The Tax-Exempt Status of Hospital Service Organizations: *HCSC-Laundry v. United States*

I. Introduction

In *HCSC-Laundry v. United States*[1] the United States Supreme Court resolved for the moment the longstanding dispute between the Internal Revenue Service (IRS) and the nonprofit hospital industry over the tax-exempt status of hospital service organizations (HSOs). Petitioner HCSC-Laundry, a nonprofit corporation organized to provide laundry and linen services exclusively to fifteen nonprofit hospitals and to an ambulance service, had sought exemption from federal income taxation under Internal Revenue Code section 501(c)(3).[2] In affirming the Court of Appeals for the Third Circuit's denial of exemption,[3] the Court held in a per curiam decision[4] that section 501(e)[5] was

1. 450 U.S. 1 (1981).
2. I.R.C. § 501 in pertinent part reads:
(a) Exemption from taxation
An organization described in subsection (c) . . . shall be exempt from taxation unless such exemption is denied under section 502 or 503.
. . . .
(c) List of exempt organizations
. . . .
(3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific . . . purposes, . . . 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 . . . , and which does not participate in, or intervene in . . . , any political campaign on behalf of any candidate for public office.
3. HCSC-Laundry v. United States, 624 F.2d 428 (3rd Cir. 1980), *rev'g* 473 F. Supp. 250 (E.D. Pa. 1979).
4. Justice White dissented without opinion, noting, however, that he would have granted certiorari and heard argument. Justice Stevens dissented with a vigorous opinion.
5. I.R.C. § 501(e) provides:
For purposes of this title, an organization shall be treated as an organization organized and operated exclusively for charitable purposes, if—
(1) such organization is organized and operated solely—
(A) to perform on a centralized basis, one or more of the following services which, if performed on its own behalf by a hospital which is an organization described in subsection (c)(3) and exempt from taxation under subsection (a), would constitute activities in exercising or performing the purpose or function constituting the basis for its exemption: data processing, purchasing, warehousing, billing and collection, food, clinical, industrial engineering, laboratory, printing, communications, record center, and personnel (including selection, testing, training, and education of personnel) services; and
(B) to perform such services solely for two or more hospitals each of which is—
(i) an organization described in subsection (c)(3) which is exempt from taxation under subsection (a),

the exclusive means by which HSOs could obtain tax-exempt status. Because laundry and linen services are not among the services enumerated in section 501(e)(1)(A),[6] the Court concluded that HCSC-Laundry was not entitled to tax-exempt status.

The dispute over the tax-exempt status of HSOs began in the mid-1950s when the IRS ruled[7] that if two or more tax-exempt hospitals created an entity to perform commercial services exclusively for them, that entity was a "feeder organization"[8] as defined by the predecessor to section 502[9] and therefore not exempt. The IRS interpretation of the feeder organization provision was immediately challenged, and in 1958 the Court of Claims rejected the conclusion of the IRS in *Hospital Bureau of Standards & Supplies, Inc. v. United States.*[10]

The IRS, however, refused to alter its position. Finally, in response to compelling policy considerations favoring the encouragement of HSOs as a means of curbing the inflationary rise in health care costs, Congress in 1968 amended section 501 to add a new subsection (e)[11] dealing specifically with HSOs. However, because of the purposeful omission of laundry services from the new subsection, the amendment did not remedy the uncertainty of the law. HSOs—particularly those that performed laundry services—continued to press for exemption under section 501(c)(3) by taking advantage of the *Hospital Bureau* decision and Congress' ambiguous treatment in section 501(e) of the entire issue of HSO exemption. The IRS, meanwhile, maintained its earlier interpretation of section 502 and construed the half-measure amendment of section 501 as congressional approval of its position.

The IRS argument was that, in view of its reading of section 502 as it related to HSOs, section 501(e) was the exclusive means by which HSOs that

---

(ii) a constituent part of an organization described in subsection (c)(3) which is exempt from taxation under subsection (a) and which, if organized and operated as a separate entity, would constitute an organization described in subsection (c)(3), or

(iii) owned and operated by the United States, a State, the District of Columbia, or a possession of the United States, or a political subdivision or any agency or instrumentality of any of the foregoing;

(2) such organization is organized and operated on a cooperative basis and allocates or pays, within 8½ months after the close of its taxable year, all net earnings to patrons on the basis of services performed for them; and

(3) if such organization has capital stock, all of such stock outstanding is owned by its patrons.

For purposes of this title, any organization which, by reason of the preceding sentence, is an organization described in subsection (c)(3) and exempt from taxation under subsection (a), shall be treated as a hospital and as an organization referred to in section 170(b)(1)(A)(iii).

6. For the enumeration of services, *see* I.R.C. § 501(e)(1)(A), *quoted in* note 5 *supra*.

7. Rev. Rul. 54-305, 1954-2 C.B. 127.

8. *See* text accompanying notes 69–81 *infra*.

9. Int. Rev. Code of 1939, ch. 1, § 101(b) (now I.R.C. § 502). Section 502(a) provides: "An organization operated for the primary purposes 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."

10. 158 F. Supp. 560 (Ct. Cl. 1958).

11. Revenue and Expenditure Control Act of 1968, Pub. L. No. 90-364, § 109, 82 Stat. 269, 26 U.S.C. § 501(e) (1968). *See* note 5 *supra*.

met its requirements could obtain tax-exempt status.[12] This position soon came under attack by courts and commentators alike. Indeed, until 1980, every federal court that had heard the issue had decided against the IRS and in favor of the view that HSOs could qualify for exemption under either section 501(c)(3) or section 501(e).[13] These decisions allowed HSOs that engaged in activities not covered by section 501(e) and those that engaged in enumerated services but nonetheless desired greater flexibility to seek exemption directly under section 501(c)(3) as charitable organizations.

In 1980 this favorable trend came to an abrupt halt. Three courts of appeals[14] and the Tax Court[15] ruled in favor of the IRS and against exemption for HSOs under section 501(c)(3). By its holding in *HCSC-Laundry* the Court has given the final imprimatur of validity to the position to which the IRS has so resolutely clung. In doing so, the Court has rewarded persistence but ignored policy.

II. THE BACKGROUND OF THE DISPUTE

A. *Why Tax-Exempt Status?*

1. *The Policy Considerations Behind the Encouragement of Hospital Service Organizations*

As the health care system in the United States consumes growing proportions of our national resources, pressures increase to adopt and implement effective strategies of cost reduction or containment.[16] The need for such

---

12. *See* Rev. Rul. 69-633, 1969-2 C.B. 121; Rev. Rul. 69-160, 1969-1 C.B. 147. *See also* text accompanying notes 97-99 *infra*.

13. Chart, Inc. v. United States, 491 F. Supp. 10 (D.D.C. 1979); HCSC-Laundry v. United States, 473 F. Supp. 250 (E.D. Pa. 1979), *rev'd*, 624 F.2d 428 (3rd Cir. 1980), *aff'd*, 450 U.S. 1 (1981); Metropolitan Detroit Area Hosp. Serv., Inc. v. United States, 445 F. Supp. 857 (E.D. Mich. 1979), *rev'd*, 634 F.2d 330 (6th Cir. 1980); Community Hosp. Servs., Inc. v. United States, 79-1 U.S. Tax Cas. ¶ 9300 (E.D. Mich. 1979); Hospital Cent. Servs. Ass'n v. United States, 77-2 U.S. Tax Cas. ¶ 9601 (W.D. Wash. 1977), *rev'd per curiam*, 623 F.2d 611 (9th Cir. 1980), *cert. denied*, 450 U.S. 911 (1981); United Hosp. Servs., Inc. v. United States, 384 F. Supp. 776 (S.D. Ind. 1974); Northern Cal. Cent. Servs., Inc. v. United States, 591 F.2d 620 (Ct. Cl. 1979); Hospital Bur. Standards & Supplies, Inc. v. United States, 158 F. Supp. 560 (Ct. Cl. 1958).

