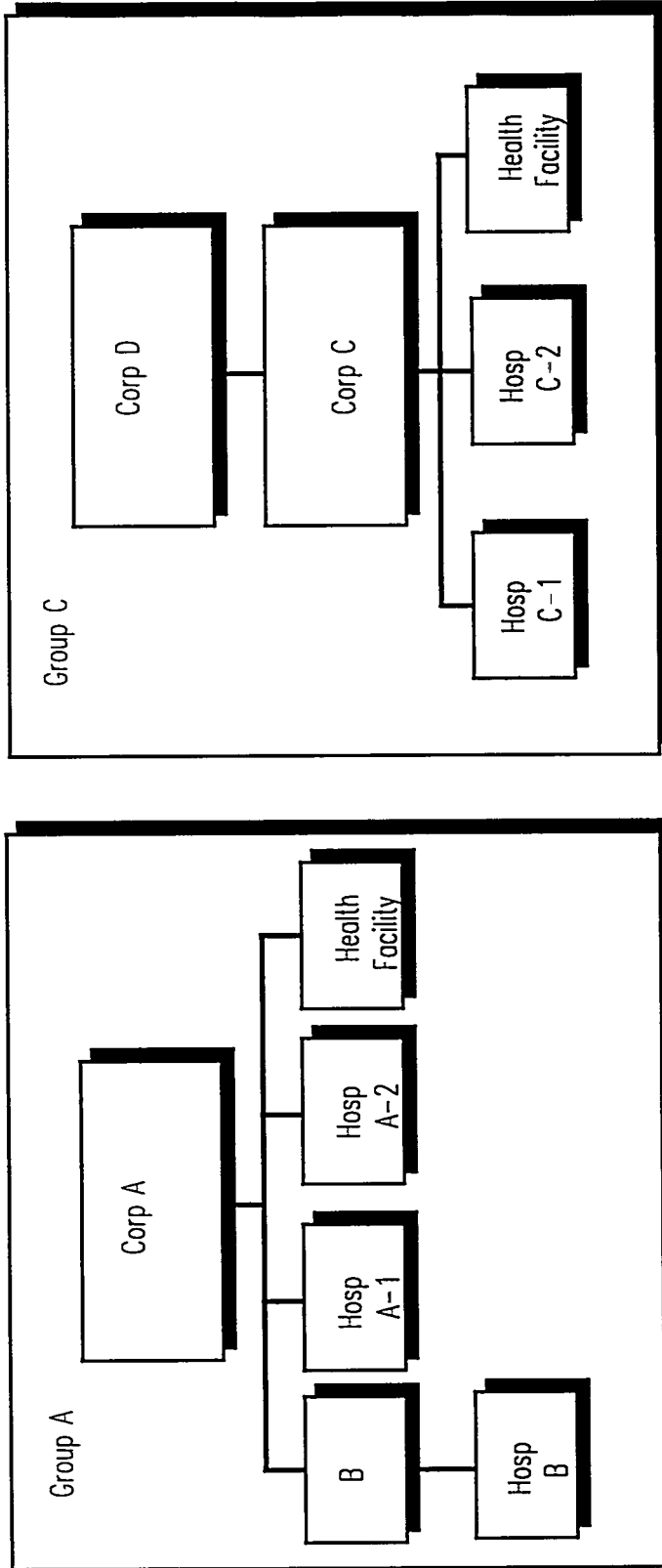


Figure 1

According to the facts provided in the ruling, both groups operated within the same geographical area. Thus, several relevant assumptions concerning the operating environment might be safely accepted. First, there existed substantial duplication of services within the geographical area. Many of the health services available from hospitals within Group A were also available from hospitals in Group C. Second, the competition between the two groups in the same geographical area increased the labor costs associated with staff physicians, nurses, technicians, administrators and staff. Third, the collective capacities of the two groups was greater than overall demand for health care. Fourth, the added effect of available health care from for-profit hospitals served to aggravate the earlier stated factors and all four factors resulted in increased costs to patients. The ruling does not explicitly acknowledge these assumptions but states that the parties proposed the joint operating agreement to unify and enhance health care services, and eliminate duplicate services in order to achieve cost efficiencies and improve health care access.⁴⁵

45. In the most recently approved joint operating agreement, the hospitals confirmed the adverse consequences by an independent study which identified areas of potential savings. Tracy & Lewis, *supra* note 43, at 449. The macroeconomic factors which make the listed assumptions more acute than they would otherwise be generally revolve around the federal government's efforts to impose cost controls on escalating health care costs. Cost control is the essence of "managed care" and is generally achieved through greater scrutiny of the need for certain health care services and shorter hospital stays. The "tools" of managed care include "preadmission certification" of need for services, controlling the length of hospital stays and close supervision and management of acute or long term care. See Paul B. Ginsburg & Jeremy D. Pickreign, *Tracking Health Care Costs*, 15 *Health Affairs* 140, 148 (1996); see also James J. McGovern, *Restructured Nonprofit Hospitals*, 16 *Tax Notes* 405 (1987). As operating costs increased, government support decreased. James J. McGovern, *The IRS Compliance Program for Nonprofit Hospitals*, 16 *Exempt Org. Tax Rev.* 201 (1997). The result was an effort to maintain viability by controlling costs through consolidation efforts, including actual mergers and acquisitions, and increased competition for patient revenue. Since health care costs remain relatively static in the new "managed care" environment, volume and efficiency has become more important. Thus hospitals, both for- and not-for-profit, have also been forced to compete for physician and staff support. See Gary J. Young et al., *Does The Sale of Nonprofit Hospitals Threaten Health Care for the Poor*, 16 *Health Affairs* 137 (1997); McGovern, *The IRS Compliance Program for Nonprofit Hospitals*, *supra*. Two commentators have cataloged the macroeconomic factors given in requests for IRS approval of joint ventures between exempt hospitals and nonexempt hospitals. These factors include (1) price competition resulting from a shift in government policies regarding reimbursements for medical care, (2) impact of managed care on cost of health care delivery to employers and other third party payers, (3) increased working capital needs, (4) providing new health care or maintaining present health care to a community, (5) increased efficiency and reduced financial risk, and (6) expanding opportunities to specialized cases in order to further medical education. Korman & Gaske, *supra* note 25, at 1575.

The adverse consequences resulting from the status quo might have been mitigated within each group and without affecting each participant's separate tax exempt status by resort to the integral part doctrine. Under that doctrine, a subsidiary which provides otherwise commercial type services, such as billing, laundry, or food service, to a parent organization may achieve or maintain tax exempt status and will not be considered as engaging in an unrelated activity, provided the commercial type services are activities in which the parent itself could have engaged without carrying on an unrelated business activity.⁴⁶ The basic rationale is that if the parent could conduct the activity without adverse tax consequences, it should not suffer these consequences simply because nontax considerations lead the parent to conduct the activity through a subsidiary.⁴⁷ The performance of services by the subsidiary is viewed merely as the shifting of income and activity from one department within an entity to another.⁴⁸ To ignore this reality, by denying tax exempt status, would unnecessarily interfere with the sound business practice which presumably led to the establishment of the subsidiary.⁴⁹

The Service's integral part doctrine has a number of distinctions relating to the relationship of the service provider and recipient of the services; some of these distinctions are rejected by or absent from judicial opinions.⁵⁰ In addition to the provision of services to a parent, a subsidiary may provide services to other exempt entities but only if they have the same parent corporation as the service-providing subsidiary. The rationale stated earlier is not violated by allowing sister organizations to consolidate since each are performing services ultimately for the benefit of a single parent which could have performed the service itself. A subsidiary corporation, though, cannot perform services for an organization with whom the subsidiary does not share a common parent even if the service-recipient organization

46. Regs. § 1.502-1(b).

47. *Id.* Whether the parent could have engaged in the activity itself is a determination made under IRC § 513. See *supra* note 24. If the subsidiary's activity is substantially related to the parent's accomplishment of the parent's exempt goals, Regs. § 1.502-1(b) will allow the subsidiary to be granted tax exempt status.

48. Rev. Rul. 38-51, 1938-2 C.B. 166 ("[W]hat a corporation, exempt under [IRC § 501(c)(3)] . . . , may do directly without forfeiting its right to exemption, it may do through a corporation organized for that purpose, and . . . a corporation so organized and operated is entitled to exemption.").

49. Regs. § 1.502-1(b) ("[E]xemption will not be lost because, as a matter of accounting between the two organizations, the subsidiary derives a profit from its dealing with its parent.").

50. This portion of the article focuses on Regs. § 1.502-1(b) to demonstrate how the joint operating agreement requirement is derived from this regulation. In Part IV, the article discusses the judicial rejection (but not overruling) of some of Regs. § 1.502-1(b)'s distinctions and therefore the invalidity of the joint operating agreement requirement.

performs a similar charitable service as the service-provider or the service-provider's parent organization.⁵¹ Nor may the subsidiary corporation perform services for multiple parent organizations even though the multiple parents share similar charitable goals.⁵² The one point on which Regulations section 1.502-1(b) is consistent with the judicial articulation of the integral part doctrine is in the regulation's recognition that a formal parent-subsidiary corporate structure is not absolutely necessary. Instead, both the service-providing and service-recipient organizations must only be in a "close and intimate" relationship with a common parent-type organization, i.e., an organization exercising some degree of control over, but not necessarily having a formal ownership relationship with all the other organizations involved.⁵³ The distinctions made by the regulation, together with its acceptance of less than a formal parent-subsidiary relationship collectively result in the necessity and applicability, respectively, of joint operating agreements.

Thus, within Group A of Private Letter Ruling 9623011, Hospital A-1 may provide administrative and medical support services to any other participant within the group. In this manner, Group A and likewise Group C could achieve some degree of consolidation and mitigate the adverse consequences discussed above, and no doubt did so. But neither Hospital A-1 nor Hospital C-1, for example, could provide services to one another or to any other hospital within the opposite group without engaging in an unrelated business activity. Hence, duplication of services, increased labor costs, capacity in excess of need and the resulting increased costs to patients is only partially mitigated through separate application of the integral part doctrine to the two groups as illustrated in Figure 1 (page 579).

