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Comment

Unrelated Trade or Business Income and Hospitals: Reconciling Operating Losses and Charity Care

I. INTRODUCTION

The exemption of hospitals and other charitable organizations from federal income tax recently has come under close scrutiny by the United States Congress.¹ This scrutiny stems from a belief that hospitals are reaping large profits, yet not returning the benefit of their tax exemptions to the communities they serve. Furthermore, Congress seeks to prevent hospitals from using their exempt status to compete unfairly against nonexempt organizations.²

Statistics show that some of the beliefs about hospitals' prosperity are unfounded.³ Many hospitals are experiencing large operating losses⁴ due to both increasing operating costs and the continued growth in the provision of uncompensated care.⁵ Hospital revenues also are being squeezed by new prospective payment systems that encourage outpatient visits and shift the financial risk of inpatient care to hospitals.⁶

³. Washington News Briefs, Hospitals' 1984 PPS Profits Totaled $5.5 Billion-Study, MODERN HEALTHCARE, June 20, 1986, at 21. A study of more than 4,100 hospitals revealed that in 1984, 52% experienced operating losses. Another study conducted by the Federation of American Health Systems predicted 59% of the 5,300 hospitals examined would experience operating losses in 1986. Id.
⁴. Operating losses occur when the income derived from operations does not exceed the expenses incurred in operations. P. FESS & C. WARREN, FINANCIAL ACCOUNTING 159-61 (1982).
⁶. Under a prospective system, a hospital receives a fixed amount of money to treat the patient (usually determined by a diagnosis prior to the patient's admission to the hospital). See G. POZGAR, LEGAL ASPECTS OF HEALTH CARE ADMINISTRATION 27-28
Hospitals that have not profited under prospective payment systems have fewer dollars available to finance charity care. As a result, many hospitals now refuse to treat indigent patients. Other hospitals have turned to non-health care activities as sources for funding charity care. These activities, when unrelated to the provision of health care, are not tax-exempt; rather, they are treated like any other for-profit venture. The resulting tax burden reduces the net income a hospital can generate from an unrelated business activity and apply to offset operating losses or provide charity care.

Faced with these growing concerns, the legislature and the Internal Revenue Service (the "IRS") should adopt a plan that would help assure hospital viability while providing for fair competition between exempt hospitals and nonexempt entities. This plan should continue the current exemption for hospitals, and also include a change in the manner in which hospitals' unrelated business income is treated.

This Comment questions the IRS' current method of determining what hospital activities constitute unrelated trade or business. The Comment first explores the legislative development of the unrelated business income test. The Comment then focuses on the IRS' and federal courts' application of the current test to hospitals, and the trend in expanding hospitals' exempt purposes. Applying economic theory and judicial findings, the Comment then criticizes the underlying philosophy of the current test. A new test is proposed that comports with both the legislative intent behind exempting hospitals from taxation and the judicial expansion of the current unrelated business income test. Finally, the impact of the new test is examined for its effect on hospital operations, competition, and the recipients of care.

(3d ed. 1987). If the hospital's costs for treating the patient are lower than the prospective amount, the hospital retains the difference as surplus. Id. If the hospital's costs for treatment are greater than the prospective amount, the hospital absorbs the additional cost. Id. In a few cases, hospitals are able to obtain additional payments for cases requiring extended treatment. Id.

7. See infra notes 25-27 and accompanying text.
8. See infra notes 13-39 and accompanying text.
9. See infra notes 40-96 and accompanying text.
10. See infra notes 97-123 and accompanying text.
11. See infra notes 124-28 and accompanying text.
12. See infra notes 129-30 and accompanying text.
II. THE DEVELOPMENT OF THE UNRELATED BUSINESS INCOME TAX

A. Hospitals' Exemption from Federal Income Tax

Congress traditionally has exempted certain charitable, scientific, and educational organizations from federal income tax. Most hospitals qualify for this exemption because they are "organized and operated exclusively for . . . charitable . . . purposes." To qualify for the exemption, section 501(c)(3) of the Internal Revenue Code (the "Code") requires that no part of an entity's net earnings inure to private shareholders or individuals, and that the entity refrain from carrying on substantial lobbying activities. The rationale for exempting hospitals as charitable organizations is that the public, not a private individual, derives a benefit from a hospital's provision of charity care. This benefit is received directly by the community through the hospitals' continued presence and growth.

B. The Determination of Unrelated Business Income Prior to 1950

Although Congress exempted the income from hospital operations from tax, the problem of how to treat income from non-operational sources remained. Prior to 1950, the test for whether the income from an unrelated business activity was taxed focused on the ultimate destination or use of the income rather than on the

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15. Id. Regarding lobbying activities, the Code states:
   "[N]o 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 any candidate for public office.