14. Metropolitan Detroit Area Hosp. Servs., Inc. v. United States, 634 F.2d 330 (6th Cir. 1980); Hospital Cent. Servs. Ass'n v. United States, 623 F.2d 611 (9th Cir. 1980), *cert. denied*, 450 U.S. 911 (1981); HCSC-Laundry v. United States, 624 F.2d 428 (3rd Cir. 1980), *aff'd*, 450 U.S. (1981).

15. Associated Hosp. Servs., Inc. v. Commissioner, 74 T.C. 213 (1980).

16. *See* D. BARRETT, MULTIHOSPITAL SYSTEMS 1 (1977) [hereinafter cited as D. BARRETT]; Robins, *Controlling Health Care Costs*, in HEALTH SERVICES 215 (1977) (proceedings of The Academy of Political Science). On the consumer side, health care expenditures as a percentage of gross national product (GNP) have more than doubled, from 4.5% in 1950 to 9.4% in 1980. Gibson & Waldo, *National Health Expenditures, 1980*, HEALTH CARE FIN. REV., Sept. 1981, at 1, 3. The proportion of GNP consumed by health care may reach 10% in 1983. Clark, *Does the Nonprofit Form Fit the Hospital Industry?*, 93 HARV. L. REV. 1416, 1422 n.11 (1980). For a further discussion of the increasing costs of health care, *see generally* MULTIHOSPITAL SYSTEMS (M. Brown & M. McCool eds. 1980) [hereinafter cited as MULTIHOSPITAL SYSTEMS].

One commentator has noted that the pressures to contain costs will come from many sources:

> During the 1980s, tax-exempt hospitals will be under increased pressure to reduce costs and to maximize existing sources while developing new revenue sources to meet current and future operating and capital requirements.
>
> This pressure will come from a variety of sources. Inflation, the aging-population increases,

strategies in the hospital industry is acute; for example, in 1980, 40.3 percent of personal health care expenditures were spent for hospital care, compared with 18.9 percent for physicians' services.[17]

The hospital industry, however, faces significant disincentives to any effort to reduce or contain costs. A majority of hospitals in the United States are nonprofit[18] and therefore are not as responsive to the competitive and cost-reductive pressures of the market place as are their profit-maximizing counterparts.[19] A further disincentive is presented by the unique position the federal government occupies in relation to the hospital industry and the health care system in general. Because of its status as a major third party payor of health care expenditures, the federal government has a significant impact on the cost and quality of health care. The presence of such cost-based reimbursements reduces or, at best, neutralizes the incentive for hospitals actively to reduce costs: "Providers of care who are paid under cost-based reimbursement of fee-for-service mechanisms have less incentive to provide 'cost-effective' care because of a general lack of price competition."[20]

Consequently, representatives of government and of the health care system have advocated institutional and structural reform of the nonprofit hospital industry as one means of reducing the cost of health care.[21] Hospitals have responded by cooperating on a multi-institutional basis to provide both

---

> population shifts and the high cost of new technology are significant as non-governmental pressures.
>
> Governmental pressures will increase as new restrictions and limitations are placed on the ability of hospitals to recover the full cost of providing services under cost-based reimbursement programs. State rate-setting and rate review agencies will contribute by using their broad powers to deprive hospitals of the ability to increase rates to offset increased costs.

D. Mancino, *Avoiding the pitfalls—New revenue sources and tax-exempt status*, HOSPITAL FIN. MANAGEMENT, May 1981, at 46.

17. Gibson & Waldo, *National Health Expenditures, 1980*, HEALTH CARE FIN. REV., Sept. 1981, at 1, 3.

18. DEP'T OF HEALTH, EDUCATION, AND WELFARE, HEALTH UNITED STATES 349 (1978); Sloan & Steinwald, *Effects of Regulation on Hospital Costs and Inputs*, 23 (J. L. & ECON. 81 (1980).

19. Allalouf, *Letting Market Forces Help Govern Provision of Health Care*, N.Y. Times, Feb. 9, 1981, § A, at 19, col. 4. *See* note 20 *infra*; Clark, *Does the Nonprofit Form Fit the Hospital Industry?*, 93 HARV. L. REV. 1416, 1459–62 (1980); Sloan & Steinwald, *Effects of Regulation on Hospital Costs and Inputs*, 23 J. L. & ECON. 81 *passim*. (1980).

20. Gibson & Waldo, *National Health Expenditures, 1980*, HEALTH CARE FIN. REV., Sept. 1981, at 1, 10. *See also* Clark, *Does the Nonprofit Form Fit the Hospital Industry*? 93 HARV. L. REV. 1416, 1426–30 (1980) In 1980, the federal government spent $70.9 billion on health care, or approximately 68% of total public expenditures. Gibson & Waldo, *National Health Expenditures 1980*, HEALTH CARE FIN. REV., Sept. 1981, at 1, 18 (table 1). Gibson and Waldo write:

> The health care market is atypical of the perfect market for goods and services envisioned by standard economic theory. More than any other market, it is dominated by third-party payers, that is, by persons or organizations who purchase care on behalf of those who consume it. In 1980, two-thirds of personal health care expenditures were made by the government or by private health insurance. To that extent, consumers of health care tend to be isolated from the true price of health care and tend to consume more care than they would were they to pay directly the full price of the goods and services they receive.

Id. at 11. *See also* McNerney, *Control of Health-Care Costs in 1980's*, 303 NEW ENGLAND J. MED. 1088, 1089 (1980).

21. *See generally* MULTIHOSPITAL SYSTEMS, *supra* note 16, at 1. The nation's largest private health-care philanthropic organization, the Robert Johnson Foundation, has changed its policy focus from facilitating patient access to medical services to the development of strategies to combat the increasing costs of medical care. *Foundation to Seek Methods to Reduce Medical Costs*, N.Y. Times, Feb. 16, 1981, § A, at 13, col. 1.

operational or administrative services and health care.[22] The popularity of and need for such multi-institutional arrangements is clear:

> Because there is a limit to volume and revenue potential, hospitals must develop survival strategies that enable their communities' perceived needs to be met within the scope of realistic economic expectations. For more than one-half of U.S. hospitals, survival strategy includes investment in multi-institutional arrangements and shared services in order to participate in the benefits of increased scale and volume.[23]

One such form is the HSO—an organization established by two or more hospitals to provide a variety of administrative or clinical services exclusively to its nonprofit hospital members.[24] The rationale behind HSOs is simple: they can provide their member hospitals with vital services that each hospital would otherwise have to provide for itself on a singular, less efficient basis.[25]

HSOs are encouraged because of their potential for containing hospital costs.[26] The benefits derived by nonprofit hospitals from such organizations can include the avoidance of capital expenditures for the unnecessary duplication of facilities, equipment, and personnel that results when each hospital performs the same service singularly; reduced operating costs that result from the economies of scale produced by their size and operational efficiency; and higher quality of services. One court has detailed the expected benefits that a laundry service organization would create:

> In 1963, five public or nonprofit, private hospitals located at Indianapolis, Indiana, and having their own separate laundry facilities, undertook feasibility studies of a centralized laundry service. . . . These studies concluded that a centralized laundry service could save the hospitals $1.1 million in capital construction costs and $159,000 in operational costs per year for a total savings of about $300,000 per year. . . . The studies further concluded that each hospital had to have an active part in managerial control of a centralized laundry facility for reasons of hospital operation and reduction of costs.[27]

---

22. Bromberg lists seven basic forms of cooperation: a § 501(c)(3) organization; a § 501(e) organization; a nonexempt cooperative under Subchapter T of the Code; a joint venture or partnership; a for-profit corporation; a program of a state or local hospital association; and an activity of an individual hospital. 1 R. BROMBERG, TAX PLANNING FOR HOSPITALS AND HEALTH-CARE ORGANIZATIONS ¶ 9.1, at 9-3 (1977) [hereinafter cited as R. BROMBERG].