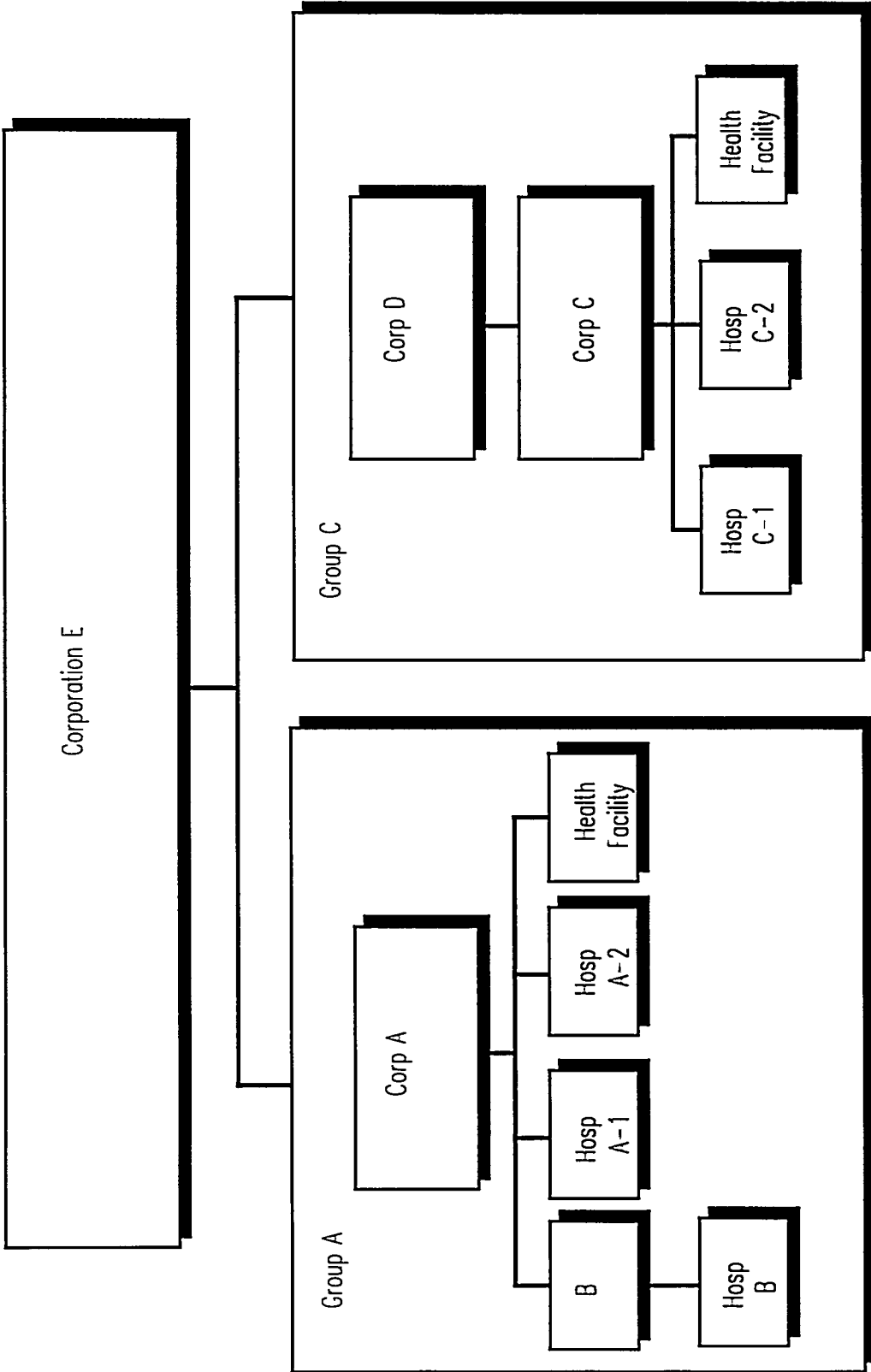
To fully alleviate the adverse consequences using the integral part doctrine, the two groups would have to submit to the control of a common parent or parent-like organization. Then, the sharing of resources and services would fit within the analogy of merely shifting income and functions between several departments of a single entity. The resulting agreement therefore created a third corporation, Corporation E, which possessed governance and managerial authority over all participating hospitals. Figure 2 (page 583) illustrates the corporate structure after the joint operating agreement.

51. Regs. § 1.502-1(b)(2) ("An exempt organization is not related to another exempt organization merely because they both engage in the same type of exempt activities.").

52. *Id.*

53. The regulation does not state this rule explicitly but it has been so interpreted by the Service. See Rev. Rul. 81-19, 1981-1 C.B. 353; Rev. Rul. 76-336, 1976-2 C.B. 143.

Figure 2



The authority ceded to Corporation E, the consolidation entity, included the right to review and approve strategic plans, manage network participants and establish overall operating procedures. Ownership and liabilities of each participant, however, remained unchanged. Corporation E also lacked any real authority over the financial integration of the parties. Instead, the net revenues were distributed to the participants according to a formula which required the two groups to make annual payments to each other.⁵⁴ The amount of the payments were based upon the value of assets and excess revenue potential contributed by each party, with more weight assigned to the value of assets contributed. The actual ratios and assigned weights given to them, however, would not be subject to change as a result of any participant's future performance. The implication is that the weights and ratios could be changed for noncompetitive reasons. Thus, although financial authority was lacking, financial integration was still achieved. No participant would have a competitive motivation vis-à-vis another participant to make capital contributions or increase its patient base. Instead, the success of any one participant would be tied to the success of all other participants.⁵⁵ The joint

54. Network Participants effectively accomplish financial integration through annual payments between Group A and Group C. The amount of payment will be based upon a weighted average of two ratios each determinable as of a financial statement date described in the [joint operating agreement]. One ratio is based upon the fair market value of the assets of Group A and the assets of Group C, plus or minus (as appropriate) certain specified assets or liabilities. The other ratio is based on the average excess of revenues over expenditures for the four most recently completed fiscal years of Group A and Group C prior to the execution of the [joint operating agreement]. The amount of weight given to each ratio will vary over a term of years with a declining weight given to the income ratio and an increasing weight given to the asset ratio.

Priv. Ltr. Rul. 96-23-011 (February 29, 1996).

55. Once the [joint operating agreement] is effective, neither the ratios nor the weighted averages will be adjusted because of the future performance of any network participant. Thus, there will be no financial incentive for any Network Participant to encourage the use of services at, or to make capital additions to, any particular facility and a Network Participant performing a service pursuant to the [joint operating agreement] will not receive any separate profit or benefit for rendering the service. Similarly, corporate and administrative services performed by any Network Participant will financially benefit any particular Network Participant only insofar as all Network Participants benefit from efficient performances of these services.

Id. It is difficult to visualize the actual methodology used to achieve financial integration. See supra note 54. But it is easier to conclude from the above quote and an understanding of Regs. § 1.502-1(b) that financial integration means that the parties must achieve the same cooperative, noncompetitive relationship as that which would result from an actual merger.

operating agreement thus resulted in the structure of a parent organization, Corporation E, having most of the attributes of ownership over, without actually owning, all the other participants. Under the integral part theory discussed above, then, any one of the participants could provide services to any other participant without engaging in an unrelated activity or otherwise jeopardizing the service-providing participant's tax exempt status. One hospital could provide billing services for the others, another could provide food service, another legal and yet another could provide payroll and labor management services. The consolidation entity could provide any of these services for any participant. This consolidation within and between both groups more fully alleviates the adverse consequences resulting from the duplication of services existing prior to the joint operating agreement and ultimately benefits the commonly shared charitable beneficiaries.⁵⁶

One significant difference between the parent-subsidary model of prior rulings and the typical joint operating agreement is that authority and control are ceded from the parents to the "subsidiary." What might appear to be a subordinate entity is, in actuality, a superior entity which exercises governance, managerial and financial control over the creating entities. Traditionally, the integral part theory is applicable to a subordinate entity which engages in some activity which its exempt *parent* organization could itself perform without adverse consequences.⁵⁷ In joint operating agreements, the integral part doctrine is applied in reverse order. As far as the integral part doctrine is relevant, the parent gains its exemption through the activity

56. A recent study demonstrates that 1990 administrative expenses accounted for approximately 25% of overall hospital spending in the United States, more than twice the percentage spent by Canadian hospitals. Steffie Woolhandler & David U. Himmelstein, *Costs of Care and Administration at For-Profit and Other Hospitals in the United States*, 336 *The New Eng. J. Med.* 769 (1997). The United States amount increased to 26% by 1994. Curiously, 1994 administrative costs accounted for 34% of spending by for-profit hospitals but only 24.5% of spending for not-for-profit hospitals. *Id.* at 770. The study included the following activities in the definition of "administrative": Administrative and General as defined by Medicare regulations, nursing administration, central services and supplies, medical records and library, employee-benefits department (salary costs only), administrative and general home health, skilled-nursing facility utilization review. *Id.* at 771. The study included the following activities as "mixed administrative and clinical": capital-related costs-building and fixtures, capital-related costs-movable equipment, employee benefits (except benefits-department salaries), maintenance and repairs, operation of plant, and debt-service. *Id.* With hospital administrative costs comprising one-quarter of nonprofit hospital spending, there is certainly incentive and need for consolidation.

57. See McGovern, *supra* note 45, at 405, 411. ("This structure suggests that the basis for the integral part theory of exemption is the control vested in the tax-exempt parent over the activities of its subsidiary. The relationships of organizations within the reorganized hospital system, however, are the inverse of that suggested by the regulations. It is the parent organization seeking to derive its exemption from subsidiary organizations.")

of its subordinate organization. If the “close and intimate relationship” exists, however, granting tax exempt status to the parent does not violate the substantive notion that income and functions are merely shifted from one department to another within a single entity.⁵⁸ Logically, that notion is more important than the hierarchy between the parties.

Private Letter Ruling 9651047 contains the Service’s most comprehensive discussion of the factors leading to approval of a joint operating agreement.⁵⁹ The facts of that ruling, prior to the implementation of the joint operating agreement, demonstrated a greater degree of duplication of services and a corresponding increased severity of adverse consequences than in other rulings. Unlike the prior rulings, none of the five hospitals involved in Private Letter Ruling 9651047 belonged to a health care network prior to the joint operating agreement.⁶⁰ Instead, each participant was a stand-alone hospital and each provided similar services all within the Cincinnati, Ohio area.⁶¹ Thus, the integral part doctrine was unavailable to allow even the partial consolidation of services.

The Service’s approval of the resulting joint operating agreement in the Private Letter Ruling 9651047 indicates that the facts and circumstances approach allows for more than one method to achieve the level of integration necessary to the application of the integral part doctrine. Particularly, the parties demonstrated a much greater degree of centralized government management, and financial integration than in other rulings.⁶² To a much

58. See Regs. § 1.502-1(b).

59. Priv. Ltr. Rul. 96-51-047 (Sept. 24, 1996).

60. The ruling does not identify the hospitals involved in the agreement. Thanks, however, are owed to Ms. Kathleen Bruvold, Associate General Counsel for the University of Cincinnati, for providing the author with a copy of the agreement. Amended and Restated Joint Operating Agreement among The Christ Hospital and University of Cincinnati and The St. Luke Hospitals, Inc. and Jewish Health System, Inc. and The Health Alliance of Greater Cincinnati (Jan. 1, 1996) (on file with *The Florida Tax Review*) [hereinafter Greater Cincinnati Joint Operating Agreement.] Certain provisions of the agreement are reproduced verbatim in the footnotes which follow.

61. The hospital participants are: The Christ Hospital, a 501(c)(3) organization having its principle offices in Cincinnati, Ohio, The University of Cincinnati Hospital, a state agency having its principle offices in Cincinnati, Ohio, The College of Medicine of the University of Cincinnati, also a state agency having its principle offices in Cincinnati, Ohio, St. Luke’s Hospital, a 501(c)(3) organization having its principle offices in Ft. Thomas, Kentucky, and Jewish Health Systems, Inc., a 501(c)(3) organization having its principle offices in Cincinnati, Ohio. Greater Cincinnati Joint Operating Agreement, *supra* note 60, at 73.