Id.
16. Congress' view was that tax revenue lost from the exemption was inuring to the public through charitable and educational services. The exemption was not permitted, however, if the income was used for private gain. See United States v. Proprietors of Social Law Library, 102 F.2d 481, 484 (1st Cir. 1939) (the exemption is permitted "in recognition of the benefit which the public derives from corporate activities of the class named, and is intended to aid them when not conducted for private gain").
17. See Helvering v. Bliss, 293 U.S. 144 (1934); Rev. Rul. 69-545, 1969-2 C.B. 117 ("By using its surplus funds to improve the quality of patient care, expand its facilities, and advance its medical training, education, and research programs, the hospital is operating in furtherance of its exempt purposes."). See also Simon v. E. Kentucky Welfare Rights Org., 426 U.S. 26 (1976) (the IRS position in Rev. Rul. 69-545 was challenged and upheld).
source of the income. Income derived from an unrelated trade or business was not taxed if used by a tax-exempt organization to further its exempt activities. For example, applying the destination-of-income test to a health care setting, a hospital would be able to acquire a nonexempt manufacturing firm. The profit from the manufacturing firm could accrue tax-free to the hospital if used to further the provision of health care. The profit from the manufacturing firm's operations could be invested by the hospital, used to expand its physical plant, or used to purchase equipment.

C. Shifting the Focus to the Source of Income: The 1950 Amendments to the Internal Revenue Code

Congress reacted to the unrest created by purchases of unrelated businesses by exempt organizations with the enactment of sections 511 to 514 of the Code. Congress' intent in adding sections 511 to 514 was to prevent unfair competition between exempt and nonexempt organizations. These amendments did not jeopardize an organization's tax-exempt status; rather, they changed the manner in which unrelated business income was treated. The income earned from activities related to an organization's exempt purpose is exempt from taxation. In contrast, the income from activities unrelated to the organization's exempt purpose, regardless of the use of the income, is taxed at the prevailing corporate rate.

Section 511 provides for a tax on the "unrelated business taxable income" of organizations exempt from taxation under section

18. Trinidad v. Sagrada Orden de Predicadores, 263 U.S. 578, 581 (1924); Roche's Beach, Inc. v. Comm'r, 96 F.2d 776, 778 (2d Cir. 1938).
20. Profit is the excess of revenues over expenses. BLACK'S LAW DICTIONARY 1090 (5th ed. 1979).
21. The extent to which an exempt organization took advantage of the destination of income test in this manner was best exemplified by reference to New York University's ("NYU") acquisition of a macaroni company. C.F. Mueller Co. v. Comm'r, 190 F.2d 120 (3d Cir. 1951). NYU, an exempt educational institution, financed the purchase of C.F. Mueller Co. through a bank loan. Id. at 121. The loan was repaid from the profits of C.F. Mueller that accrued tax-free to NYU. Id. The result was the exempt NYU's operation of the country's largest macaroni company. Id. See also Note, The Macaroni Monopoly: The Developing Concept of Unrelated Business Income of Exempt Organizations, 81 HARV. L. REV. 1280, 1280-81 (1968).
22. See supra note 21 and accompanying text.
24. H.R. Rep. No. 2319, 81st Cong., 2d Sess. 36 (1950). See also Treas. Reg. § 1.513-1(b) (1986). The regulation states that "[t]he primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete." Id.
Unrelated business taxable income is defined as the "gross income derived . . . from any unrelated trade or business . . . regularly carried on" by the exempt organization, less any deductions permitted. An unrelated trade or business is defined as:

[A]ny 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.

Although determining what activities fall within the definition of an unrelated trade or business is difficult, several activities are expressly excluded. Hospital activities for which substantially all the work is performed for the hospital without compensation do not qualify as unrelated trade or business activities. Also, activities carried on primarily for the convenience of the hospital's "members, students, patients, officers, or employees" are excluded from the definition of an unrelated trade or business. Finally, "the selling of merchandise, substantially all of which has been received by the [hospital] as gifts or contributions," does not constitute an unrelated trade or business.

The legislative history of sections 511 to 514 reveals no definitive guidelines for whether an activity is related to an organization's exempt purpose. Hence, the Treasury has sought to develop a single test. For an activity to be so related, it must be a trade or

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26. I.R.C. § 512(a) (1986). The deductions allowed must be directly connected with the carrying on of the unrelated trade or business. Id. Gross income and deductions mentioned in § 512(a) are subject to modifications in § 512(b). Id. Such modifications exclude from income all dividends, interest, payments with respect to security loans, and deductions connected with these sources. I.R.C. § 512(b)(1) (1986). A hospital, therefore, may organize a nonexempt corporation to engage in unrelated activities. The nonexempt corporation will be taxed on its income, but any dividends paid to the hospital, as a shareholder, will be tax exempt to the hospital. Id.
28. See infra notes 29-31 and accompanying text.
31. I.R.C. § 513(a)(3) (1986). A hospital rummage sale, the articles of which were donated to the hospital, would not be an unrelated trade or business. See S. HOLUB & L. KALICK, HOSPITAL TAX MANAGEMENT 37 (1983).
business, and substantially related to the organization's exempt function. An activity is related to an organization's exempt purpose if conducting the activity has a "causal relationship to the achievement of exempt purposes." The relationship is substantial if the performance of the activity contributes importantly to the organization's accomplishment of its exempt purposes.