23. Latimer, *Systems that secure resources help ensure hospitals' survival*, HOSPITALS, Mar. 1, 1977, at 57, 58.

24. Longest, *A Conceptual Framework for Understanding the Multihospital Arrangement Strategy*, HEALTH CARE MANAGEMENT REV., Winter 1980, at 17, 20. Administrative services are typically described as the following: purchasing; electronic data processing; laundry and linen; library and information retrieval; biomedical or clinical engineering. Clinical services are typically described as the following: blood bank; laboratory; pathology; radiology; electrocardiogram; physical therapy. For a more comprehensive list, *see id.* at 21 (table 22, listing 38 services shared by hospitals). *See also* D. Wegmiller, *Shared service programs are on the rise*, HOSPITALS, Apr. 1, 1980, at 147; B. Latimer, *Systems that secure resources help ensure hospitals' survival*, HOSPITALS, Mar. 1, 1977, at 57, 58–59.

25. The services could be provided in-house or by commercial providers.

26. *See generally* D. BARRETT, *supra* note 16, at 1; MULTIHOSPITAL SYSTEMS, *supra* note 16; 1 R. BROMBERG, *supra* note 22.

27. United Hospital Servs. v. United States, 384 F. Supp. 776, 777 (S.D. Ind. 1974). *See, e.g.*, 1 R. BROMBERG, *supra* note 22, ¶ 9.1, at 9-2; Brown, *Sharing: An Overview*, in MULTIHOSPITAL SYSTEMS, *supra* note 16, at 87, 92–93; Shillings, *Cost containment through sharing*, HOSPITALS, Jan. 16, 1975, at 48. *See also Tax Reform Act of 1975: Hearings on H.R. 10612 Before the Senate Comm. on Finance*, 94th Cong., 2d Sess. 2765, 2771 (1976) (statement of the American Hospital Ass'n).

HSOs are also encouraged because the rapid development of medical technology and the accompanying rise in medical specialization make it difficult for an individual hospital to obtain or make effective use of newly developed technologies and services.[28] In view of both the high cost of medical technology and increasingly limited economic resources, HSOs are widely regarded as an attractive option[29] and a necessary adjunct to the nonprofit hospital industry's effort to respond to the economic realities of the 1980s.[30]

The federal government has long been aware that "the hospital market is far from the competitive ideal,"[31] and has undertaken to encourage the development of cost-efficient methods of operation within the nonprofit hospital industry. In 1967 Congress declared that "[o]rganizational and administrative practices in the health service industry must be updated and brought into line with the most modern practices in other sections of the economy."[32] The government also recognized that HSOs are one step in that direction. One of the planning goals set forth in the National Health Planning Act of 1974 was to encourage "[t]he development of multi-institutional arrangements for the sharing of support services necessary to all health service institutions."[33] The former Department of Health, Education, and Welfare accordingly declared its intention "to revise current Medicare regulations to encourage nonprofit hospitals to pool their resources and to share services, from laundry to billing services to basic medical programs."[34] And its successor, the Department of Health and Human Services, has likewise expressed its intention to encourage the cooperative sharing of hospital services.[35]

The foregoing demonstrates that hospital planners and government representatives recognize the important role HSOs can play in the effort to contain rising health care costs. HSOs are designed to provide high quality hospital services at costs lower than they can be provided in-house on an individual basis. Present experience indicates that they remain popular and should be encouraged.[36]

---

28. S. REP. NO. 724, 90th Cong., 1st Sess. 14, *reprinted in* [1967] U.S. CODE CONG. & AD. NEWS 2076, 2089. *See also* Latimer, *Systems that secure resources help ensure hospitals' survival*, HOSPITALS, Mar. 1, 1977, at 57, 58.

29. *See* text accompanying notes 21–23 *supra*.

30. *See* D. Mancino, *Avoiding the pitfalls—New revenue sources and tax-exempt status*, HOSPITAL FIN. MANAGEMENT, May 1981, at 46.

31. Sloan & Steinwald, *Effects of Regulation on Hospital Costs and Inputs*, 23 J. L. & ECON. 81, 81 (1980). For a detailed discussion of the reasons for the hospital industry's noncompetitive aspect, *see id., passim*; Clark, *Does the Nonprofit Form Fit the Hospital Industry?*, 93 HARV. L. REV. 1416, 1419-30 (1980).

32. S. REP. NO. 724, 90th Cong., 1st Sess. 12, *reprinted in* [1967] U.S. CODE CONG. & AD. NEWS 2076, 2087.

33. National Health Planning and Resources Development Act of 1974, Pub. L. 93–641, § 1502(5), 88 Stat. 2225, 42 U.S.C. § 300k-2(5) (1975).

34. DEP'T OF HEALTH, EDUCATION, AND WELFARE, H.E.W. NEWS, Apr. 12, 1978, at 8 (statement of former Secretary Joseph A. Califano, Jr.).

35. Fitschen, *Shared Services: Two Viewpoints*, in MULTIHOSPITAL SYSTEMS, *supra* note 16, at 129. In a recently published interview, Treasury Secretary Donald T. Regan noted that "an awful lot can be done to cut the cost of health care. And I think that's something that we . . . have to get control of." Cowan, *How Regan Sees the Budget*, N.Y. Times, Oct. 18, 1981, § 3, at 4, col. 2. As to how this might be accomplished, he replied, "By insisting upon efficiency and productivity to equal the amount of price increase." *Id.*

36. *See, e.g.*, Longest, *A Conceptual Framework for Understanding the Multihospital Arrangement Strategy*, HEALTH CARE MANAGEMENT REV., Winter 1980, at 17, 20–22.

2. *The Benefits of Tax-Exempt Status*

The tax status of an HSO can be critical to its development. Tax-exempt status under section 501(a) brings the obvious advantage of shielding an organization from the imposition of federal income tax on its net earnings.[37] But in some ways, the collateral benefits of tax-exempt status are more valuable to charitable organizations. Tax-exempt status under federal law is often a prerequisite to corresponding status under state or local laws.[38] Because charitable contributions to organizations exempt under section 501(a) are tax deductible by corporate and individual donors,[39] "[q]ualification as an organization within section 501(c)(3) is a prerequisite to successful fund-raising among individuals and corporations."[40] In addition, organizations exempt from taxation under section 501(a) are exempt from federal Social Security taxes[41] and from federal unemployment taxes.[42] They also have the privilege of mailing at preferred postal rates and the option of choosing the special taxation of annuities under section 403(b).[43]

Without tax-exempt status, HSOs would be disadvantaged in their ability to raise capital and operating funds, because they would be unable to attract tax-deductible contributions and foundation grants. These benefits of tax-exempt status now accrue only to HSOs that perform one or more of the services enumerated in section 501(e)(1)(A). HSOs that perform any services not enumerated in section 501(e)(1)(A) are unable to seek funds in this manner and must pay income tax on their net income.

3. *The Statutory Provisions*

Section 501(a) confers tax-exempt status on certain organizations described in section 501(c)(3). To qualify under section 501(c)(3) an organization must satisfy three major requirements: it must be both organized and operated exclusively for one or more exempt purposes and no part of its net earnings

---

37. I.R.C. § 501(a). The same result can be accomplished by an HSO's distribution or allocation of its net earnings pursuant to a preexisting obligation to its patron hospitals within the time and in the manner prescribed for cooperative organizations in I.R.C. §§ 1381–1383, which would leave the organization without taxable income. *See* Rev. Rul. 69-633, 1969-2 C.B. 121.

38. *See, e.g.*, Children's Hosp. Medical Cent. v. Board of Assessors, 353 Mass. 35, 227 N.E.2d 908 (1967). *See also* R. BROMBERG, *supra* note 22, ¶ 9.2[1], at 9–4; Associated Hosp. Servs., Inc. v. Commissioner, 74 T.C. 213, 220 (1980).

39. I.R.C. § 170(c)(2). *See generally* 1 R. BROMBERG, *supra* note 22, ¶ 9.2[1], at 9-3 to 9-5; P. TREUSCH & N. SUGARMAN, TAX EXEMPT CHARITABLE ORGANIZATIONS 38–40 (1979); 1 S. WEITHORN, TAX TECHNIQUES FOR FOUNDATIONS AND OTHER EXEMPT ORGANIZATIONS § 1.02 (1979).