62. Priv. Ltr. Rul. 96-51-047 (Sept. 24, 1996). Article III of the Greater Cincinnati Joint Operating Agreement, *supra* note 60, at 14-15, provides:

3.3. Role of the Joint Operating Company Board. The JOC Board, subject to certain powers reserved to the Participating Entities, shall have responsibil-

greater extent than other rulings, the overall facts support the conclusion that the five formally separate hospitals achieved an "all for one, one for all" relationship such that competitive motivations between the participants would be preempted by cooperative motivation. The result, as in prior and subsequent rulings, was the unification of services and conservation of funds to the benefit of shared charitable beneficiaries.⁶³

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- ity for the overall management and supervision of the JOC and its activities, including but not limited to the operation of the Alliance, in furtherance of the purposes set forth in the Articles of Incorporation, including but not limited to the power to:
- 3.3(a). Establish appropriate policies and strategic direction to enable the Alliance to function as an integrated health care delivery system providing a full range of health care services without regard to race, creed, color, national origin or economic status;
 - 3.3(b). Facilitate cooperative and collaborative efforts by and among the Participating Entities with respect to the provision of health care services, including but not limited to efforts to enhance existing health care delivery facilities and systems and establish efficient and economical systems of health care delivery operating on an integrated basis and providing a continuum of care;
 - 3.3(c). Reduce the cost of the delivery of health care services and otherwise effect efficiencies and economies of scale in the delivery of health care services by the Participating Entities;
 - 3.3(d). Enhance the health status of the community by developing and offering new and/or expanded health care services, including but not limited to wellness programs, preventative health initiatives and services, and community and patient need and satisfaction assessments;
 - 3.3(e). Govern the Alliance and provide health care services in a non-discriminatory manner for the benefit of all persons in the community, including the indigent and those persons whose care is paid for in whole or in part through government sponsored programs such as Medicare or Medicaid;
 - 3.3(f). Develop, promote, operate and/or support educational and scientific research activities and programs through the Alliance in furtherance of the general health of the communities served by the Alliance;
 - 3.3(g). Review and approve financial and strategic plans and operating and capital budgets for the Alliance to be developed and implemented by JOC management, including issuance of all debt;
 - 3.3(h). Enter into contracts on behalf of the Participating Entities with respect to the organization and operation of the Alliance;
 - 3.3(i). Hire, evaluate and compensate the JOC CEO and participate in the selection of the other senior management of the Alliance; and
 - 3.3(j). Do all other things necessary and appropriate to carry out the duties and responsibilities of the JOC in governing, managing and operating the Alliance and achieving its strategic goals consistent with the terms and conditions of this Agreement.

63. Priv. Ltr. Rul. 96-51-047 (Sept. 24, 1996). Article II of the Greater Cincinnati Joint Operating Agreement, *supra* note 60, at 12, states:

The consolidation entity created in Private Letter Ruling 9651047 has virtually all the power and authority over the five participants that a single governing board would have over its own single institution. For example, the consolidation entity has the authority to enter into contracts on behalf of the entire system or any one of the participants. It also has authority to formulate strategic and financial plans, direct which hospital would perform which service, reassign assets from one hospital to another, coordinate the practices of the hospitals' staff physicians, and establish budgets for the hospitals.⁶⁴ Additionally, the consolidation entity's chief executive officer serves as the chief executive officer for each of the five participating hospitals.⁶⁵ Unlike the prior and subsequent rulings, however, this ruling did not involve a formalistic method of annualized payments between the participants. Instead, the consolidation entity has the authority to retain all net revenues and direct them to any facility within the system as the system's needs dictate.⁶⁶ Thus the consolidation entity has financial governance authority greater than that in other rulings. The Service reviewed the facts in great detail and concluded that the consolidation entity qualified for tax exempt status and that any party to the joint operating agreement could transfer assets, resources and personnel to any other party without jeopardizing its tax exempt status or engaging in

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- 2.2. Strategic Goals. The Alliance will accomplish its mission by achieving the following strategic goals:
- 2.2(a). To enhance the ability of the Participating Entities to respond to health care needs of the communities served by the Participating Entities by creating an integrated health care delivery system serving Ohio, Kentucky and Indiana, developing a primary care network, and developing the necessary infrastructure and information systems to more effectively manage the delivery of health care to enrolled populations.
- 2.2(b). To reduce the costs of health care providers participating in the Alliance, and the ultimate cost of health care to the communities served by the Alliance.
- 2.2(c). To improve the quality of educational programs offered by the Participating Entities through continual support of the teaching and research activities of the Participating Entities, focusing resources and expanding primary care training venues and modalities, and as otherwise provided herein.
- 2.2(d). To enhance the general health status of the communities by developing the capabilities to manage enrollee health care costs through risk-sharing arrangements including capitation; offering new methods of health care delivery including wellness, preventative health initiatives and patient satisfaction measures; and maintaining a commitment to provide care (subject to the availability of resources) on a nondiscriminatory basis to the indigent and those whose health care is paid for, in whole or in part, by any governmental program, including Medicare and Medicaid.

64. Priv. Ltr. Rul. 96-51-047 (Sept. 24, 1996).

65. Id.

66. Id.

an unrelated business activity.⁶⁷ The parties were therefore able to achieve complete consolidation.

The resulting merger in Private Letter Ruling 9651047 was more actual than virtual, since the consolidation entity exercised almost all the attributes of ownership over assets, legal title to which remained with the participants. That fact leaves one to wonder about the degree of integration that the Service's facts and circumstances test actually requires. A synthesis of the rulings certainly suggests that at a minimum the parties must achieve a codependent/cooperative rather than competitive/duplicative relationship. But if the degree of integration in the third ruling is now the standard or even a safe harbor, there is little difference between a virtual and actual merger, the latter of which the parties presumably disdained for sound nontax operating reasons. Hence, the joint operating agreement requirement, at least as demonstrated by the third ruling, results in the law's coming full circle from a point at which an actual parent-subsidiary relationship need not exist to the requirement that such a relationship be proven even while the parties disdain and deny its existence.

The overall conceptualization of joint operating agreements begs the question not whether the virtual merger requirement is sensibly imposed from a tax policy standpoint, but whether actual or virtual mergers are sensible alternatives to the simple creation of a mutually-owned captive subsidiary or mutual cooperation between exempt organizations. Certainly, approval of joint operating agreements represents the Service's grant of relief to entities who need to consolidate but who do not wish to effect an actual merger. But joint operating agreements, *vis-à-vis* mutual subsidiaries, are as burdensome and complex as actual mergers and hence provide little or no relief for those exempt organizations who, for sound operating reasons, do not wish to actually merge but still need to eliminate duplication of services. The need, moreover, is caused by the Service's prohibition of mutual subsidiaries under Regulations section 1.502-1(b)'s articulation of the integral part theory, not from an apparently logical limitation of choices to mergers on the one hand, and debilitating and wasteful duplication of services on the other. None of the rulings or internal training material, though, address the necessity for the complexity engendered by joint operating agreements. In fact, the emergence of joint operating agreements is notable for the lack of any real policy discussion beyond the way these agreements work. Such a discussion is necessary and should first acknowledge the problem of complexity in tax law and how joint operating agreements contribute to that complexity, and then examine the policy reasons, if any, which justify the complexity particular to joint operating agreements.

67. *Id.*

III. THE BANE OF COMPLEXITY

There is no great revelation in the recognition that the tax code, along with its interpretive byproducts, is massive, complex, and massively complex.⁶⁸ In fact, any statement concerning the tax code's complexity necessarily falls in the category of understatement since no single scholar can accurately measure the infinitesimal nature of the code's complexity. Nevertheless, several scholars have identified particular aspects of the complexity with both elegance and analytical acuity.⁶⁹ Although the problem is stated differently and only by way of anecdotal examples, commentators and indeed the courts⁷⁰ generally accept the notion that tax law is simply too complex.

The manifestation of complexity, oddly enough, can be summarized in a few easily understood statements. First, complexity is manifested in the inability of taxpayers and tax collectors to arrive at a "reasonably certain conclusion [concerning a transaction] despite diligent and expert research."⁷¹ This first type of complexity might generally be stated as an inability to know the law. The most immediate cause of this form of complexity, although certainly not the only cause, is the sheer length of the code.⁷² Even a straight line between two points can be confusing if one cannot know where to start or when to stop. If nothing else, the code's volume creates anxiety

68. Defining "complex" is itself a complex exercise. The American Heritage College Dictionary seems to have the tax code in mind when defining "complex." It uses a list of synonyms in the following discussion:

These adjectives mean having parts so interconnected as to make the whole perplexing. *Complex* implies a combination of many associated parts *Complicated* stresses elaborate relationship of parts *Intricate* refers to a pattern of intertwining parts that is difficult to follow or analyze *Involved* stresses confusion arising from the commingling of parts and the consequent difficulty of separating them *Tangled* strongly suggests the random twisting of many parts *Knotty* stresses intellectual complexity leading to difficulty of solution or comprehension.

The American Heritage College Dictionary 285 (3d ed. 1993).

69. See Eustice, *supra* note 4; Pollock, *supra* note 4; Roberts et al., *supra* note 4; Sawyer, *supra* note 4; Surrey, *supra* note 4; White, *supra* note 4.

70. The courts have, on occasion, noted or decried the complexity even in the provisions relating to tax exempt organizations. See *Bob Jones University v. United States*, 461 U.S. 574, 596-99 (1983); *Windsor Foundation v. U.S.* 77-2 USTC (CCH) ¶ 9,709 (E.D. Vir. 1977) ("On the basis of the congressional enactment, 26 U.S.C. § 501, et seq., the Internal Revenue Service has drafted fantastically intricate and detailed regulations in an attempt to thwart the fantastically intricate and detailed efforts of taxpayers to obtain private benefits from foundations while avoiding the imposition of taxes."). For a compilation of judicial statements concerning the code's complexity see, Katz, *supra* note 4.

71. Roberts et al., *supra* note 4, at 327.

72. One commentator notes that the code and regulations consisted of a single volume of approximately 400 pages in 1913, but, by 1994, the code and regulations took up eight volumes and consisted of more than 36,000 pages. Pollock, *supra* note 4, at 320 n.3.

which in real terms translates into delay and expense as practitioners are forced to consider and then apply or discard, as the case may be, the many different cross-referenced provisions which may be relevant to a transaction. Second, complexity is manifested in the inability to achieve a reasonably certain conclusion except after an inordinate expenditure of time and money.⁷³ This type of complexity can be summarized as an inability to afford the law. Being unable to afford knowledge of the law is too often the case with provisions which are intended to narrow the path to a desirable result, i.e., anti-abuse provisions.⁷⁴ Third, a conclusion might be knowable with or without much time or effort, but implementation may require an inordinate amount of time and money, or an inordinate change in operating practices. In other words, the tax rule might be easily found and stated, but its substance requires involved or detailed changes in operating practice, which would otherwise not be undertaken. This type of complexity is best described as "transactional complexity" because the tax rule is easy enough to determine but difficult to implement.⁷⁵ Each of the three types of complexity, but the third most of all, violate the accepted notion that tax rules should be neutral and "not distort the economy or the efforts" of those subject to the rules.⁷⁶ Thus, in all respects and however crude it may sound, complexity is defined by reference to time and money. Too much time and too much money must be diverted to tax compliance and away from the purpose of the taxpayer's principle endeavors.