The size and extent of the activities involved must also be examined in determining whether an activity is substantially related to an exempt purpose. When activities are partially related to an exempt purpose, but conducted on a scale larger than reasonably necessary, the income in excess of the needs of the exempt function is unrelated business income. The final determination of whether an activity contributes importantly to an exempt purpose is made case-by-case.

III. APPLYING THE TEST FOR UNRELATED BUSINESS INCOME TO HOSPITAL ACTIVITIES

Prior to the 1980's, little incentive existed for hospitals to look for sources of revenue outside of patient care and charitable donations. Insurance companies and other payors reimbursed hospitals for actual charges or costs. When a hospital was reimbursed by a charge-based payor, the charge included a premium. This premium was used to recover the cost of providing services to cost payors and charity or indigent patients. If the hospital provided a higher level of charity care, the premium assessed to charge based payors was increased. The result was that the financial risk for treating patients rested on certain payors.

Because of these reimbursement mechanisms, hospitals enjoyed

32. Treas. Reg. § 1.513-1(b) (1986). A trade or business has the same characteristics as a trade or business within I.R.C. § 162. Id.
33. Treas. Reg. § 1.513-1(c) (1986).
36. Id.
38. Id.
41. A charge-based payor reimburses the hospital for the amount charged and not the actual cost of services. Id.
42. Id.
43. Id.
considerable flexibility in setting prices.\textsuperscript{44} As a result, hospitals could easily finance growth, and increases in the delivery of charity care could be met by increases in prices charged to other patients. There seemed to be little need to look to unrelated business ventures as a source of revenue for financing operations.

Changes in reimbursement mechanisms made it more difficult for hospitals to finance growth and charity care with operating revenue. Consequently, hospitals turned to activities unrelated to the traditional delivery of health care as alternative sources of revenue. For example, hospitals began to offer pharmaceutical and lab services to non-patients.\textsuperscript{45} Initially, hospitals argued that the provision of these expanded services was not an unrelated trade or business because the hospital provided the services for the convenience of patients or doctors.\textsuperscript{46}

In a 1968 revenue ruling, however, the IRS narrowed the scope of who qualified as a patient for purposes of identifying activities provided primarily for the patient's convenience.\textsuperscript{47} Following the 1968 revenue ruling, the courts decided a series of cases in which hospitals argued that activities conducted for the convenience of patients and physicians were also substantially related to the hospital's exempt purpose.\textsuperscript{48} These cases resulted in the judicial expansion of what constitutes an exempt purpose, thereby allowing previously unrelated activities to fall within the scope of hospitals' exemptions.

In the first of these cases, \textit{Carle Foundation v. United States},\textsuperscript{49} a


\textsuperscript{45} See infra notes 49-50 and accompanying text.

\textsuperscript{46} I.R.C. § 513(u)(2) (1986). See supra note 30 and accompanying text.

\textsuperscript{47} Rev. Rul. 68-376, 1968-2 C.B. 246. The ruling narrowed the scope of activities that fell within section 513(a)(2). \textit{Id.} at 246-47. The IRS identified six situations in which a person qualified as a patient of the hospital. \textit{Id.} at 247. These situations are:

1) A person admitted to a hospital as an inpatient.

2) A person receiving general or emergency diagnostic, therapeutic, or preventive health services from outpatient facilities of a hospital.

3) A person directly referred to the hospital's outpatient facilities by his private physician for specific diagnostic or treatment procedures.

4) A person refilling a prescription written during the course of his treatment as a patient of the hospital.

5) A person receiving medical services as part of a hospital administered home care program.

6) A person receiving medical care and services in a hospital-affiliated extended care facility.

\textit{Id.} at 247.

\textsuperscript{48} See infra notes 61-93 and accompanying text.

\textsuperscript{49} 611 F.2d 1192 (7th Cir. 1979), cert. denied, 449 U.S. 824 (1980).
tax-exempt foundation\textsuperscript{50} operated an exempt hospital and an exempt pharmacy.\textsuperscript{51} The foundation supplied pharmaceuticals to the hospital, a private clinic composed of the hospital's physicians, and the clinic's private patients.\textsuperscript{52} The foundation argued that the sale of pharmaceuticals to the clinic and the clinic's private patients was substantially related to the foundation's exempt purpose.\textsuperscript{53} The foundation's exempt purpose, as stated in its exemption affidavit to the IRS, was managing a hospital for treating sick and disabled persons, engaging in research for the treatment of diseases, and training interns in caring for the sick.\textsuperscript{54}

The district court held that the income from sales to the clinic and its patients was not unrelated business income because the sales were substantially related to the foundation's exempt purpose.\textsuperscript{55} The United States Circuit Court of Appeals reversed, finding that the sales were incident to patients visiting their private physicians and not to the use of the hospital.\textsuperscript{56} Because the sales were not connected with the patients' use of the hospital facilities, the sales were unrelated to the foundation's charitable function.\textsuperscript{57}