40. Skinrud, *Recognition Under Section 501(c)(3) of the Internal Revenue Code as a Prerequisite to Arts Grants*, 26 CLEV. ST. L. REV. 529, 546 (1977). *See* 1 R. BROMBERG, *supra* note 22, ¶ 9.2[1], at 9-4. *See also* 114 Cong. Rec. 7516 (1968) (remarks of Sen. Carlson).

Both of these benefits would be available to an HSO irrespective of the source of its tax-exempt status, for the last sentence of § 501(e) states that an organization meeting its requirements shall be treated as both a hospital and an organization referred to in § 170(b)(1)(A)(iii). The last sentence thus eliminates any problem with respect to the public charity status of HSOs and permits private foundations to make grants to them. *See* Tuthill, *Qualifying as a Tax Exempt Cooperative Hospital Service Organization*, 50 NOTRE DAME LAW. 448, 455 (1975).

41. I.R.C. § 3121(b)(8)(B).

42. I.R.C. § 3306(c)(8).

43. McGovern, *The Exemption Provisions of Subchapter F*, 29 TAX LAW. 523, 528 (1976).

can inure to the benefit of a private shareholder or individual.[44] If an organization meets these and other requirements of section 501(c)(3) it will be deemed exempt from federal income taxation.

Section 501(e)[45] provides that "cooperative hospital service organizations" shall be treated as charitable organizations described in section 501(c)(3) so long as four requirements are met. To qualify under section 501(e), an organization must: (1) perform only certain enumerated services that if performed on its own behalf by an exempt hospital would constitute part of that hospital's exempt activities;[46] (2) be organized and operated to provide those services solely to two or more nonprofit private or public hospitals;[47] (3) be organized and operated on a cooperative basis and allocate or pay to its patrons, within 8½ months after the close of its taxable year, all its net earnings on the basis of services performed;[48] and (4) if the organization has capital stock, restrict ownership of that stock to its patrons.[49]

A comparison of the two subsections reveals that section 501(c)(3) provides more flexibility than does section 501(e). Exemption under section 501(c)(3) eliminates the need to comply with the earnings distribution or allocation requirements of section 501(e)(2). This would enable an HSO to retain its net earnings for such purposes as retiring indebtedness or generating permanent capital for expansion and acquisition of new equipment.[50] Further, an HSO exempt under section 501(e) is unable to provide services to organizations other than tax-exempt or public hospitals without endangering its tax-exempt status.[51] By contrast, an HSO exempt under section 501(c)(3) would arguably be able to provide services to for-profit hospitals if the provision of such services remained an insubstantial part of its overall activities.[52] Finally, an HSO exempt under section 501(e) is limited in the kinds of services it can provide; if it were exempt under section 501(c)(3) it could provide any service,

---

44. I.R.C. § 501(c)(3); Treas. Reg. §§ 1.501(c)(3)-1(a), (b) & (c) (1959). The regulation states in part:

> 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.

Id. § 1.501(c)(3)-1(c)(1).

45. *See* note 5 *supra.*

46. I.R.C. § 501(e)(1)(A). For the list of services, *see id.* quoted in note 5 *supra.*

47. I.R.C. § 501(e)(1)(B).

48. I.R.C. § 501(e)(2).

49. I.R.C. § 501(e)(3).

50. 1 R. BROMBERG, *supra* note 22, ¶ 9.2(1), at 9–3; D. Mancino, *Court Ruling Casts Doubt on Shared Services' Tax Status,* HOSPITAL PROGRESS, Sept. 1981, at 62.

51. *See* I.R.C. § 501(e)(1)(B)(i)–(iii); Chart, Inc. v. United States, 491 F. Supp. 10, 13–14 (D.D.C. 1979).

52. Treas. Reg. § 1.501(c)(3)-1(c)(1) (1959); *accord,* Chart, Inc. v. United States 491 F. Supp. 10 (D.D.C. 1979), in which plaintiff, an HSO exempt under § 501(e) that provided electronic data processing services to its tax-exempt member hospitals, sought and was granted tax-exempt status as a § 501(c)(3) charitable organization in order to enable it to expand its services to include nursing homes.

For a more detailed discussion of the relative disadvantages of § 501(e) status, *see generally* 1 R. BROMBERG, *supra* note 22, at ch. 9 (1979); Vracui & Zuckerman, *Legal and Financial Constraints on the Development and Growth of Multiple Hospital Arrangements,* in MULTIHOSPITAL SYSTEMS, *supra* note 16, at 415, 422.

including laundry, so long as the provision of the service was compatible with a charitable purpose.

Thus, section 501(e) has been a flawed and "faulty vehicle from the very start,"[53] and primary among its flaws has been the exclusion of laundry services from the section 501(e)(1)(A) enumeration.[54] As will be developed in greater detail below,[55] the exclusion was not inadvertent. The Conference Committee report states, "The new subsection does not grant tax-exempt status if the [HSO] performs any services other than those specified in the new subsection *(for example, laundry services)*."[56] The Court relied on this legislative history in *HCSC-Laundry* to support its holding that HSOs are ineligible for tax-exempt status under section 501(c)(3).

HSOs have sought to be characterized as section 501(c)(3) charitable organization on the basis of two interrelated theories: the "promotion of health" theory and the "integral part" theory.[57] The promotion of health is recognized as a charitable purpose.[58] Therefore, under this theory, HSOs would be entitled to exemption because they materially further the promotion of health by peforming services that bear a close connection to the charitable functions of their hospital members[59] and enable those hospitals to further their charitable purposes.[60]

Under the "integral part" theory, which is closely related to the "promotion of health" theory and recognized as a method of exemption,[61] exemption is based on the fact that the services provided by HSOs "are an integral part of the hospital's activities,"[62] that is, they are "necessary and indispensable to the operation" of its hospital members.[63] Under either theory, an HSO satisfies the requirement that the charitable organization serve a public rather than a private interest:[64] the nonprofit tax-exempt hospitals that are served by an HSO serve, by definition, a public interest; and the benefits that an HSO produces ultimately redound to the public in the form of lower costs and higher quality service.[65] Applying these theories, the District Court in *HCSC-*

---

53. 1 R. BROMBERG, *supra* note 22, ¶ 9.3[1], at 9-14.

54. *See* I.R.C. § 501(e)(1)(A), quoted in note 5 *supra*.

55. *See* text accompanying notes 90–99 *infra*.

56. CONF. REP. NO. 1533, 90th Cong., 2d Sess. 43, *reprinted in* [1968] U.S. CODE CONG. & AD. NEWS 2373, 2390 (emphasis supplied); *see also* S. REP. NO. 94-938 (Part II), 94th Cong., 2d Sess. 76, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3969.

57. 1 R. BROMBERG, *supra* note 22, ¶ 9.2[3], at 9–11.

58. *See* Eastern Ky. Welfare Rights Org. v. Simon, 506 F.2d 1278 (D.C. Cir. 1974), *rev'd on other grounds*, 426 U.S. 26 (1976); Lugo v. Simon, 453 F. Supp. 667 (N.D. Ohio 1978). *See also* Rev. Rul. 79-17, 1979-1 C.B. 193; Rev. Rul. 75-197, 1975-1 C.B. 156; Rev. Rul. 73-313, 1973-2 C.B. 174; Rev. Rul. 72-124, 1972-1 C.B. 145; Rev. Rul. 70-590, 1970-2 C.B. 116; Rev. Rul. 69-545, 1969-2 C.B. 117; Rev. Rul. 68-1, 1968-1 C.B. 251. *See generally* Note, *Profitable Business Activities and Charitable Exemption Under Section 501(c)(3)*, 44 GEO. WASH. L. REV. 270, 272–74 (1976).

59. *Cf.* Rev. Rul. 69-572, 1969-2 C.B. 119 (construction of building to house exempt organizations).