Congress is foremost amongst the list of usual suspects responsible for tax complexity.⁷⁷ It is faulted for several reasons, including the apparently opposite assertions that statutes are written much too ambiguously⁷⁸ and with too much detail and specificity.⁷⁹ This criticism might be reconciled by

73. Roberts et al., *supra* note 4, at 327.

74. See, e.g., IRC §§ 469, 1272-1275, 7872.

75. Charles E. McLure, Jr., *The Budget Process and Tax Simplification/Complication*, 45 *Tax L. Rev.* 25, 46 (1989) ("For one thing, factoring tax considerations into business decisions can be expected to complicate decision making, creating transactional complexity.").

76. Eustice, *supra* note 4, at 10.

77. *Id.* at 13.

78. Pollock, *supra* note 4, at 339 (discussing vague and overly-broad language).

79. Eustice, *supra* note 4, at 10 ("But surely the charitable deduction section, a provision commonly used by taxpayers with widely varying levels of expertise in statutory analysis, is not worthy of a 13-page provision in the Code, but there it is."); see also Dunn, *supra* note 6, at 321. Dunn states:

[A] full and detailed legislative solution is not only enormously complicating, but it allows taxpayers to develop schemes and plans to avoid the legislative purpose when that purpose is set forth in precise and detailed statutory language. This, in turn, as noted above, leads to further legislative responses. . . . Because such legislation is necessarily complicated and detailed, it is normally very difficult for taxpayers, their advisors

the notion that it ought to be possible to draft a statute in broad general terms and still adequately identify the consequences of a particular transaction, or favored/disfavored transactions, without including the degree of specificity which gives the code its impenetrability.⁸⁰ The use of overly specific language merely expresses a lack of confidence in the judiciary's role in interpreting tax provisions. It co-opts the judiciary's role by stating a rule and determining a result in a fact situation far too specific to be reasonably injected into a statute.⁸¹ Courts too often accede to this subordination by stating that the code's complexity necessitates the judiciary's acceptance of a passive role.⁸² This accession by the courts only reinforces the result. The Code becomes increasingly specific, i.e., complex, as the judiciary become more and more reluctant to interpret or analyze these tax provisions ostensibly because of their complexity.

and tax administrators to understand and implement such legislation. Such complex tax legislation presents taxpayers, tax professionals, and tax administrators with enormous compliance problems and not infrequently leads to a general disregard and disrespect for such legislation.

Id.

80. The danger to this observation and the catch-22 for drafters, at least with respect to regulations, is that if a regulation is drafted too generally, it may be struck down as unconstitutionally vague. See *Big Mama Rag, Inc. v. United States*, 631 F.2d 1030 (D.C. Cir. 1980) (finding the definition of "educational" in Regs. § 1.501(c)(3)-1(d)(3) unconstitutionally vague.) But IRC § 61 is a good example of legislative drafting that is general, yet with the assistance of the judiciary, has a generally understood and agreed upon meaning. Professor Eustice argues that drafting statutes and regulations in general terms does not solve the complexity problem but merely shifts the problem to another branch—from the legislative and executive to the judiciary. Eustice, *supra* note 4, at 10-11. But one of the problems of statutory detail is that it discourages the simplification of tax laws through the application of trial and error that is most appropriate to the executive and judicial branches. Courts seem most reluctant to offer the benefit of interpretation under a sharply focused set of facts when the statute is long and cumbersome, trusting instead that the detail is in the statute and the executive branch knows the detail best.

81. See generally Michael Livingston, *Congress, the Courts, and the Code: Legislative History and the Interpretation of Tax Statutes*, 69 *Tex. L. Rev.* 819 (1991); Karla W. Simon, *Constitutional Implications of the Tax Legislative Process*, 10 *Am. J. Tax Pol'y* 235 (1992) [hereinafter Simon, *Constitutional Implications*]; Karla W. Simon, *Congress and Taxes: A Separation of Powers Analysis*, 45 *U. Miami L. Rev.* 1005 (1991) [hereinafter Simon, *Congress and Taxes*].

82. See *Bob Jones University v. United States*, 461 U.S. 574, 596 (1983). But see Simon, *supra* note 80, at 244 ("The rules developed by the Treasury and the Service will tend not to reflect the wishes of special interest groups. As a result, courts by and large may defer to Treasury and Internal Revenue Service rules and regulations without fear that the process of their adoption has been tainted. . . .").

Another criticism not as often mentioned as a source of complexity is Congress' excessive reliance on nonstatutory legislative material.⁸³ By using committee reports and other nonstatutory material to express substantive tax law, Congress contributes to both the inability to know and the ability to afford the law in procedural and substantive ways. From a procedural standpoint, the use of nonstatutory legislative material contributes to the diffusion of authority which makes tax practice so time consuming, unscientific and expensive relative to other areas of law. In addition to statutes, regulations, revenue rulings and judicial opinions, practitioners must also find and decipher various committee reports, post-enactment explanations and any number of other bits and pieces from the legislative process.⁸⁴ Substantively, nonstatutory legislative material contributes to tax complexity because it raises serious questions of authority. Since it is enacted, if at all, entirely outside of the constitutional process,⁸⁵ committee reports and the like are of dubious value. Yet, however dubious and obscure it may be, a piece of legislative history regarding a particular transaction can be ignored only at the taxpayer's peril.⁸⁶

83. See Livingston, *supra* note 81, at 847 (“[T]he use of legislative history results in an unnecessary expenditure of time and money, and lawyers (and perhaps some judges) lack the ability to interpret and apply such history correctly.”).

84. For a good discussion of the difficulties of finding and then interpreting the mass of tax legislative history created by Congress and the interpretive statements issued by the Service, see Sheldon I. Banoff, *Dealing With the “Authorities”: Determining Valid Legal Authority In Advising Clients, Rendering Opinions, Preparing Tax Returns and Avoiding Penalties*, 66 *Taxes* 1072, 1075-1133 (1988).

85. See Simon, *Constitutional Implications*, *supra* note 81, at 256. Professor Simon states:

By elevating legislative history to the level of a statute and giving the materials as much deference as is given to the words of a statute, Congress would be writing laws without going through the normal political process. And it would be stealing power from the executive by telling it how to write rules and from the judiciary by telling it how it must interpret them. This is something the courts should not readily permit. . . .

Id.

86. A simple case demonstrates the proposition. In *Porten v. Commissioner*, 65 T.C.M. (CCH) 1994 (1993), a student sought relief from the realization of income from the discharge of a student loan under IRC § 108(f)(1). IRC § 108(f)(1) provides relief from realization if the discharge is made conditional upon the student's agreement to work “for a certain period of time in certain professions for any of a broad class of employers.” The post-enactment legislative history known as the “Bluebook” amongst tax practitioners, limits the “certain professionals” to medicine, nursing, and teaching, although the limitation is not stated in the statute or regulations. Staff of The Joint Comm. on Taxation, 98th Cong., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1994*, at 1200 (Joint Comm. Print 1985). The Court, though, adopted the post-enactment legislative history and relied upon it to deny relief to the student. *Porten*, 65 T.C.M. (CCH) at 1996.

The Treasury Department, too, is faulted for its role in creating unnecessary complexity. Unlike Congress, Treasury's role can be summarized by reference to a fiscal stinginess, which is entirely appropriate, but which is too often manifested by an overly cautious and sometimes obsessive approach to substantive questions of tax law.⁸⁷ Final regulations, for example, are routinely enacted years after they are initially proposed, apparently as a result of a fear of expressing a binding (upon the Service) interpretation lest the interpretation leave room for abuse.⁸⁸ Treasury's obsessive characteristics are most demonstrated, frankly, by an inability or unwillingness to take "no" for an answer when to do so would be both reasonable and provide needed certainty to an issue. This is particularly true with respect to judicial decisions with which the Treasury disagrees and, despite well reasoned opinions, continues to litigate.⁸⁹ That the Treasury might continue to litigate a point encourages a disrespect for the judiciary's role in tax jurisprudence and increases the transactional burdens, i.e., the complexity, of a related transaction since the taxpayer must factor in the risk of future litigation. One final example of treasury's stinginess concerns the length of time the Service takes to issue technical advice and private rulings to taxpayers, who, being unable to safely conclude a transaction due to already existing complexity, must invariably seek prior approval from the Service. This latter result, the necessity to obtain prior IRS approval, might appropriately be called the "reverse tax lottery." The tax lottery is said to occur when, because tax laws are so complex and the stakes in a particular transaction are relatively low,

87. Eustice, *supra* note 4, at 14 ("[T]he Treasury has been excessively concerned with the fisc—some have even called this fiscal paranoia—the fact that they might lose a dollar of revenue if they ever gave in on something."); Roberts et al., *supra* note 4, at 36 ("[T]he Treasury has sometimes been obsessed with the fear of possible tax abuse by some and consequently has pushed for provisions which lean too far in the direction of specificity and complexity.").

88. For example, the Service proposed regulations to interpret IRC § 117 on June 9, 1988. Prop. Regs. § 1.117-6. Almost ten years later, the regulations have still not been enacted in final form. Likewise, the Service initially proposed regulations to interpret IRC § 125 on May 7, 1984. Prop. Regs. § 1.125-1. Those regulations have also not been enacted in final form. On the other hand, temporary regulations interpreting IRC § 170(f)(8) were issued on May 27, 1994. 59 Fed. Reg. 27458 (May 27, 1994). Final regulations regarding IRC § 170(f)(8) were issued on December 16, 1996. 61 Fed. Reg. 65,946 (Dec. 16, 1996).

89. Even after a string of defeats and partial victories with respect to the definition of "royalty" for purposes of IRC § 512(b)(2), including a well-reasoned opinion by the Ninth Circuit Court of Appeals, the Service continues to challenge the definition as it might apply to proceeds from "affinity" credit cards. See *Sierra Club, Inc. v. Commissioner*, 86 F.3d 1526 (9th Cir. 1996); *Disabled Am. Veterans v. Commissioner*, 94 T.C. 60 (1990), *rev'd*, 942 F.2d 309 (6th Cir. 1991); *Disabled Am. Veterans v. Commissioner*, 650 F.2d 1178 (Ct. Cl. 1981); *Oregon State Univ. Alumni Ass'n v. Commissioner*, 71 T.C.M. (CCH) 1935 (1996); see also *Mississippi State Univ. v. Commissioner*, T.C. Memo. 1997-397.

a taxpayer takes a position that is probably unjustified but unlikely to be challenged by the Service.⁹⁰ The reverse tax lottery is the opposite; the inability to come to a “reasonably certain conclusion” coupled with the relatively high value of the transaction requires that the taxpayer always seek the Service’s prior review and approval. The result of the reverse tax lottery is an increase in time and money necessarily diverted from the principle endeavor.

Complexity, of course, is an elusive and relative concept. Rules and regulations applicable to any endeavor necessarily increase the number of discrete tasks which must be achieved to accomplish the endeavor. In the tax exempt arena, for example, there is a basic endeavor, providing charitable goods and services, which is accomplished through a basic subsidy, tax exemption. To that basic subsidy, though, is attached certain other rules and regulations generally involving prohibitions against the use of tax exemption for unfair competition,⁹¹ private profit⁹² or political purposes.⁹³ Thus the basic endeavor is complicated by the necessity to accomplish the tasks dictated by the added rules and regulations. These added rules and regulations, being directed to real possibilities of human nature, have never been seriously questioned and indeed are viewed as necessary and worth the added complexity—worth the diversion of time and money from the provision of charitable goods and services. That is, the benefits of the rules and regulations outweigh the diversion of time and money from the basic endeavor because without the rules and regulations there is the real possibility that even more time and money might be diverted from the subsidized goal by those who would engage in profit taking or political advocacy. Thus, the question in any case is not merely whether a particular tax rule or regulation increases complexity. Invariably rules and regulations do so. The question is whether the benefits of the rule or regulation outweigh the diversion of time and money from the basic endeavor.