In arriving at its holding, the court stated that the inquiry into whether the sales contributed importantly to the foundation's exempt purpose necessitated examining the size and extent of the activities.\textsuperscript{58} If the activity was conducted on a scale larger than reasonably necessary for the performance of an exempt purpose, the income "\textit{in excess of the needs of exempt functions}" constituted unrelated business income.\textsuperscript{59} The court found that sales to the

\begin{itemize}
\item \textsuperscript{50} The foundation was an I.R.C. § 509(a) organization operating a hospital. \textit{Id.} at 1193-94. In order to qualify as a § 509(a) organization, the foundation must be a § 501(c)(3) organization. I.R.C. § 509(a) (1986).
\item \textsuperscript{51} \textit{Id.}, 611 F.2d at 1193-94.
\item \textsuperscript{52} \textit{Id.} at 1193. The foundation and the association were two distinct legal entities. \textit{Id.} at 1194. The association was a private, for-profit enterprise owned by the physicians. \textit{Id.} Although all of the clinic's physicians possessed admitting privileges, none of them were employees of the hospital. \textit{Id.}
\item \textsuperscript{53} \textit{Id.} at 1196.
\item \textsuperscript{54} \textit{Id.}
\item \textsuperscript{55} \textit{Id.} at 1194; Carle Found. v. United States, 78-1 U.S. Tax Cas. (CCH) ¶ 9369 (E.D. Ill. 1978).
\item \textsuperscript{56} Carle Found., 611 F.2d at 1199.
\item \textsuperscript{57} \textit{Id.}
\item \textsuperscript{58} \textit{Id.} at 1197 (citing Iowa State Univ. of Science and Technology v. United States, 500 F.2d 508 (Ct. Cl. 1974)).
\item \textsuperscript{59} \textit{Id.} at 1198 (citing Treas. Reg. § 1.513-1(d)(3) (1986)) (emphasis added). The regulation states: \\
\begin{quote}
[I]ncome realized . . . from activities which are in part related to the performance of [exempt functions] but which are conducted on a larger scale than is reasonably necessary for performance of such functions, the gross income at-
\end{quote}
Clinic competed directly with other nonexempt pharmacies, and resulted in substantial income to the hospital. The court determined, therefore, that the foundation's activity resembled a commercial enterprise and thus constituted an unrelated trade or business. Although the court recognized that income from the activity may have been used to satisfy the needs of the hospital, the court failed to consider not only what these needs were, but also the amount attributable to such needs.

In *St. Luke's Hospital Of Kansas City v. United States*, the hospital's pathology department performed Pap tests and other pathological tests for private patients of its staff physicians. The IRS relied on *Carle Foundation* and claimed that the pathology tests were not substantially related to the hospital's exempt purpose. The hospital claimed that the tests were conducted for the convenience of the members of its medical staff. The hospital asserted that providing this service to its staff physicians contributed "importantly to the hospital's functions of providing the utmost in medical treatment and services to the community." The court first determined that the tests performed for private patients provided a supply of specimens necessary to train the hospital's residents. The court also determined that the tests were provided for the convenience of the hospital's members. Moreover, the court recognized that the hospital had an exempt purpose of providing the utmost in community care. The court held that the income from the tests was not unrelated business income because the provision of the lab services for the private patients furthered this broader exempt purpose of providing complete health care.

Tributary to that portion of the activities in excess of the needs of exempt functions constitutes gross income from the conduct of unrelated trade or business. Treas. Reg. § 1.513-1(d)(3) (1986).

60. *Carle Found.*, 611 F.2d at 1198. The gross sales were $800,000, resulting in a net income of $150,000. *Id.* The tax deficiency assessed was $67,266. *Id.* at 1194. This amount represented the tax liability on 100% of the net income derived from sales of pharmaceuticals to persons other than the hospital and its patients. *Id.*

61. *Id.* at 1198.


63. *Id.* at 86-87.

64. *Id.* at 90.

65. *Id.* at 91-92.

66. *Id.* at 91.

67. *Id.*

68. *Id.* at 91-92. The court agreed with the hospital's definition of "members" as "any group of persons limited in size who are closely associated with the entity involved and who are necessary to the achievement of the organization's purposes." *Id.* at 92.

69. *Id.* at 91.
care services.\textsuperscript{70}

The Code specifically excludes services provided for the convenience of hospital doctors and patients from the definition of an unrelated trade or business.\textsuperscript{71} Accordingly, if the \textit{St. Luke’s Hospital} court concluded that the services were provided primarily for the convenience of the hospital’s patients, no further inquiry was necessary.\textsuperscript{72} The court expressly held, however, that the provision of lab services was substantially related to the hospital’s providing complete health care services.\textsuperscript{73} The recognition of the provision of complete care as an exempt purpose reveals the court’s concern with ensuring the necessary delivery of health care to the community. So important was the need for complete care in the community that the court was willing to expand the scope of related trade or business activities.