60. *See* 1 R. BROMBERG, *supra* note 22, ¶ 9.23, at 9-11 to 9-12.

61. *See, e.g.*, Treas. Reg. § 1.502-1(b) (1952), discussed in text accompanying notes 75–78 *infra*.

62. Chart, Inc. v. United States, 491 F. Supp. 10, 11 (D.D.C. 1979).

63. Hospital Bur. Standards & Supplies, Inc. v. United States, 158 F. Supp. 560, 562 (Ct. Cl. 1958).

64. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (1959).

65. *See* text accompanying notes 23–30 *supra*.

Laundry said: "It is undisputable that a hospital cannot discharge its purposes without reliable and quality laundry and linen services, which service must meet standards particular to hospital situations. Therefore, plaintiff undisputedly performs an integral and necessary function of charitable organizations, and we conclude that plaintiff is a charitable organization."[66]

The nature of an HSO's functions is unquestionably charitable, a conclusion that, even in the face of the IRS contention that HSOs were feeder organizations, had not been seriously questioned; indeed, the IRS abandoned its feeder organization argument in its appeal of *HCSC-Laundry* to the Third Circuit.[67]

It can be said that under section 501(e) HSOs receive the most essential benefits of tax-exempt status. But this argument overlooks the fact that section 501(e), because of its enumeration of services, unduly restricts the kinds of HSOs that can invoke its provisions. It is bad enough that a service as valuable to the provision of health care as laundry was intentionally excluded from section 501(e) by Congress and from section 501(c)(3) by the IRS and the Court; far worse, in an industry as innovative and fast-changing as the hospital and health care industry, such a narrow view will have significant and untoward effects. A recent survey of "shared services" identified some thirty-eight services that are shared in some manner by hospitals.[68] As technologies and approaches to the provision of health-care services advance and begin to outstrip the services listed in section 501(e), the restrictions on the tax-exempt status of HSOs may well be proved shortsighted.

B. *Exempt or Not Exempt?*

1. *The IRS Position: Section 502 Feeder Organizations*

The refusal of the IRS to acknowledge the tax-exempt status of HSOs under section 501(c)(3) was grounded in its interpretation of section 502,[69] the feeder organization provision. First enacted in 1950,[70] section 502, in conjunction with the unrelated business income provision in sections 511–514,[71] was

---

66. HCSC-Laundry v. United States, 473 F. Supp. 250, 254 (E.D. Pa. 1979).

67. HCSC-Laundry v. United States, 624 F.2d 428 (3rd Cir. 1980), *aff'd*, 450 U.S. 1 (1981). *See* cases collected in note 13 *supra*.

68. Longest, *A Conceptual Framework for Understanding the Multihospital Arrangement Strategy*, HEALTH CARE MANAGEMENT REV., Winter 1980, at 17, 21. *See* Bromberg, *The Effect of Tax Policy on the Delivery and Cost of Health Care*, 53 TAXES 452, 460 (1975).

69. *See* note 9 *supra*.

70. The feeder organization provision was added to the tax statute as an amendment to § 101 of the 1939 Code. Revenue Act of 1950, Pub. L. No. 814, § 301(b), 64 Stat. 906, 953 (1950). The provision was carried over materially unchanged into the 1954 Code. Act of Aug. 16, 1954, Pub. L. No. 83-591, 68A Stat. 166, 26 U.S.C. § 502 (1954).

71. I.R.C. § 511 imposes a tax on the "unrelated business taxable income" of certain tax-exempt organizations. I.R.C. § 512 defines "unrelated business taxable income" as "the gross income derived by any organization from any unrelated trade or business," as further defined by I.R.C. § 513(a): "any trade or business the conduct of which is not substantially related . . . to exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 . . ."

intended to eliminate an unfair competitive advantage that certain corporations, operated for the primary purpose of carrying on a trade or business for profit, were perceived to enjoy by virtue of tax-exempt status acquired under the so-called "destination of income" test.[72] Under this test, a corporation could obtain tax-exempt status regardless of the nature of its activity so long as its income was transferred to one or more exempt organizations.[73]

In 1952 the IRS issued a controversial regulation that, in the words of one commentator, "clearly extended the application of Section 502 to situations never contemplated by Congress."[74] The regulation[75] begins by stating that a subsidiary organization of a tax-exempt organization that would be exempt on the ground that "its activities are an integral part of the exempt activities of the parent organization" will not lose its exemption because, as a matter of accounting between it and the parent organization, it "derives a profit from its dealings with its parent organization . . . ."[76] The regulation then provides that a subsidiary organization will not be deemed exempt if it engages in activities that would be unrelated to its parent organization's exempt activities if performed by the parent. The regulation gives this example: "[I]f 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

---

72. *See* H. REP. NO. 2319, 81st Cong., 2d Sess., *reprinted in* 1950-2 C.B. 380, 408-09, 412, 469; S. REP. NO. 2375, 81st Cong., 2d Sess. *reprinted in* 1950-2 C.B. 483, 504-05, 509, 565-66.

The "destination of income" test was first enunciated in Trinidad v. Sagrada Orden de Predicadores De La Provincia Del Santismo Rosario De Filipinas, 263 U.S. 578 (1924). Plaintiff, an incorporated religious order, earned income from properties consisting of real estate and securities holdings and from occasional sales of wine and chocolate. All the income was used to fund its religious and charitable activities. The IRS, though admitting that plaintiff was organized and operated for religious, charitable, and educational purposes, nonetheless argued that the organization was not exempt because it received income from business sources and was not, therefore, operated exclusively for those purposes. In response the Supreme Court said:

> Whether the contention is well taken turns primarily on the meaning of the excepting clause, before quoted from the taxing act. Two matters apparent on the face of the clause go far towards settling its meaning. First, it recognizes that a corporation may be organized and operated exclusively for religious, charitable, scientific or educational purposes, and yet have a net income. Next, it says nothing about the source of the income, but makes the destination the ultimate test of exemption.

Id. at 581. The Court concluded that holding the properties for income and the incidental transaction in wine and chocolate did not constitute engaging in a trade or business. *Id.* at 582.

The "destination of income" test was later applied to hold exempt an organization that was organized and operated for the purpose of conducting a business for profit but which "fed" all its income to an exempt charitable foundation, on the ground that the destination, not the source, of the income was dispositive. Roche's Beach, Inc. v. Commissioner, 96 F.2d 776 (2d Cir. 1938); *accord,* Lichter Foundation, Inc. v. Welch, 247 F.2d 431 (6th Cir. 1957); Boman v. Commissioner, 240 F.2d 767 (8th Cir. 1957); C.F. Mueller Co. v. Commissioner, 190 F.2d 120 (3rd Cir. 1951); Willingham v. Home Oil Mill, 181 F.2d 9 (5th Cir. 1950).

A number of courts, however, rejected the "destination of income" test as applied to organizations not directly engaged in exempt activities, and instead focused on the nature of the organization's activities and the source of the income. University Hill Foundation v. Commissioner, 446 F.2d 701 (9th Cir. 1971); Riker v. Commissioner, 244 F.2d 220 (9th Cir. 1957); Randall Foundation v. Riddell, 244 F.2d 803 (9th Cir. 1957); Ralph H. Eaton Foundation v. Commissioner, 219 F.2d 527 (9th Cir. 1955); United States v. Community Servs., Inc., 189 F.2d 421 (4th Cir. 1951), *cert. denied,* 342 U.S. 932 (1952); Universal Oil Prods. Co. v. Campbell, 181 F.2d 451 (7th Cir. 1950).

73. *See, e.g.,* C.F. Mueller Co. v. Commissioner, 190 F.2d 120 (3rd Cir. 1951).