With regard to joint operating agreements, the inquiry involves an identification of the benefits obtained by adherence to the complexities

90. Roberts et al., *supra* note 4, at 330. Roberts states:

The “appallingly complicated” tax law, the inadequacy of audits by the Service, the manpower of the Service devoted to complexity, the impracticality of training revenue agents to achieve expertness in the morass of the existing tax law and the flexibility available to the taxpayer in legitimately resolving to his own advantage the numerous doubtful issues resulting from those complexities, all serve to turn the income tax return of the affluent taxpayer into a lottery. . . .

Id.

91. IRC §§ 502, 511.

92. IRC § 501(c)(3).

93. Id.

engendered. And because the complexity is indeed a relative concept, it is also relevant to compare the joint operating agreement model to other forms of achieving the consolidation goal which ultimately benefit the more effective delivery of charitable goods and services ("the basic endeavor"). The result of this inquiry will answer the question whether joint operating agreements are unnecessarily complex impositions on tax exempt organizations.

The basic endeavor of joint operating agreements is the consolidation of services, reduction in overhead costs and the resulting delivery of greater portions of the charitable fisc to charitable beneficiaries. Joint operating agreements accomplish this goal by eliminating the practical requirement that several different nonprofit hospitals within a general area and having the same or substantially similar goals each offer identical services. Consolidation is achieved because different tasks are undertaken by one hospital for the benefit and use of the others, rather than several hospitals each undertaking the same tasks for their own benefits.

To achieve this consolidation without adverse tax consequences, a joint operating agreement requires completion of several incremental tasks.⁹⁴ Foremost, the several hospitals must negotiate and agree upon basic philosophical goals and embody these goals in an overall constitutional document.⁹⁵ Since the essential aspect of a joint operating agreement is the formation of and acquiescence of power to a consolidation entity, the several participants must somehow coordinate their individual philosophies into a single articulation which, in turn, will be assumed by the consolidation entity.⁹⁶ Although several hospitals may appear functionally identical to one another, religious, historical, educational, public and private affiliations and commitments make the coordination process both sensitive and time

94. See generally Hollis, *supra* note 25, at 131-33.

95. One hospital consultant lists twelve different areas which hospital boards must coordinate with those with whom it enters into a joint venture. Hollis, *supra* note 25, at 134. Each hospital participant should be able to demonstrate or agree upon the following: commitment to a central mission, sharing of governance, commitment to serve a certain region, continuation of services deemed important to a particular participant, evidence of regional exclusivity, ability to effect physician integration, ability to attract patients, ability and willingness to undertake risky managed care contracts, employee development, financial strength, commitment to sufficient capitalization, and demonstrated ability to achieve economies of scale. *Id.*

96. The strategic rationale that leads a hospital to seek an affiliation may be clear; the process, however, is never easy. The boards of community hospitals typically are emotionally attached to "their" hospital, fiercely loyal to its employees, and very concerned about their community. In addition, boards often are highly protective of their independence and reluctant to share control.

See, Hollis, *supra* note 25, at 132.

consuming,⁹⁷ necessarily involving discussions and negotiations as to basic points and then the more difficult task of actually articulating those basic points in a manner politically acceptable to the participants, their individual governing bodies and their constituents.⁹⁸ Once agreement on a basic philosophy is reached and sufficiently recorded, the participants must then begin the process of completing the discrete tasks necessary to the accomplishment of the joint operating agreement.

Initially, the parties must agree upon how their individual interests and concerns will be represented in the consolidation entity's governance structure. The natural tendency to retain autonomy must give way to the consolidation entity's authority over the previously independent participants. The parties must negotiate the extent of the authority ceded to the consolidation entity, keeping in mind that too little authority will preclude the application of the integral part doctrine, but too much authority will result in a sacrifice of identity. The resulting agreement as to the cessation of power is merely one part of the joint operating agreement's foundation.

A necessary next step in the process involves the creation of trust between the parties, particularly concerning each participant's ability to perform its role in the joint operating agreement and avoid harming another participant's financial status. Trust is not inherent in the basic endeavor. It is created by each hospital's governing members, in meeting their respective fiduciary duties, obtaining and reviewing the normally confidential papers, documents and performance histories pertaining to other participants with the help of various auditors, consultants, and attorneys skilled in such matters.⁹⁹ After having done so, and perhaps having innumerable questions and

97. In *Priv. Ltr. Rul. 96-51-047* (Sept. 24, 1996), the parties were required to coordinate the philosophies of a state university and medical school with three other hospitals operating in conformance with three different religious faiths. *Greater Cincinnati Joint Operating Agreement*, *supra* note 60. Certain hospitals in that ruling reserved the power to veto changes effecting their abilities to provide certain services with which the hospitals were traditionally associated. *Id.* In the most recently approved joint operating agreement, one participant was owned and operated by a religious order which abided by certain policies limiting the alienation of church property. *Tracy and Lewis*, *supra* note 43, at 455. The parties were also required to make certain promises to the state regarding the continuation of certain types of health care. *Id.*

98. The joint operating agreement in *Priv. Ltr. Rul. 96-23-011* eventually dissolved due to the participant's inability to agree upon a single leadership, operating, and managing philosophy. David Burda, *Joint Operating Agreement Gets IRS Nod*, *Modern Healthcare*, June 17, 1996, at 6. The *Greater Cincinnati Joint Operating Agreement* became the subject of litigation involving the Cincinnati City Council, the Legal Aid Society of Cincinnati and a coalition of taxpayers all seeking to block the University of Cincinnati Hospital's conversion from a public teaching hospital to a private nonprofit medical center. *Gold*, *supra* note 25, at G-1.

99. See *Hollis*, *supra* note 25, at 138.

concerns answered through meetings and exchanges of correspondence, the governing authorities may satisfy themselves that involvement in the virtual merger will not adversely jeopardize their basic missions.

The similarity of the joint operating agreement to actual mergers, as well as its involvement of entities which are essentially public trusts and, in some cases, financed by tax exempt bond issues, necessarily requires that the participants make statutory or regulatory notifications to state and federal organizations having enforcement authority over certain issues. In the Private Letter Ruling 9651047, for example, the parties felt it necessary to notify the United States Department of Justice concerning antitrust issues,¹⁰⁰ and request rulings from the Service regarding change of use in facilities financed by tax exempt bonds, in addition to application for recognition of the consolidation entity as a tax exempt organization.¹⁰¹ These required notices and requests for rulings and approval involving incremental governmental review necessarily increase the time and money which must be dedicated to the endeavor.

The final major group of tasks which go into the building of the joint operating agreement concerns financial integration. The parties must determine the formula by which risks and costs will be shared. Participants will likely bring to the agreement assets and earning potentials of varying values. These contributions must be reconciled with the need to achieve a unitary, noncompetitive structure necessary to the application of the integral part doctrine. A hospital with lower contribution values must nevertheless be granted a degree of representation in the overall governance such that individual autonomy and identity is maintained to whatever extent is allowable within a virtual merger. Additionally, each hospital may bring with it financial obligations and accrued liabilities which must be integrated into the whole structure. This may involve the other participant's assumption of liabilities through guarantees and other third party undertakings. These financial integration tasks, as with prior tasks, involved significant expenditures of time and money.

The incremental tasks discussed above are also complimented by the undertaking of prospective obligations. The parties must make various

100. Greater Cincinnati Joint Operating Agreement, *supra* note 60, at 3. The parties to Priv. Ltr. Rul. 96-23-011 also submitted the proposed agreement to the Department of Justice for antitrust review. Burda, *supra* note 98, at 6. See generally 15 U.S.C. §§ 1, 2 (1988). The antitrust implications of joint operating agreements are beyond the scope of this article but are explored in Gloria J. Bazzoli et al., Federal Antitrust Merger Enforcement Standards: A Good Fit for The Hospital Industry? 20 J. Health Pol. Pol'y & L. 137 (1995).

101. Conditions under which the IRS will issue a favorable change of use ruling are generally explained in Rev. Proc. 93-17, 1993-1 C.B. 507 and Rev. Proc. 97-13, 1997-6 I.R.B. 13.

warranties and accept mutual prohibitions all designed to ensure that the investment into the unitary structure is maintained for a period of time sufficient to make the joint operating agreement worth the effort and expense incurred by each participant and also to achieve the level of permanence sufficient to achieve a virtual merger. The entire endeavor is completed by various enforcement and supervision mechanisms which allow each party to monitor the performance and viability of the other participants.

From a more global perspective, the joint operating agreement mechanism, at least in the manner in which it is presently implemented, increases the complexity surrounding the tax code. The joint operating agreement contributes to the diffusion of authority because it allows exempt entities to do that which is otherwise prohibited by statute, regulations and case law¹⁰² but only after accessing the minds and opinions of those in the Service charged with enforcing applicable tax law. This is particularly true with respect to joint operating agreements because the entire mechanism is implemented via private, nonprecedential letter rulings having no general applicability.¹⁰³ Indeed, implementation of the joint operating agreement as a condition of necessary consolidation takes undue drafting specificity to new heights. It essentially involves administrative adjudication one case at a time, as each joint operating agreement must be submitted to the Service for review and approval. This final result, too, is essentially a pushing aside of the judiciary's role since law is applied to fact in the piecemeal fashion most appropriate to the judicial process.

The building of the joint operating agreement, then, involves transactional complexity. While, the integral part doctrine is relatively simply determined, it is very difficult to implement, at least with respect to separate tax exempt entities who might otherwise consolidate their efforts through the

102. For example, IRC § 501(e) unquestionably denies tax exempt status to an organization which provides laundry services to unrelated exempt hospitals. *HSCS-Laundry v. U.S.*, 450 U.S. 1, 7 (1981). But a group of unrelated hospitals can use a joint operating agreement to create a tax exempt mutually owned laundry facility. In a recent tax court memorandum decision, Judge Foley made the astonishing distinction that IRC § 501(e) prevents an organization from gaining tax exempt status by virtue of their provision of services to "two or more hospitals." But if the organization serves two hospitals and a nonhospital tax exempt organization, IRC § 501(e) is rendered inapplicable. *University Med. Resident Servs. v. Commissioner*, 71 T.C.M. (CCH) 3130, 3131-33 (1996) ("To qualify as a hospital cooperative under section 501(e), the organization must provide services 'solely for two or more hospitals.' Petitioners serve schools in addition to hospitals. Thus, they are not hospital cooperatives, and section 501(e) does not preclude petitioners from qualifying under section 501(c)(3)."). If upheld, the interpretation would render IRC § 501(e) a nullity since hospital service organizations would only have to add a single nonhospital to get around the prohibition of IRC § 501(e).