The IRS does not follow that part of the \textit{St. Luke’s Hospital} opinion which held that income from lab tests is exempt from unrelated business income tax because the tests were performed primarily for the convenience of the hospital’s members.\textsuperscript{74} The IRS contends that staff physicians are not members or employees of a hospital when serving patients as “private practitioners of medicine.”\textsuperscript{75} The IRS agrees that lab tests used in a hospital’s teaching program are substantially related to an exempt educational purpose.\textsuperscript{76}

In a subsequent revenue ruling, the IRS outlined the unique circumstances under which a non-teaching hospital may provide lab tests for private patients of staff physicians, and the resulting income is exempt from taxation.\textsuperscript{77} When emergency diagnosis of samples is needed to detect toxins or prevent overdoses, the income derived from the service is exempt from taxation.\textsuperscript{78} Also, if other laboratories are not available within a reasonable distance of the hospital or available facilities are inadequate to conduct the desired tests, the provision of the services is not an unrelated trade or busi-

\textsuperscript{70} \textit{Id.} at 93.
\textsuperscript{71} I.R.C. § 513(a)(2) (1986).
\textsuperscript{72} See supra note 30 and accompanying text.
\textsuperscript{73} \textit{St. Luke’s Hosp.}, 494 F. Supp. at 91. See also Rev. Rul. 69-463, 1969-2 C.B. 131 (hospital leasing space to medical group was not unrelated to exempt purpose of “fulfilling the hospital’s role as the health center of the community”).
\textsuperscript{74} Rev. Rul. 85-109, 1985-2 C.B. 165, 166.
\textsuperscript{75} \textit{Id.}
\textsuperscript{76} \textit{Id.}
\textsuperscript{78} \textit{Id.}
The IRS' rationale is that the lab services "further [the hospital's] exempt function of promoting community health."\(^8\)

**Hi-Plains Hospital v. United States\(^8\)** further expanded the circumstances under which an activity is related to a hospital's exempt purpose.\(^8\) Hi-Plains Hospital ("Hi-Plains") operated an exempt hospital in a small town in Texas.\(^8\) To induce physicians to practice at Hi-Plains, the hospital provided offices, nursing assistance, bookkeeping, and billing services to physicians in return for a percentage of the physician's collected fees.\(^\text{84}\) In addition, the hospital pharmacy sold drugs both to the physician's private patients and to the general public.\(^\text{85}\)

The district court concluded that the sales to non-hospital patients were not substantially related to the hospital's exempt purpose of providing a hospital.\(^\text{86}\) The appellate court overruled and held that the district court erred in not considering the particular facts and circumstances of Hi-Plains' claim.\(^\text{87}\) The court stated that whether an activity contributes importantly to an exempt purpose depends upon the particular problems encountered in trying to provide medical services to the community.\(^\text{88}\) The court determined that the activities conducted by Hi-Plains were necessary to induce physicians to practice medicine in the area.\(^\text{89}\) The court accepted the district court's finding that the hospital's exempt purpose was "the providing of a hospital."\(^\text{90}\) Because the hospital offered the services, physicians were more likely to practice at Hi-Plains.\(^\text{91}\) This resulted in the hospital's ability to remain open to

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79. Id. See also Priv. Ltr. Rul. 8721103 (Feb. 27, 1987) (income from lab tests provided by hospital for private patients of staff physicians was not unrelated business income when nearest adequate lab was twenty miles away because the services furthered the hospital's exempt function of promoting community health); Priv. Ltr. Rul. 8125007 (n.d.) (income from toxicology tests provided by hospital for industrial concerns was not unrelated business income because commercial lab services were not available in the community).
81. 670 F.2d 528 (5th Cir. 1982).
82. Id. at 532.
83. Id. at 529. Prior to Hi-Plains' arrival, the town of 2,250 people was served by only one doctor and no hospital. Id.
84. Id. at 529-30.
85. Id. at 530.
87. Hi-Plains Hosp., 670 F.2d at 531. See supra note 39 and accompanying text.
88. Hi-Plains Hosp., 670 F.2d at 531.
89. Id.
90. Id.; 81-1 U.S. Tax Cas. (CCH) ¶ 86,435.
91. Hi-Plains Hosp., 670 F.2d at 531.
the community. The court concluded that the sale of pharmaceuticals facilitated the practice of medicine at Hi-Plains, and thus contributed importantly to the goal of providing medical services to the community.

The result of the case law and IRS rulings on unrelated business activities for hospitals has been an expansion of hospitals’ exempt purposes beyond those expressly stated by the exempt organizations. Even though the court in Carle Foundation held against the taxpayer, the court recognized that certain needs may exist that would necessitate exempting income from an unrelated trade or business. In St. Luke’s Hospital and Hi-Plains Hospital, both courts recognized a broader exempt purpose of providing and maintaining a community hospital. This movement toward a broader, implied purpose permitted both hospitals to engage in traditionally unrelated activities because the activity helped to insure the provision of care in their communities.