74. Bromberg, *The Effect of Tax Policy on the Delivery and Cost of Health Care,* 53 TAXES 452, 456 (1975).

75. Treas. Reg. § 1.502-1(b) (1952).

76. *Id.*

business would be an unrelated trade or business if regularly carried on by the parent organization."[77] If a subsidiary organization furnishes electric power to *related* tax-exempt organizations, its tax-exempt status is not endangered. However, the statement in the regulation that "[a]n exempt organization is not related to another exempt organization merely because they both engage in the same type of exempt activities,"[78] makes it abundantly clear that if the subsidiary[79] engages in activities for the benefit of "several unrelated exempt organizations,"[80] it is not exempt—even though the so-called *unrelated* exempt organizations created, own, and control the subsidiary and engage in the same type of exempt activities, and even though the subsidiary's activities are integrally related to their exempt activities.

On the authority of this interpretation of section 502, the IRS in 1954 ruled that the corporation organized and operated for the primary purpose of operating a purchasing agency for a number of tax-exempt hospitals was not itself exempt on the ground that it was engaged in business activities that would be unrelated activities if carried on by any one of the organizations served.[81] Thus, in baffling fashion, was born the IRS antipathy toward HSOs.

2. *The* Hospital Bureau *Decision: Exempt as Charitable Organizations*

The IRS interpretation was rejected by the Court of Claims in a decision that continues to be the starting point of any analysis of the issue, *Hospital Bureau of Standards & Supplies, Inc. v. United States*.[82] The case involved a corporation that was organized to purchase hospital supplies for its tax-exempt member hospitals and to maintain a research department to establish uniform standards of quality and price for the supplies. The plaintiff sought exemption under the predecessor of section 501(c)(3)[83] as a charitable organization. The IRS argued that since it performed no hospital services as such, the corporation was organized for the primary purpose of carrying on a trade or business for profit and was therefore a feeder organization under the predecessor to section 502. On the basis of *Squire v. Students Book Corp.*,[84] a 1951 Ninth Circuit decision which had held that a bookstore owned by a tax-exempt university was exempt from taxation because its activity bore an intimate relationship to the functioning of the university, the Court of Claims

77. *Id.*
78. *Id.*
79. Note that the regulation does not say "subsidiary organization." The word "subsidiary" was dropped from Treas. Reg. 118 § 39.101-2(b) (1950), in response to Hospital Bur. Standards & Supply, Inc. v. United States, 158 F. Supp. 560 (Ct. Cl. 1958). "Apparently the Commissioner realized that the inaccurate use of the word subsidiary in this sentence drew too much attention to the close relationship between the controlled corporation and its tax-exempt owners." Associated Hosp. Servs., Inc. v. Commissioner, 74 T.C. 213, 219 (1980). *See* T.D. 6662, 1963-2 C.B. 214, 216.
80. Treas. Reg. § 1.502-1(b) (1952).
81. Rev. Rul. 54-305, 1954-2 C.B. 127. The IRS's interpretation is analyzed below. *See* text accompanying notes 100-27 *infra*.
82. 158 F. Supp. 560 (Ct. Cl. 1958).
83. Int. Rev. Code of 1939, ch. 2, § 101(6), 53 Stat. 1 (now I.R.C. § 501(c)(3)).
84. 191 F.2d 1018, 1020 (9th Cir. 1951).

found in *Hospital Bureau* that the plaintiff was an integral part of the operation of its hospital members because the services it performed were "necessary and indispensable to the operation of . . . member hospitals."[85] Of no consequence was the fact that in this case the HSO performed its services for more than one tax-exempt hospital. Without detailed analysis, the court questioned the applicability of the feeder organization regulation to member hospitals that were engaged in related charitable activities,[86] and then concluded that plaintiff was not a feeder organization: the nature of its activities and its corporate and financial structure were not the "indicia of an organization operating for the primary purpose of carrying on a trade or business for profit."[87] "At most," the court continued, presaging the argument that would be made twenty years later, "the plaintiff was performing a function which each of its member hospitals would have to assume were it not for plaintiff's existence."[88]

The IRS refused to follow the holding of *Hospital Bureau* and instead amended the regulation under section 502 to make clear what the regulation meant by "related."[89] Despite their success in court, the proponents of HSOs were thus faced with the alternatives of continuing the expensive and time-consuming litigation to compel the IRS to alter its position or of seeking legislative relief to reach the same result.

3. *The Enactment of Section 501(e)*

In the face of the IRS's intransigency, the nonprofit hospital industry sought redress by means of a legislative solution to the problem of the tax-exempt status of HSOs. Resort to the legislative process was deemed preferable to uncertain, costly, and prolonged litigation, notwithstanding the cer-

---

85. 158 F. Supp. 560, 562 (Ct. Cl. 1958).

86. *Id.* at 563. The court stated:

> We question the applicability of [the] Treasury . . . Regulations to a membership corporation where the members are engaged in related charitable activities. Here the plaintiff is composed entirely of member hospitals. Its services are available only to the member institutions. To construe the Regulations as denying exemption in this particular case could require distortion of the language employed.

Id. (footnote omitted). The language to which the court referred was that part of the regulation which read: "Similarly, if the subsidiary 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." Treas. Reg. 118 § 39.101-2(b) (1950). The court evidently read "unrelated" limitedly—not, as the IRS did, in its technical corporate-structure sense. Hence, for the court, the hospitals at issue were "related" in that they all performed hospital services on a nonprofit basis; they were, therefore, "engaged in related charitable activities." The IRS reaction to the *Hospital Bureau* decision confirms this view. *See* note 89 *infra*. The IRS was, then, hoisted by its own petard.

87. 158 F. Supp. 560, 564 (Ct. Cl. 1958).

88. *Id.*

89. The IRS amended Treas. Reg. § 1.502-1(b) in 1963, adding the provisions explaining that organizations are to be considered related only if they are a parent and one or more of its subsidiaries, or subsidiaries having a common parent. Engaging in the same kind of exempt activities would not constitute relatedness. Treas. Reg. § 1.502-1(b), T.D. 6662, 1963-2 C.B. 214; *see* note 86 *supra*.

tainty of spirited resistance from the vocal commercial laundry and linen industry lobby.[90]

The first effort, in 1967, ended in failure. Under a proposed amendment to the Social Security Amendments of 1967,[91] organizations created by tax-exempt hospitals to supply them with certain services would have been treated as charitable organizations, provided the service performed was of a type that, if performed by the hospitals on their own behalf, would constitute an integral part of their exempt activities.[92] This amendment was rejected in conference.[93]

In 1968 Congress succeeded in amending section 501 by adding the new subsection (e).[94] Unlike the 1967 version, the 1968 version contained the enumeration of services, which of course had the effect of limiting the utility of section 501(e) by excluding laundry services and of prolonging the dispute between the nonprofit hospital industry and the IRS. Had laundry services been included in section 501(e)(1)(A)—or better, not excluded, by eliminating the enumeration altogether—it is unlikely the present controversy would have arisen. But since laundry services are an extremely valuable—indeed, indispensable[95]—aspect of a hospital's health care task, proponents of HSOs continued to press for exemption under section 501(c)(3). It takes little familiarity with the costs and inconveniences of litigation to appreciate that hospital laundry service organizations would have forgone section 501(c)(3) status had section 501(e) status been available to them, notwithstanding the advantages of status under the former section.[96]

The IRS understandably viewed the enactment of section 501(e) as vindication of its position that HSOs do not qualify for exemption under section 501(c)(3). In Revenue Ruling 69-160[97] the IRS ruled that an HSO providing laundry services for its member hospitals in addition to services specified in section 501(e)(1)(A) did not meet the requirements of section 501(e). In Revenue Ruling 69-633[98] it ruled that an HSO organized and operated on a cooperative basis to provide laundry services to its member hospitals was not exempt

---

90. It is generally accepted that the ultimate form of § 501(e) and the exclusion of laundry services from the enumerated list were the result of lobbying by the commercial laundry and linen supply industries. *See* HCSC-Laundry v. United States, 624 F.2d 428, 435 (3rd Cir. 1980), *aff'd*, 450 U.S. 1 (1981); Bromberg, *The Effect of Tax Policy on the Delivery and Cost of Health Care*, 53 TAXES 452, 459 (1975). The commercial laundry and linen industry lobby urged the Senate Finance Committee not to give special tax treatment to laundry service organizations. *See Certain Committee Amendments to H.R. 10612: Hearings Before the Senate Comm. on Finance*, 94th Cong., 2d Sess. 200 (1976) (statement of John J. Contney, Executive Director, Linen Supply Association of America).