103. IRC § 6110(j)(3) states that such rulings may not be relied upon as precedent.

use of mutually-owned subsidiaries or by providing commonly needed administrative services to one another; that is, the separate entities might consolidate their efforts without joint operating agreements were it not for the restrictions of Regulations section 1.502-1(b). But for the adverse tax consequences created by Regulations section 1.502-1(b), the parties might very well eliminate the wasteful duplication by creating a mutually-owned subsidiary using the customary parent-subsidiary model. Alternatively, or additionally, the parties might enter into relatively simple joint service contracts whereby one hospital undertakes to provide needed administrative support services for the others. From a policy standpoint, then, the inquiry should identify and analyze the tax rules which prevent the hospitals from resorting to the more simple alternatives and instead undertaking the difficulties of creating joint operating agreements.

IV. THE UNFAIR COMPETITION RATIONALE

Exactly what is meant by the term "unfair competition" is a useful inquiry since that is the primary concern of Regulations section 1.502-1(b) and its resulting joint operating agreement requirement. In its most relevant sense, unfair competition is the harm to the taxable business community which results when a tax exempt entity engages in a noncharitable activity.¹⁰⁴ Although the term "charitable activity" is often defined by traditional

104. "Unfair competition" is more often defined by reference to harm to individual taxable businesses or their investors, as if the harm were actually provable. See John M. Strefeler & Leslie T. Miller, *Exempt Organizations: A Study of Their Nature and The Applicability of the Unrelated Business Income Tax*, 12 *Akron Tax J.* 223, 230-31 (1996); Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 *Va. L. Rev.* 605 (1989) [hereinafter *Hansmann, Unfair Competition*]; Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 *Stan. L. Rev.* 1017 (1982). But the cases in which unfair competition is found are notable for the lack of proof with regard to a particular taxable entity. Note the hypothetical nature of Justice Marshall's discussion of unfair competition in *American Bar Endowment v. United States*:

If ABE's members may deduct part of their premium payments as a charitable contribution, the effective cost of ABE's insurance will be lower than the cost of competing policies that do not offer tax benefits. Similarly, if ABE may escape taxes on its earnings, it need not be as profitable as its commercial counterparts in order to receive the same return on its investment. Should a commercial company attempt to displace ABE as the group policyholder, therefore, it would be at a decided disadvantage.

The Claims Court failed to find any taxable entities that compete with ABE, and therefore found no danger of unfair competition. It is likely, however, that many of ABE's members belong to other organizations that offer group insurance policies. Employers, trade associations, and financial services companies frequently offer group insurance policies.

notions of kindness and altruism,¹⁰⁵ in practice it is just as often identified by reference to gaps in market availability. The provision of goods and services which the market does not adequately provide is considered a “charitable” activity regardless of its dissimilarity to traditional or “inherently” charitable activities such as the provision of food and shelter.¹⁰⁶ Filling

Presumably those entities are taxed on their profits, and their policyholders may not deduct any part of the premiums paid. Such entities may therefore find it difficult to compete for the business of any ABE members who are otherwise eligible to participate in these group insurance programs.

477 U.S. 105, 114-15 (1986); see also *Living Faith v. Commissioner*, 950 F.2d 365, 373 (7th Cir. 1991) (“It is significant that *Living Faith* is in direct competition with other restaurants.); *Presbyterian and Reformed Publ’g Co. v. Commissioner*, 743 F.2d 148, 152 (3d Cir. 1984) (“The principal issue we must address is at what point the successful operation of a tax exempt organization should be deemed to have transformed that organization into a commercial enterprise and thereby to have forfeited its tax exemption.”); *Carolinas Farm & Power Equip. Dealers Ass’n v. United States*, 699 F.2d 167, 169 (4th Cir. 1983) (“One [court] has held that the proper inquiry is whether the activity might be unfairly competitive with taxpaying enterprises While . . . another concludes that . . . the proper inquiry is whether the activity is conducted in a competitive and commercial manner.”) (citations omitted); *United States v. Community Servs., Inc.* 189 F.2d 421, 425 (4th Cir. 1951) (“Manifestly, a corporation engaged in commercial activities, if exempt from federal taxes, would have a tremendous economic advantage over competitors in the same field. Such a corporation could effectively eliminate competitors, actual and potential, since it could undersell corporations, whose earnings are subject to diminution by federal taxation.”); *Hope School v. United States*, 612 F.2d 298, 304 (7th Cir. 1980) (evidence must prove a “possibility” of an unfair competitive advantage over taxpaying greeting card business). Hence, individual taxable entities are rarely, if ever, actually identified as proven victims of unfair competition. Instead victims are hypothetically assumed as a proxy for the taxable economy. That is, potential harm is as equally important as actual harm. See also Bruce R. Hopkins, *The Law of Tax Exempt Organizations* 863 (6th ed. 1993) (“[I]t is theoretically possible for an activity of a tax-exempt organization to be wholly uncompetitive with a taxpaying organization activity and nonetheless be treated as an unrelated trade or business.”).

105. For the traditional and historical discussion of the concept of “charity,” see Hopkins, *supra* note 104, at 70-84.

106. This definition of “charitable activity” is not one which I have found explicitly stated in the literature or judicial opinions, but one which is implied in cases finding that an organization is either primarily engaged in a business activity or engaged in an unrelated business activity. See, e.g., *supra* note 104. Implicit in both findings is the conclusion that taxable organizations stand willing and able to engage in the activity alleged to be “charitable” by the organization claiming exempt status. Economically put, then, a “charitable” activity is one that does not prevent or supplant the normal market operation. At least one other commentator, Professor Henry Hansmann, seems to indulge a similar “market failure” based definition. Hansmann, *Unfair Competition*, *supra* note 104; Henry B. Hansmann, *The Rationale for Exempting Nonprofit Reorganizations from Corporate Income Taxation*, 91 *Yale L.J.* 54 (1981) [hereinafter *Hansmann, Rationale*]. Although he states the issue with more sophistication, he still seems to postulate that nonprofits are necessary and justifiable when consumers cannot reasonably obtain goods and services from the taxable economy:

a market gap is, rather, “functionally” charitable and therefore entitled to the indirect subsidy represented by exemption from tax.¹⁰⁷ But since the taxable economy is the preferred method by which goods and services should be provided,¹⁰⁸ the government subsidy is unnecessary and counterproductive to the extent the taxable economy is willing and able to fill the need. Thus, when the market recognizes and responds to the need, it naturally demands and is, under economic theory, entitled to the greatest share of the customer base. The label, unfair competition, is therefore more likely applied to tax exempt organizations which operate in a market economy supplying similar

Contract failure arises when, owing to the nature of the service itself or to the circumstances under which it is consumed, the purchasers of the service—whether we style them donors or consumers—are likely to have difficulty in (1) comparing the quality of performance offered by competing providers before a purchase is made, or (2) determining, after a purchase is made, whether the service was actually performed as promised. As a result of such conditions, ordinary market competition may be insufficient to police the performance of for-profit firms, thus leaving them free to charge excessive prices for inferior service. In such circumstances consumers often turn to nonprofit providers, which, owing to the nondistribution constraint, [i.e., the prohibition against private inurement] have less opportunity and incentive to exploit consumers than do for-profit firms, and thus serve as fiduciaries of a sort for their consumers.

. . .

In short, under circumstances of substantial contract failure, nonprofit firms may serve consumers more efficiently than for-profit firms. Perhaps, then, tax exemption can be justified as a means of encouraging the development of nonprofit firms in those industries in which, owing to the existence of contract failure, they are likely to have this efficiency advantage.

Hansmann, *Rationale*, *supra*, at 69, 71. If this means that tax exemption is necessary and justified when the market forces leave large number of “patron” needs unfulfilled—because prices are too high for most patrons, for example—then I agree with the conclusion, although I do not necessarily agree with the steps leading to the conclusion. At other times, Professor Hansmann appears to state the conclusion explicitly. See Hansmann, *Unfair Competition*, *supra* note 104, at 617 (“The rationale for granting tax exemption to nonprofits that perform these functions, such as aiding the poor or performing scientific research, is presumably that the services involved would be underprovided in the absence of a subsidy.”); see also Hopkins, *supra* note 104, at 829 (“A tax-exempt organization is engaged in a nonexempt activity when that activity is engaged in in a manner that is considered ‘commercial.’ An act is a commercial one if it has a direct counterpart in the world of for-profit organizations.”).

107. See *supra* note 106. Tax exemption is granted in other cases when the market fails to provide what is considered a necessary or desirable service. For example, IRC § 108(f) exempts from taxation income from the discharge of a student loan in exchange for the performance of services in industries or areas with labor shortages. See IRC § 108(f); see also *supra* note 86.

108. Hopkins, *supra* note 104, at 830.

goods and services via taxable entities.¹⁰⁹ Correspondingly, when the market is either unwilling or unable to provide a good or service, an exempt organization is less likely to be considered to be engaging in unfair competition.

Thus, when tax exemption subsidizes an entity that prevents or supplants the normal operation of the taxable economy, the tax exemption is viewed as encouraging "unfair competition." Hence, the more efficient the taxable economy is functioning, the easier it is that a tax exempt entity violates the unfair competition prohibition. The apparent anomaly is that the tax exempt organization's survival is dependent upon a market structure which does not satisfy all needs. As the market gets better, the justification for tax exemption erodes. The goal, though, from a policy standpoint, is to subsidize the satisfaction of the need, not the operation of a particular entity. Tax exemption is not a job program. Ideally, then, the managers of a tax exempt entity would be satisfied that the need is met and voluntarily relinquish tax exempt status or, still motivated to do good rather than collect profits, the managers may go on to another charitable endeavor—that is, identify and satisfy some other need not being met by the market economy.

Some charitable endeavors, primarily the provision of food and shelter for the poor, education and health care are viewed as so inherent to human existence that the taxable market can never satisfy the needs involved.¹¹⁰ As implied above, these needs are most often thought of with respect to the term "charity." In contrast to exempt organizations which provide functionally charitable activities, exempt organizations which provide inherently charitable activities are much less likely to be viewed as engaging in unfair competition precisely because that market is not subject to monopolization by taxable entities. Thus, unfair competition has a different meaning or, perhaps no meaning at all, when applied to exempt organizations engaging in inherently charitable activities.

Implicit in the phrase, "unfair competition," and regardless of whether one is discussing inherently or functionally charitable activities, is the recognition that there is some level of competition which is fair, otherwise the prohibition would simply limit "competition."¹¹¹ Indeed, for exempt

109. *Id.*

110. Hansmann, too, acknowledges that his "contract failure" theory, see *supra* note 106, does not provide a rationale for nonprofit health care organizations generally operating in a market environment which meets consumer demand. Hansmann, *Rationale*, *supra* note 106, at 70.

111. Indeed, the Service recognizes that the primary impetus of joint operating agreements is the necessity for nonprofit hospitals to compete in the health care market. Darling & Friedlander, *supra* note 8, at 132 ("Virtual mergers are intended to unify operations to achieve cost efficiencies necessary to compete successfully in a managed care environment.").

organizations which collect and depend in part on user fees, competition is essential to the accomplishment of the subsidized goal. For example, to subsidize nonpaying customers or high cost areas, provide a cooperative discount to all customers, and/or fund research,¹¹² exempt hospitals must provide a level of service which equals or exceeds the quality of service available at for-profit hospitals. In the absence of doing so, the exempt hospital will not attract a sufficient amount of paying customers to supplement its grants and private donations. At least some of the paying customers might otherwise patronize nonexempt hospitals. Thus, however charitable the hospital may be, it could not achieve its subsidized goal were it required to maintain a completely hands off attitude with respect to abled customers. Certainly, then, the term "unfair competition" is not synonymous with "competition," but refers to that point at which harm to the taxable economy is foreseeable.