The IRS’ refusal to acquiesce to that portion of the St. Luke’s Hospital opinion pertaining to providing services for the convenience of physicians should not be troubling. The court in St. Luke’s Hospital rested its final determination on the finding that the provision of the services furthered the hospital’s exempt purpose. The IRS refuses to recognize only that part of the St. Luke’s Hospital opinion that held the services were conducted primarily for the convenience of the hospital’s members. In Revenue Ruling 85-110, the IRS recognizes that lab services provided to private patients could be related to a hospital’s exempt purpose of promoting community care. Consequently, the IRS has not negated that part of the St. Luke’s Hospital opinion that held the activity furthered the hospital’s exempt purpose of providing complete community health services.

IV. PROPOSED NEW TREATMENT OF UNRELATED BUSINESS INCOME

A. The Paradoxical Position of the IRS

Because the courts have recognized that a hospital has an exempt purpose of promoting community health, the IRS should also recognize that all activities in furtherance of this goal are related to

92. Id.
93. Id.
94. See Carle Found., 611 F.2d at 1196.
the hospital’s exempt purpose. The IRS, however, currently treats activities in furtherance of this goal as related when the hospital is the sole organization engaged in the particular activity within the community. The IRS implies that the same activity is unrelated to the exempt purpose of promoting community health when a nonexempt competitor is present. This indicates that the activity, which is identical in both situations, is not substantially related to a hospital’s exempt purpose because of the presence of nonexempt competition.

This paradoxical position of the IRS can be explained by the fear of unfair competition between exempt hospitals and nonexempt organizations. Hospitals’ goals of promoting and maintaining viable health centers do not change merely because competition is present from the private, for-profit sector. As the IRS and the courts have recognized, it is a permissible exempt purpose for a hospital to provide health care to a community; yet, without adequate revenue, hospitals will be unable to finance health care, and may even close. This will leave many communities unserved, and subjugate the aim of exempting hospitals from income taxation.

Why should an activity, the income from which enables a hospital to remain open and serve the community, be taxed simply because a nonexempt competitor occupies the same market? The only argument put forth is that exempting hospital activities from income taxation enables the hospital to compete unfairly against nonexempt organizations.

B. Rejection of the Unfair Competition Argument

By adding sections 511 to 514, Congress expressly intended to prevent unfair competition between exempt and nonexempt organizations. Taxable entities claimed that an exempt organization, because its profits are exempt from tax, could charge a lower price for the same product.

For example, assume an exempt corporation and a nonexempt corporation are selling an identical, non-health care product.

97. See supra notes 77-80 and accompanying text.
98. See supra notes 16-17 and accompanying text.
100. A non-healthcare product is a product not associated with the delivery of healthcare. Presumably, a product associated with the delivery of healthcare (e.g., outpatient surgical procedures) is related to a hospital's purpose of treating sick patients, and would be exempt from taxation under the current test for unrelated business income.
Assume further that both companies have identical average costs equal to $100.00, and identical desired profit margins equal to 25%. The exempt organization must sell the product for $133.33 in order to receive $33.33 in profit (the 25% return). For the nonexempt organization to achieve the 25% profit margin, measured in after tax dollars, it must set its price, P, such that: After Tax Profit = (P - Average Cost) x (1 - Tax Rate). Assuming a 34% corporate tax rate, the nonexempt organization must charge a price equal to $160.98 to receive $40.24 in after tax profit and achieve the 25% profit margin. Accordingly, the exempt organization appears to have an unfair advantage because it can charge a lower price than the nonexempt firm to achieve the same profit margin.

The fallacy of this unfair price argument is the belief that, in the long run, firms possess the ability to charge whatever price they desire. In a competitive market, the consumer's decision to buy is based solely on price.

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101. Average cost is the total cost of producing a quantity of N products, divided by N. See P. Samuelson & W. Nordhaus, Economics 467 (12th ed. 1985).

102. The profit margin, PM, on the sale of a single product is determined by the following equation:

\[
PM = \frac{(Price - Average\ Cost)}{Price} = \frac{Profit}{Price}
\]


103. Using the profit margin equation, the solution is:

\[
PM = \frac{133.33 - 100.00}{133.33} = 25%
\]

104. The required profit for the nonexempt firm is:

After Tax Profit = (P - $100.00) x (1 - .34)

After Tax Profit = (.66 x P) - $66.00

Substituting this into the profit margin equation, the nonexempt firm obtains the 25% profit margin by charging the price, P, computed as follows:

\[
.25 = \frac{.66 \times P - 66.00}{P}
\]

P = $160.98

105. H. Hovenkamp, Economics and Federal Antitrust Law 4-8 (1985). The assumption of a competitive market is necessary for the analysis. If markets are not purely competitive, then certain firms already possess unfair advantages, such as unequal access to relevant information. Id. at 2. If such is the case, arguing that an exemption for hospitals should not be permitted will not cure the inefficiencies in the market.
buy and firms will produce is determined by a combination of supply and demand. The point at which supply and demand meet determines the market price. In the long run, firms can charge a price neither higher nor lower than the market price. As a result, competing firms are "price takers." The firms discussed above could not charge whatever price they desired, they could only charge the market determined rate.