91. Pub. L. No. 90-248, 81 Stat. 821 (1967).

92. *See* S. REP. NO. 774, 90th Cong., 1st Sess. 200-01, 318-19, *reprinted in* [1967] U.S. CODE CONG. & AD. NEWS. 2834, 3158.

93. *See* CONF. REP. NO. 1030, 90th Cong., 1st Sess. 73, *reprinted in* [1967] U.S. CODE CONG. & AD. NEWS 3179, 3220.

94. *See* note 9 *supra*.

95. *See* text accompanying note 66 *supra*.

96. *See* text accompanying notes 45-68 *supra*.

97. 1969-1 C.B. 147.

98. 1969-2 C.B. 121.

under section 501(c)(3).[99] The unarticulated premise of the latter ruling was that HSOs do not qualify for exemption under section 501(c)(3) because they are feeder organizations, the same contention rejected in *Hospital Bureau.*

4. *The Feeder Organization Contention*

In light of the Court's disposition of the *HCSC-Laundry* case, it is perhaps academic to analyze in depth the IRS feeder organization objection to the tax-exempt status of HSOs.[100] But to view in the proper light the effort by the proponents of HSOs to seek amendment of section 501 after the IRS refusal to follow the *Hospital Bureau* decision and the effect of that amendment, the merits of that position should be explored.

Section 501(a) provides that an organization described in subsection (c)(3) is exempt from taxation unless the exemption is denied under section 502.[101] The IRS concluded that HSOs came within section 502 and therefore denied them exemption. The *Hospital Bureau* court apparently deemed the IRS interpretation incongruous with the language and reason of section 502.[102] If the feeder organization contention lacks persuasive force, then added support would be given to the view that Congress intended section 501(e) to be a safe harbor of exemption for certain HSOs.[103]

The IRS contention is challenged on the ground that neither the regulation[104] nor Revenue Ruling 54-305[105] bears a logically consistent relationship to the language or reason of section 502.[106] The gravamen of the criticism, succinctly put, is that "[t]here is simply no justification for taxing a collective effort that, if individually performed, would not be subject to taxation."[107] An analysis of Treasury Regulations section 1.502-1(b) supports this view.

For purposes of analysis, reference will be made to the following three examples representing the IRS interpretation of section 502:[108]

(1) A subsidiary organization is exempt if it is operated for the sole

99. *Id.* The ruling's reasoning went as follows:

> In order to qualify as a cooperative hospital service organization under the provisions of section 501(e) of the Code, an organization must be organized and operated solely to perform one or more of the services specified in section 501(e)(1)(A). . . . Since laundry services are not one of the services specified in that section, the organization does not meet the requirements of section 501(e). . . , and thus is not exempt from Federal income taxation under section 501(c)(3).

Id.

100. *See* note 9 *supra.*

101. *See* note 2 *supra.*

102. *See* note 86 *supra.*

103. *See* text accompanying notes 129–39 *infra.*

104. Treas. Reg. § 1.502-1(b) (1952). *See* text accompanying notes 75–78 *supra.*

105. 1954-2 C.B. 127. *See* text accompanying note 81 *supra.*

106. *See* 1 R. BROMBERG, *supra* note 22, ¶ 9.2[3], at 9-8 to 9-10; Bromberg, *The Effect of Tax Policy on the Delivery and Cost of Health Care,* 53 TAXES 452, 456-57 (1975).

107. Brief Amicus Curiae of the American Hospital Association in Support of Petition for Certiorari at 3, HCSC-Laundry v. United States, 450 U.S. 1 (1981). *See* text accompanying note 88 *supra.*

108. The examples are a distillation of those given in Treas. Reg. § 1.502-1(b) (1952). *See* Associated Hosp. Servs., Inc. v. Commissioner, 74 T.C. 213, 224 (1980). *See also* text accompanying notes 74–80 *supra.*

purpose of providing a service for the benefit of its parent organization, so long as that service is an integral part of the latter's exempt activities;

(2) A subsidiary organization is not exempt if it is operated primarily for the purpose of providing a service (*e.g.*, electric power) to consumers other than its parent organization, since such business would be an unrelated trade or business if regularly carried on by the parent organization; and

(3) An organization owned by several unrelated exempt organizations and operated for the purpose of providing a service to each of them is not exempt, because that business would be an unrelated trade or business if regularly carried on by any one of the tax-exempt organizations.

The first example describes the situation in which one organization provides a service that is an integral part of the functions of a tax-exempt organization and thereby assumes the tax-exempt status of its parent organization.[109] The "integral part" theory has been applied elsewhere by the IRS[110] and by the courts—most notably in *Squire v. Students Book Corp.*,[111] relied upon by the court in *Hospital Bureau*. The second example clearly fits the feeder organization mold: the subsidiary organization is operated primarily for commercial, not charitable, purposes. If it then "feeds" the resulting profits to its tax-exempt parent organization, it becomes identical with the very examples of the application of the discredited destination of income test of exemption that section 502 was designed to eliminate.[112]

The logic and familiarity of the regulation disappears, however, upon consideration of the third example. There is no obvious connection between it and the language of section 502, nor between it and the second example, to which the analogy of nonexemption is drawn. The Tax Court, although affirming the validity of the regulation,[113] expressed doubt about whether the third example reflected the import of section 502, and noted, "What the regulation should tell us is why the analogy should bę made to the second

---

109. *See* text accompanying notes 61–66 *supra*.

110. *See* Rev. Rul. 78-41, 1978-1 C.B. 148, which held that a trust created by a hospital to serve as repository of funds to satisfy malpractice claims against the hospital was exempt. The ruling states:

> By serving as a repository for funds paid in by the hospital, and by making payments at the direction of the hospital to persons with malpractice claims against the hospital, the trust is operating as an *integral part* of the hospital. Of equal importance is the fact that the trust is performing a function that the hospital could do directly.

Id. at 149 (emphasis supplied). *See also* Rev. Rul. 67-291, 1967-2 C.B. 184; Rev. Rul. 67-217, 1967-2 C.B. 181; Rev. Rul. 58-194, 1958-1 C.B. 240.

111. 191 F.2d 1018 (9th Cir. 1951).

112. *See, e.g.*, C.F. Mueller Co. v. Commissioner, 190 F.2d 120 (3rd Cir. 1951); Roche's Beach, Inc. v. Commissioner, 96 F.2d 776 (2d Cir. 1938). For a discussion of the destination of income test, *see* note 72 *supra*.

It is clear from the legislative history of the predecessor to § 502 that the section was intended to change the result of the cases applying the destination of income test. *See* S. REP. NO. 2375, 81st Cong., 2d Sess., *reprinted in* [1950] U.S. CODE CONG. & AD. NEWS 3053, 3088. The technical discussion of the section gives the following example of the section's intended effect: "The paragraph applies to organizations operated for the primary purpose of carrying on a trade or business for profit, as for example, a feeder corporation whose business is the manufacture of automobiles for the ultimate profit of an educational institution." *Id.* at 3176.

113. Associated Hosp. Servs., Inc. v. Commissioner, 74 T.C. 213 (1980).

example rather than the first example, where the opposite result obtains."[114] Indeed it should. This part of the regulation ignores the fact that an HSO performs services that are an integral part of the exempt functions of each member hospital. It is, in that respect, no different from a subsidiary organization of one hospital or the respective subsidiary organizations of a number of hospitals, all of which come within the exemption ambit of the first example. To say, as does the regulation, that an HSO that performs services for two or more hospitals is nonexempt because the *hospitals are unrelated to one another*[115]—that is, do not enjoy a parent-subsidiary relationship—does not address the issue.[116] The only distinction between the situation in which an HSO performs services for a number of hospitals and the one in which the same services are provided to a number of hospitals individually by their respective subsidiary organizations is that in the former the subsidiary organizations have been consolidated into one organization for purposes consistent with the federal government's effort to encourage cost containment measures.