One of the two primary vehicles for preventing unfair competition is the requirement that to achieve tax exempt status, an organization must be "exclusively" engaged in a charitable activity under section 501(c)(3). The second is that an otherwise qualified tax exempt organization may be subject to tax on a portion of its revenues under section 511 if those revenues were obtained through an unrelated activity. Both concepts revolve in sort of a circular manner around the idea of "substantiality." That is, an organization may qualify in the first instance as long as any noncharitable activity may be deemed "insubstantial."¹¹³ But the insubstantial activity, if engaged in with sufficient regularity, will be subject to taxation unless the insubstantial activity is "substantially" related to the exercise or performance of the organization's subsidized goal.¹¹⁴ With respect to the one saving provision,

112. User fees collected by exempt organizations are often used to "cross-subsidize" other users unable to pay the fees or other high cost functions which do not necessarily account for revenue (e.g., research). Hansmann, *The Role of Nonprofit Enterprise*, 89 *Yale L.J.* 835, 877-78 (1980).

113. *Better Bus. Bureau of Wash. v. United States*, 326 U.S. 279, 283 (1945) ("[T]he presence of a single non-[exempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly [exempt] purposes."); Regs. § 1.501(c)(3)-1(c) ("An organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.").

114. IRC §§ 511-513. Regs. § 1.513-1(d)(2) states:
Type of relationship required. Trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is "substantially related," for purposes of section 513, only if the causal relationship is a

it should be noted that when a noncharitable activity is essential to the success of the charitable activity, the organization can more efficiently utilize the tax subsidy if it may itself engage in the necessary but noncharitable activity. Thus, the foregone tax in that instance encourages the efficiency of self-help and is apparently based upon the conclusion that the market opportunity lost to the taxable economy does not result in unfair competition. The only "customer" lost to the taxable economy is the tax exempt organization which performs the noncharitable activity in-house. The loss of that single customer, moreover, is outweighed by the benefits ultimately directed to charitable beneficiaries in greater amounts than if the tax exempt organization could not economize.

Collectively, these two tools, section 501(c)(3) and section 511, address the need to establish a basic formula for identifying charitable institutions on the one hand, and permissible activities for those institutions on the other. The vagueness necessarily inherent in the term "substantial" in both provisions is rather to be commended given the market based variability of the term "charitable." In those difficult cases where the market variability does not clearly determine whether an activity is charitable or noncharitable, the judicial system is properly available to make the determination on a case-by-case basis.

Another provision aimed at preventing unfair competition is section 502.¹¹⁵ Commendable, too, for its simplicity, that provision provides that an organization does not qualify as tax exempt merely because its profits are used exclusively to support a charitable endeavor. The provision thus eliminated the "destination of income" rationale as a means of achieving tax exemption. The operation of that rationale is demonstrated by such cases as *Roche's Beach v. Commissioner*¹¹⁶ and the more infamous successor, *C.F. Mueller v. Commissioner*.¹¹⁷ The entities in both cases achieved tax exempt status because they were "feeder organizations;" the entities "fed" all of their profits to entities which were tax exempt under section 501(c)(3) because

substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the service from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

115. IRC § 502 provides:

An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt from taxation under Section 501 on the ground that all of its profits are payable to one or more organizations exempt from taxation under section 501.

116. 96 F.2d 776 (2d Cir. 1938).

117. 190 F.2d 120 (3d Cir. 1951).

they engaged in the direct provision of charitable services. In *Roche's Beach*, the profits were obtained through the normal operation of a beach resort¹¹⁸ and, in *C.F. Mueller*, the profits were obtained through the normal operation of a pasta manufacturing corporation.¹¹⁹ Thus, comparing the activities to the market-based theory discussed above easily demonstrates the nature of unfair competition. In both cases, neither entity provided an inherently charitable service such as food or shelter for the poor, or education. Nor is there any indication that pasta or beach umbrellas, for example, were in short supply in the taxable economy because of a lack of consumer demand or provider willingness or ability. The tax subsidy—tax exemption—was therefore superfluous and rightly revoked by section 502.

The Service's promulgation of its version of the integral part doctrine in Regulations section 1.502-1(b) as an interpretive byproduct of section 502 thus suggests a conclusion that the unfair competition potential of companies which provide goods and services only to exempt organizations is substantially similar to the unfair competition created by feeder organizations. Recall that under the Service's integral part doctrine, 1) a company is not entitled to tax exemption merely because it provides necessary goods and services to unrelated exempt organizations, 2) an exempt organization engages in an unrelated business activity if it provides necessary goods and services to unrelated exempt organizations, and 3) an organization can achieve exempt status and will not engage in unrelated activity if it limits its provisions of goods and services to its single controlling entity and its sister entities.¹²⁰ The first determination is based upon the conclusion that acting as a cost or below cost provider of goods and services exclusively to unrelated tax exempt organizations is not an "exclusively" charitable activity, even though the recipients need the goods and services and could provide the goods and services in-house or through a wholly owned subsidiary without jeopardizing their exempt status. The second and third determinations are based upon the conclusions that a tax exempt organization's provision of cost or below cost goods and services to other exempt organizations is not substantially related to the accomplishment of the service provider's charitable goals and is therefore an unrelated business activity. Collectively, the Service's integral part doctrine treats consolidation entities as though they created unfair competition to the same extent as feeder organizations.

Treating consolidation entities and feeder organizations as though they created the same effect, however, is supported neither by statute nor judicial opinion. Initially, section 502 is not logically consistent with

118. 96 F.2d at 777.

119. 190 F.2d at 120.

120. See *supra* note 18 (referring to the integral part doctrine).

Regulations section 1.502-1(b). Section 502 was enacted to address organizations characterized by two identifying factors. First, the organization provides goods and services to any willing and able purchaser, and only to willing and able purchasers.¹²¹ If nothing else, the desire to sell to any willing and able to pay customer most characterizes encroachment upon the taxable economy. Second, the excess revenues realized by the organization are used exclusively to fund admittedly charitable organizations.¹²² The Service's integral part doctrine deals with consolidation entities that provide goods and services solely to exempt organizations, not to any willing and able to pay customer. That limitation, too, eliminates the second factor which would make consolidation entities functionally identical to feeder organizations. By limiting itself to tax exempt entities, the consolidation entity cannot expect or desire to fund the admittedly charitable endeavors of the other organizations, except to the extent the consolidation entity allows the exempt organizations to save funds they have raised from other sources. Thus, section 502 of the Code and Regulations section 1.502-1(b) are not logically related.

The apparent inconsistency between the statute and regulation is the reason why the regulation has been so forcefully criticized by courts which have explicitly addressed the regulation. In *United Hospital Services v. United States*,¹²³ for example, the court was so baffled by the inconsistency that it incredulously asked: What does [IRC § 502] have to do with two or more [exempt] organizations setting up a not-for-profit corporation, wholly controlled by them and not serving the public, in order to effect the economies in their own charitable operations?¹²⁴

An even more effective indictment is contained in *Associated Hospital Services, Inc. v. Commissioner*¹²⁵ where the Tax Court stated:

Unlike the abuse situations like *Mueller*, which sections 502 and 511 were clearly meant to foreclose, we are here dealing with a closed circle. The "profit" does not derive from outside sources and flow to the exempt organizations, as in the *Mueller* line of cases. Nor does it flow from vendors to

121. See *United States v. Community Sers.*, 189 F.2d 421, 424 (4th Cir. 1951) ("Taxpayer was, in effect, organized and operated for two purposes: (1) to engage in commercial business, for profit, and (2) to turn over the profits realized from its commercial activities to charitable organizations."), cert. denied, 342 U.S. 932 (1952), reh'g denied, 343 U.S. 911 (1952).

122. *Id.*

123. 384 F. Supp. 776 (S.D. Ind. 1974).

124. *Id.* at 782.

125. 74 T.C. 213 (1980).

potentially nonexempt destinations, as in *B.S.W. Group Inc. v. Commissioner* . . . and *Federation Pharmacy Service, Inc. v. Commissioner*. We would therefore question whether the profit, if any, derived by petitioner was any different from the profit between an exempt parent and its wholly-owned subsidiary¹²⁶

Associated Hospital Services, Inc., is worth reviewing in detail because it provides a useful case study of the issues raised by Regulations section 1.502-1(b) and the joint operating agreement requirement. In that case, four 501(c)(3) hospitals and two county-owned hospitals created Associated Hospital Service, Inc. ("Associated").¹²⁷ Associated's sole purpose was to provide bacteria free laundry service exclusively to the six hospitals. Although taxable entities provided normal laundry services in the locale in which the hospitals operated, they did not provide the specialized laundry services needed by the hospitals.¹²⁸ Nevertheless, the Service denied Associated Hospital's application for tax exempt status because, in its view, Associated was a feeder organization described in section 502 and also failed to meet the qualification provisions of section 501(e).¹²⁹

Section 501(e) is one of the Congressional provisions mentioned earlier which recognize the consolidation concept as a basis of tax exemption.¹³⁰ The provision grants tax exempt status to organizations which provide statutorily identified services exclusively to hospitals. Laundry service, however, is not one of the identified categories.¹³¹ The Service therefore concluded that Associated did not qualify under section 501(e). At the time of Associated's application for tax exempt status, every other court to have considered the issue, all of which were district courts, had concluded that section 501(e)'s specific delineation of services did not preclude organizations which provided nondelineated services from qualifying for tax exempt status.¹³² The Tax Court, however, had not previously addressed the issue and did not do so in this case either.

126. *Id.* at 229 (citations omitted).

127. *Id.* at 214.

128. *Id.* at 215.

129. *Id.* at 213.

130. See *supra* note 31.

131. The listed services are "data processing, purchasing (including purchasing of insurance on a group basis), warehousing, billing and collection, food, clinical, industrial engineering, laboratory, printing, communications, record center, and personnel (including selection, testing, training, and education of personnel) services." IRC § 501(e)(1)(A).

132. 74 T.C. 213, 222-23.

Since Associated provided laundry services to unrelated exempt organizations, the Service also concluded that it could not gain exempt status in any event because Regulations section 1.502-1(b) prevented tax exemption for consolidation entities. The Tax Court gave considerable attention to this conclusion. Its discussion not only reflected unfavorably on the methods by which the Service promulgated the regulation but also demonstrated the logical invalidity of the regulation. If the Court had the magic of foresight and known that the Service would later allow that which Associated sought, via joint operating agreements and without any change to statutes or regulations underlying the Service's arguments in the case before it, the Tax Court might have overturned the Service's conclusions as simply creating unnecessary complexity. Instead, even despite the unfavorable analysis, the Court sustained the regulation essentially on the ground that the regulation had not been changed in the thirty years since it had been enacted.¹³³

The Tax Court began its discussion by tracing the purpose of section 502's enactment in 1950 and the history of Regulations section 1.502-1(b)'s enactment in 1952. It noted that the regulation purported to further the legislative purpose of preventing the unfair competition which motivated the enactment of sections 502 and 511.¹³⁴ Following the statutory enactment, the Service issued the regulation and Revenue Ruling 54-305¹³⁵ in both of which it concluded that consolidation entities such as Associated created unfair competition. The Court noted, however, that Revenue Ruling 54-305 "made no effort to analyze the commercial aspects of the subject corporation's activities, notwithstanding the foregoing legislative rationale for the adoption of the feeder organization provisions."¹³⁶ Instead, according to the Court, the Service "simply assumed" that a consolidation entity creates unfair competition.