Economists claim that the imposition of tax on nonexempt organizations does not affect their ability to compete with exempt organizations on the basis of output. Because the price of a product is set by the market, a firm's marginal revenue is equal to the market price. A firm will continue to increase output until its marginal cost equals its marginal revenue. Accordingly, if a firm has an unfair advantage that results in a lower marginal cost, it can produce more of the product than an identical firm that does not possess the advantage. If a hospital's exemption served to lower its marginal cost, it would possess such an unfair advantage. A firm's marginal cost, however, is a function of total cost, and total cost is composed solely of fixed costs and variable costs, neither of which includes tax on profits as a component.

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107. Id.
109. Id.
111. Id. at 513-14.
112. Id. Marginal cost is the additional cost "at any output level . . . of producing 1 extra unit more (or less); it comes from subtracting total dollar costs of adjacent outputs." Id. at 514.
113. Id. While marginal cost is less than marginal revenue, the firm still has additional profits to gain by increasing production. Producing an additional item will result in more revenue than cost. At the point where marginal cost equals marginal revenue, the production of one additional unit will result in more cost than profit. Id.
114. Id. For example, if a firm's total cost to produce 100 units is $5,000, and its total cost to produce 101 units is $5025, the marginal cost associated with producing one additional unit is $25. Id. at 463-64.
115. Id. at 462-63. Total costs are "the lowest total dollar expenses needed to produce each level of output . . . ." Id. Fixed cost is "the total dollar expense that goes on even when a zero output is produced. It is a sunk cost that is completely unaffected by any variation in [output]." Id. Variable cost is "all items of [total cost] except for [fixed cost], including raw materials, wages, fuel, etc. Always, by definition, [total cost = fixed cost + variable cost]. Id.

In order to maximize profits, the individual firm determines price and output to
This analysis suggests that an exempt hospital has neither the benefit of being able to charge a lower price, nor the benefit of lower costs on account of its tax exemption. Also, whether a tax is imposed on profits has no effect on a firm’s decisions concerning output. Without an effect on price, costs, and output, the exempt status of a hospital provides no unfair advantage over a nonexempt organization in a competitive market.

The nonexempt organization might claim that a reduction in profits retained by the firm, due to the imposition of tax, would constrain its ability to finance growth, but would not affect an exempt firm in the same manner. Using the above example, if the market determined rate was $133.33, the nonexempt firm would receive only $22.00 in after tax profit. The tax-exempt organization would retain all $33.33 of its profits. As a result, the exempt organization has more capital with which to expand, to further develop its product, and to invest in new ventures.

The fact that the income retained by the exempt organization exceeds the after tax income retained by the nonexempt organization serves as a valid argument against allowing an exemption for a hospital competing directly with a nonexempt organization. Yet, this argument has merit only if the hospital uses the income for expanding the unrelated activity that directly competes with the nonexempt firm. If the hospital employs the income to provide

\[
\text{After Tax Profit} = (133.33 - 100.00) \times (1 - .34) = 22.00
\]

118. At a corporate tax rate of T, the exempt firm retains (T \times \text{Profit}) more income than the nonexempt firm.

119. The amount is calculated as follows:

120. Using profit margin analysis, the exempt firm’s profit margin is still 25%, while the nonexempt firm’s after tax profit margin is 17%. See supra note 97 and accompanying text.
Operating Losses and Charity Care

charity care or to offset operating losses, that portion of the exempted income does not benefit the unrelated activity. Rather, the benefit of exemption is transferred directly to the hospital and then to the community. The exempt organization has gained an unfair advantage only to the extent that it retains its exempt dollars to compete against the nonexempt organization.

The nonexempt firm might argue also that the reduction in profits due to taxation affects its ability to obtain equity financing. Shareholders demand a certain rate of return on their market investments. If a nonexempt firm is not as profitable, and therefore unable to distribute dividends at a rate comparable with other investments, its return on investment will be lower than comparable investments. As a result, shareholders will be less likely to invest in the nonexempt firm.

This argument has no merit because of the prohibition against private inurement placed upon exempt organizations. Hospitals do not offer the investment opportunity that a publicly traded, nonexempt firm offers. The nonexempt firm competes with other nonexempt firms for shareholders by offering a return that is comparable with investments with similar risks. Because hospitals offer no such investment opportunity, shareholders do not compare the hospital's return with that offered by a nonexempt organization. The amount of profits retained by the nonexempt organization must be comparable with other tax-paying entities, not tax-exempt entities.

C. The Proposed Treatment of Unrelated Business Income

To facilitate the goal of providing continual health care, and to avoid unfair competition, the income from an unrelated trade or business should be exempt from taxation, regardless of its source, to the extent that it is used to offset a hospital's operating losses. In a way, this proposed test is reminiscent of the destination of income test, only with more stringent limitations. This treatment of unrelated business income will enable a hospital to remain

121. Equity financing is the "[r]aising of capital by [a] corporation by issuing (selling) stock." BLACK'S LAW DICTIONARY 485 (5th ed. 1979).
122. I.R.C. § 501(c)(3) (1986). The Code mandates that "no part of the net earnings ... inures to the benefit of any private shareholder or individual." Id. See also Treas. Reg. § 1.501(c)(3)-1(c)(2) (1986) (net earnings may not inure "in whole or in part to the benefit of private shareholders or individuals").
124. See supra notes 13-16 and accompanying text.
a viable provider of care to a community, thus furthering its exempt purpose. Also, the method will eliminate any unfair advantage which the exempt hospital may possess in competing directly with nonexempt firms.

An example best illustrates the application of this proposed method. Assume that a hospital has the following financial data:

<table>
<thead>
<tr>
<th>Operating Revenue</th>
<th>$5,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Charity or Free Care</td>
<td>(500,000)</td>
</tr>
<tr>
<td>Uncollectible Accounts</td>
<td>(500,000)</td>
</tr>
<tr>
<td>Operating Revenue</td>
<td>4,000,000</td>
</tr>
<tr>
<td>Operating Expenses</td>
<td>4,600,000</td>
</tr>
<tr>
<td>Net Operating Income</td>
<td>(600,000)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Nonoperating Revenue — Pharmacy Operation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Revenue</td>
</tr>
<tr>
<td>Expenses</td>
</tr>
<tr>
<td>Net Income</td>
</tr>
</tbody>
</table>

The hospital would be able to use $600,000 of the revenue derived from the operation of the pharmacy, free from taxation, to offset its operating loss. The remaining $400,000 would be taxed at the prevailing corporate rate. At a corporate rate of 34%, the hospital would pay $136,000 in tax, and retain $264,000 for further use.

The use of the unrelated business income in this manner takes into consideration the hospital’s true needs. Only the amount of revenue needed by the hospital to further its existence and to help it continue to provide care to the community is exempted from taxation. All other income from the unrelated trade or business is taxed at the prevailing corporate rate. This eliminates any unfair advantage the exempt firm would have in retaining tax-exempt income for development of its unrelated activity.

125. This represents the amount of care provided at no cost to indigent patients.
126. This represents the amount of care that is uncollectible and is a bad debt.
127. This represents sales solely to non-patients, and not sales to the hospital and its patients. See supra note 30 and accompanying text.
V. IMPACT OF THE PROPOSED TEST ON HOSPITAL OPERATIONS

Aside from eliminating the difficulty associated with determinations of substantial relationship, exempting unrelated business income to the extent of operating losses offers several advantages. The use of the exempt income will protect against operating losses and help to maintain hospital viability. By keeping a hospital open in certain communities, the hospital returns the benefit of its exemption to the community, thus furthering the purpose for the hospital's exemption from taxation.129

Permitting hospitals to engage in an unrelated trade or business also signals market opportunities. If an exempt hospital successfully provides a service, other competitors will be alerted to the opportunity available in the market. On the other hand, if an activity is exempt only when no competition exists, the emergence of a nonexempt competitor may result in the hospital's withdrawal from the market. This decreases competition, and leaves the nonexempt firm with the increased potential for market dominance or monopolization.

Finally, by allowing hospitals to offset operating losses with unrelated business income, there is less of a detriment to the hospital providing indigent care. A hospital faced with full cost reimbursement can provide indigent care only if willing and able to absorb an operating loss. The knowledge that revenue foregone by the provision of indigent care will be offset with exempt income from an unrelated trade or business may encourage the hospital to treat indigents. To the extent that a hospital has engaged in a successful unrelated trade or business, more indigent care may be financed, and the burden for treating the indigent is not unduly shared by only a few hospitals.

The disadvantage of permitting hospitals to offset losses with unrelated business income is that it may encourage operating inefficiencies. A hospital may not focus on lowering its operating costs, knowing that any deficiencies will be offset by the unrelated business income. The result is that cost-based reimbursers may be faced with increasing treatment costs.

The potential for operating inefficiencies, however, will not be a concern under a prospective reimbursement program.130 The hospital's increased operating costs will serve only to decrease its net

129. See supra notes 16-17 and accompanying text.
130. See supra note 130 and accompanying text.
income under a prospective plan. The increased costs are not passed on to the prospective reimbursers or the patient, but are born solely by the hospital. Under the proposed test, the incentive still remains for a hospital to maintain lower operating costs.

VI. CONCLUSION

The IRS and the courts have recognized that peculiar circumstances merit the exempting from taxation of unrelated business activities carried on by hospitals. The financial difficulty faced by many hospitals today and the need for the provision of indigent care are two such circumstances. For hospitals to continue to operate and to treat charity patients, sufficient operating revenues must be available. One method of making increased revenues available is to exempt unrelated business income from taxation to the extent of operating losses. By permitting this exemption, tax-exempt hospitals do not gain a competitive advantage over nonexempt organizations. Rather, the exemption merely permits hospitals to continue to benefit their communities by continued operation and service.

D. LOUIS GLASER