The Court referred to a 1958 Court of Claims decision¹³⁷ rejecting the conclusions stated in Regulations section 1.502-1(b) and noted that the Service "rather obliquely" attempted to solidify the rejected regulation by "quietly" amending it.¹³⁸ According to the Court, the Service clarified that

133. Id. at 230.

134. Id. at 216-18.

135. Rev. Rul. 1954-2 C.B. 127. In that ruling, the Service concluded that a purchasing organization which served only exempt hospitals was engaged in a noncharitable trade or business and therefore was not entitled to tax exemption.

136. Id. at 218.

137. *Hospital Bureau of Standards & Supplies, Inc. v. United States*, 158 F. Supp. 560 (Ct. Cl. 1958).

138. The commissioner declined to go along with the result in *Hospital Bureau of Standards & Supplies, Inc.*, and rather obliquely attempted to solidify his position by amending section 1.502-1(b) to limit the concept of related organizations to a formal parent-subsidiary relationship. The

organizations are not sufficiently related simply because they engage in the same activity.¹³⁹ The amendments contradicted the conclusions made by the Court of Claims and, if upheld, would mean that consolidation entities do not achieve tax exempt status under the integral part doctrine unless there exists some formal relationship between the parties served by the consolidation entity. Significantly, though, the Court found the focus on the relationship between the consolidation entity and the service recipients as “totally beside the point.”¹⁴⁰ That conclusion was the Court’s way of saying that the relationship has no relevancy to the question of whether a particular activity results in unfair competition. The Court stated as much when it observed:

In terms of effect on competition, the case where a subsidiary provides integrally related services to only one entity, its exempt parent, may, depending on the facts and circumstances, stand in contrast to the jointly owned service organization situation. In the former situation, it might be argued that the entity could not, standing alone, preempt the market because it only serves one parent, while in the latter situation, it could. On the other hand, there may be little to distinguish, in terms of frustrating commercial competition, between one giant hospital doing its own laundry and four small ones using a jointly owned cooperative.¹⁴¹

Although it did not reject the regulation, the Court’s opinion persuasively articulated the inherent inconsistencies between section 502 and Regulations section 1.502-1(b). It also clearly suggested the logical invalidity of the regulation.

The invalidity demonstrated by comparing the statute and regulation and by judicial opinions, though, is for the most part merely technical. Certainly, the regulation is misplaced to the extent it purports to interpret or expand upon the problem addressed by section 502. In *Associated Hospital Service*, the damning opinion is largely a result of the Court’s comparison of the regulation with section 502, the statute under which the regulation was enacted. But the regulation could be divided into its constituent parts and those parts would logically fall under either section 501 or section 511. The

amendment stated that “An exempt organization is not related to another exempt organization merely because they both engage in the same type of exempt activities.”

74 T.C. 213, 219 (citations omitted); Regs. § 1.502-1(b)(2) (last sentence).

139. 74 T.C. at 219.

140. *Id.*

141. *Id.* at 227.

determination that tax exemption should not be granted to a consolidation entity is essentially stating a conclusion that such activity is not exclusively charitable; that instead it is a nonexempt activity. As such, that portion of Regulations section 1.502-1(b) containing that determination would more properly be promulgated under section 501, setting aside for the moment the determination's substantive merit. The second and third determinations which state that a tax exempt organization engages in unrelated activity if it provides goods and services to an unrelated exempt organization, but does not do so if the other exempt organization is a parent or sister organization, are essentially drawing distinctions between activities that are and are not substantially related to the achievement of the parent's charitable goal. Thus, the last two parts would more properly be promulgated under section 511. The apparent misplacement of Regulations section 1.502-1(b) may prove its technical invalidity but it does not address its substantive merit.

It is, as shown above, possible to identify the overriding concern of the unfair competition prohibitions, i.e., the maintenance of the taxable market's ability to provide goods and services.¹⁴² It is altogether a different matter to identify those facts which, in every case, will support the conclusion that the activities of a particular tax exempt organization impedes the market's ability to function effectively.¹⁴³ Therefore it is impossible to state categorically that the consolidation efforts prohibited by the integral part doctrine do not constitute unfair competition. The one thing that can be determined, however, is that joint operating agreements allow the identical degree of consolidation otherwise prohibited by the Regulations section 1.502-1(b). Where the regulation prohibits unrelated exempt organizations from sharing the costs of goods and services, the Service's joint operating agreement allows such sharing. Where the regulation denies tax exempt status to a consolidation entity, the Service's joint operating agreement requirement grants exemption. Likewise, where specific statutory law denies tax exempt status to an entity which provides laundry service to unrelated hospitals, for example, the joint operating agreement allows such activity.

It is difficult to see how the *result* in one instance can be characterized as unfair competition while the identical *result* in another is fair competition. The identical *result* in either case, where one method is prohibited and the other allowed, leads inexorably to the conclusion that consolidation such as that prohibited in the absence of joint operating agreements does not really constitute unfair competition. With the joint operating agreement mechanism, it is the achievement of centralized control

142. See *supra* notes 104-110 and accompanying text.

143. "While an economically sophisticated definition of unfairness is possible, its application involves subtle empirical issues—so subtle that they may be beyond the administrative capacities of the IRS." Rose-Ackerman, *supra* note 104, at 1022.

between otherwise unrelated exempt organizations that apparently is thought to alleviate the market harm which characterizes the concept of unfair competition. The lack of centralized control is the apparent basis of Regulations section 1.502-1(b)'s consolidation prohibitions. This suggests, without explanation, that the *process* of consolidation embodied in joint operating agreements somehow alleviates the unfair competition resulting in the absence of joint operating agreements. But the unfair competition is concerned with the *resulting* harm to the taxable economy, not the *process* by which the harm occurs. With joint operating agreements, the *result* relative to the policy interest in maintaining the viability of, or at least maintaining governmental neutrality with respect to, the taxable economy, is identical to the *result* which would occur without Regulations section 1.502-1(b). To the extent taxable entities would be denied certain market opportunities in the absence of the regulation, the *resulting* denial is identical using the joint operating agreement mechanism.

Certainly, unchecked consolidation between tax exempt entities might very well constitute unfair competition in the same manner that monopolies are thought to affect the taxable economy,¹⁴⁴ but that case has not been made and indeed is weakened by the approval of joint operating agreements which allow an identical, and in most cases increased consolidating *result* as that which would be available in the absence of Regulations section 1.502-1(b)¹⁴⁵. The only difference is the *process* by which that *result* is obtained. As the Tax Court in *Associated Hospital Services* noted, focusing on the process is "totally beside the point."¹⁴⁶ This conclusion is supported by prior rulings and statutory provisions which grant tax exempt status to consolidation entities without regard to the relationship between the consolidation entity and the service-recipient organizations.¹⁴⁷ Thus, had the Tax Court in *Associated Hospital Services* been presented with the knowledge that the decried consolidation was available under a more complicated process, it very well might have been more confident in its speculation that consolidation does not *ipso facto* constitute unfair competition and rejected the regulation.

As noted earlier, creating a joint operating agreement is a complicated and burdensome process. The transactional complexity of joint operating agreements, by discouraging consolidation, ultimately decreases the extent to

144. See *supra* note 100.

145. The imposition of the joint operating agreement requirement essentially makes mergers, real or otherwise, a necessary step to achieve consolidation and will therefore encourage market clout being concentrated in larger organizations than would result if unrelated exempt hospitals were allowed to share burdens or utilize mutual organizations.

146. 74 T.C. at 219.

147. See *supra* notes 28-29 and accompanying text.

which charitable funds are used to achieve the charitable goal and, to that extent, reduces the effectiveness of the tax subsidy.¹⁴⁸ Since *process* is irrelevant to the unfair competition, the transactional complexity of joint operating agreements serves no purpose except a counterproductive one. That is, exempt organizations which would consolidate in any event, using multiple in-house facilities or single, multiple-parent subsidiaries, are forced to divert even more of the charitable fisc away from charitable beneficiaries and instead to tax compliance activities. Hence, the subsidy of tax exemption would be more effective if Regulations section 1.502-1(b) were repealed.

V. CONCLUSION

When exempt organizations share the costs of necessary administrative services by providing at or below costs goods and services to one another, they effectuate what is essentially a self-contained economy. Charitable funds come to the economy through grants, donations, user fees, and government tax exemption. Ideally, these funds should leave the self-contained economy only by way of charitable beneficiaries and then in the greatest amounts possible. When entities within the self-contained economy must duplicate the efforts of one another, the goal of providing the greatest amount of funds to charitable beneficiaries is thwarted and all contributing sources to the charitable fisc are used inefficiently. The charitable fisc is wasted. Taxation of the effort to share administrative costs discourages efficiency and renders counterproductive the tax subsidy represented by tax exemption.

It is incorrect to simply assume, as Regulations section 1.502-1(b) does, that efficiencies between unrelated entities necessarily results in "unfair" competition and therefore should be discouraged by the imposition of taxation. Indeed, consolidation might be viewed as denying a market opportunity to taxable entities that would otherwise be called upon to provide the goods and services necessary to the charitable goal. But it is not a given that taxable entities are entitled or would be called upon to provide these goods and services. Regulations section 1.502-1(b), being logically related to

148. The prospect of merging with a neighbor can excite a board that is focused on reducing costs and investing the community's charitable resources as rationally as possible, without duplication of services. Yet, boards can be frustrated in their attempt to merge by a regulatory structure that ascribes private, corporate (profit-maximizing) motives to them. Although many such mergers are announced, far fewer actually close, and an even smaller number proceed to achieve the kind of rationalization that spurred the merger in the first place.

Hollis, *supra* note 25, at 135.

the substantiality concepts of sections 501 and 511, admits that even when an exempt organization may not resort to another unrelated tax exempt organization for goods and services, the exempt organization can provide the services on an in-house basis or through a wholly-owned subsidiary. Thus, the foregone market ostensibly thought to be protected by the integral part doctrine is not one which would necessarily be satisfied by taxable entities or one that even exists since exempt organizations are not at all more likely to chose a higher costing taxable entity to provide the goods and services over an in-house facility or a wholly-owned subsidiary. The prohibition of consolidation between unrelated exempt entities contained in Regulations section 1.502-1(b) incorrectly assumes that tax exempt entities will indeed become customers of taxable entities.

The repeal of Regulations section 1.502-1(b) would therefore eliminate the complexity of joint operating agreements and leave sections 501 and 511 as the basic tools with which to prevent unfair competition. Providing tax exemption to consolidation entities through the joint operating agreement mechanism already suggests that consolidation entities would pass muster under those provisions since centralized control is the only element added by joint operating agreements and that element has no logical relationship to the prevention of unfair competition. Insistence upon that added element mistakenly assumes that the market harm of “unfair” competition is a function of *process*—building a joint operating agreement—rather than a function of *result*. Since it is the *result* that determines “unfair” competition and since the permitted consolidating *result* is the same whether joint operating agreements are required or not, Regulations section 1.502-1(b) and its resulting joint operating agreement requirement serves only to create unnecessary complexity and should therefore be discarded.