Section 502 addresses itself to an organization operated for the primary purpose of carrying on a trade or business *for profit*.[117] The primary purpose of an HSO, notwithstanding that it performs commercial services, is charitable when determined on the basis of all the circumstances.[118] Its purpose is to facilitate the accomplishment of its member hospitals' exempt functions—the provision of health care—by providing them with cost-effective and high quality services. The benefits of their activities redound to the public in the form of lower hospital costs and better care.[119] Rather than bringing to mind section 502, this suggests the "promotion of health" theory of exemption under section 501(c)(3).[120] As far as profit-making potential is concerned, an HSO does not derive profit by selling its services to outside consumers—the second example—and then "feed" the ensuing profit to its tax-exempt hospital members. Rather, as the Tax Court noted, any profit results from transactions taking place within "a closed circle,"[121] not within a commercial market. Profit in this context typically results from an HSO setting user fees

---

114. *Id.* at 228.

115. Treas. Reg. § 1.502-1(b) (1952). *See* text accompanying notes 75–78 *supra*.

116. Judge Nims in Associated Hosp. Servs., Inc. v. Commissioner, 74 T.C. 213, 219 (1980), though finding in favor of the IRS on the ground that Treas. Reg. § 1.502-1(b) had been congressionally approved by means of the reenactment doctrine, said: "It might be observed in this connection that the question of whether the common owners of the scrutinized corporation are or are not related to each other is totally beside the point—a more relevant inquiry . . . would appear to be whether the service organization is integrally related to the common owners." *Id.* at 219.

117. *See* note 9 *supra*. *See also* Veterans Foundation v. United States, 178 F. Supp. 234, 238 (D. Utah 1959), *aff'd*, 281 F.2d 912 (10th Cir. 1960); United States v. Community Servs., Inc., 189 F.2d 421, 426 (4th Cir. 1951). Judge Nims observed: "The critical inquiry is whether petitioner's primary purpose for engaging in its sole activity is an exempt purpose, or whether its primary purpose is the nonexempt one of operating a commercial business producing profits for [itself]. . . ." Associated Hosp. Servs., Inc. v. Commissioner, 74 T.C. 213, 228–29 (1980) (quoting B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352, 357 (1978)).

118. *See* Treas. Reg. § 1.501(c)(3)-1(e) (1959). *See also* HCSC-Laundry v. United States, 450 U.S. 1, 15 n.13 (1981) (Stevens, J., dissenting).

119. *See* text accompanying notes 26–30 *supra*.

120. *See* text accompanying notes 57–60 *supra*.

121. Associated Hosp. Servs., Inc. v. Commissioner, 74 T.C. 213, 229 (1980).

slightly above operational cost to enable it to service its debt and invest in capital equipment.[122] Thus, any profit is derived from the hospital members and, implicit in the arrangement, ultimately accrues to each of them in the form of patronage refunds or the HSO's own heightened capacity to perform services. Accordingly, "[w]e would therefore question whether the profit, if any, derived by [an HSO] was any different from the profit between an exempt parent and its wholly owned subsidiary exempted by the [IRS] in regulation sec. 1.502-1(b)."[123] Both would merely reflect bookkeeping arrangements between the parent and subsidiary organizations.[124]

The third example suggests that an HSO would not be exempt because the service it provides would be an unrelated trade or business if regularly carried on by any one of the parent organizations. This presumes that through the subsidiary, each of the parent organizations is providing services to and deriving income from the others.[125] Conceptual difficulties aside, this contention is likewise not supported by the evidence. Each hospital is in effect doing business only with itself and in the same manner as if each had established a subsidiary to perform a service for itself alone—the first example. The relation between each hospital and the HSO depends upon and is directly proportional to the demand for services. Any profit realized by the HSO is derived from and in turn benefits directly or indirectly each hospital in direct proportion to the volume of business done with each.[126] In this sense, the HSO is nothing more than a more efficient analogue of each hospital's previous service provider. It cannot be said that each hospital is vicariously engaged in an unrelated trade or business through the instrumentality of the HSO.

The foregoing analysis has attempted to show that HSOs do not fall within the language or reason of section 502. On the other hand, the argument for the tax-exempt status of HSOs as charitable organizations fares considerably better. As noted,[127] under either the "promotion of health" or "integral part" theory it can be demonstrated that an HSO serves a public rather than a private interest by providing its hospital members with essential services efficiently and at low cost.

The dubious validity of the IRS feeder organization contention thus lends an ironic counterpoint to the dispute over the tax-exempt status of HSOs. The IRS position that HSOs were feeder organizations compelled the legislative effort to amend section 501. Had the IRS not persisted in its wrong-headed

---

122. *See, e.g.*, HCSC-Laundry v. United States, 624 F.2d 428, 430 (3rd Cir. 1980), *aff'd*, 450 U.S. 1 (1981):

> The corporation has no capital stock. Each participating hospital is a dues-paying member. . . . HCSC-Laundry's only income in addition to the dues is a laundry charge of 1½¢ per pound of laundry serviced which is charged to each customer over the actual cost. "Cost" for this purpose includes operating expenses, debt retirement, and linen replacement. This charge in excess of cost is placed in a fund for equipment replacement and acquisition.

123. Associated Hosp. Servs., Inc. v. Commissioner, 74 T.C. 213, 229 (1980).

124. *See* Treas. Reg. § 1.502-1(b) (1952) (first sentence).

125. *See* 1 R. BROMBERG, *supra* note 22, ¶ 9.2[3], at 9-8 to 9-9, for an excellent discussion of the issue.

126. *Id.*

127. *See* text accompanying notes 57–66 *supra*.

interpretation of section 502, Congress would not have undertaken its ill-fated attempt to clarify the law, and HSOs, including laundry service organizations, would be exempt today as charitable organizations under section 501(c)(3). In this case, an unnecessary problem led to a regrettable solution.

C. *The Return to the Courts*

It was clear soon after its enactment that section 501(e) was inadequate as a vehicle of exemption for HSOs. Consequently, HSOs—almost exclusively those performing laundry services[128]—returned to the courts armed with *Hospital Bureau* to seek exemption under section 501(c)(3). They were met not only by the feeder organization argument, wounded by *Hospital Bureau*, but also by an argument made possible by the enactment of section 501(e), one that in *HCSC-Laundry* would prove decisive. The IRS contended that since laundry services were not specified in section 501(e)(1)(A), laundry service organizations could not qualify for exemption under section 501(e)—a position consistent with the earlier IRS rulings. Even more important, the argument continued, the deliberate exclusion of laundry services from section 501(e) is conclusive evidence that Congress intended not to favor such organizations with tax-exempt status. It followed, therefore, that Congress intended section 501(e) to be the exclusive method of exemption for HSOs as a class, for to hold otherwise would permit them to obtain the same tax-exempt status, as well as additional benefits under section 501(c)(3). According to the IRS, such a result would render section 501(e) a nullity and frustrate congressional purpose.

The first case to consider this argument was *United Hospital Services, Inc. v. United States*,[129] which involved the claim of a laundry service organization that it qualified for exemption as a section 501(c)(3) charitable organization.[130] The IRS countered with the argument that section 501(e) precluded plaintiff from seeking exemption under section 501(c)(3). The IRS also continued, however, to press its original point, arguing that in any event plaintiff was a feeder organization.[131] The court rejected both contentions. As for the first, the court ambiguously[132] reasoned that though Congress had excluded laundry services from section 501(e)(1)(A), it did not follow that the addition of section 501(e) precluded plaintiff from consideration under section 501(c)(3) "on its own merits."[133] The court concluded that

> [t]he clearly expressed Congressional purpose behind the enactment of Section

---

128. By the time the Supreme Court decided *HCSC-Laundry*, in only one case, Chart, Inc. v. United States, 491 F. Supp. 10 (D.D.C. 1979), had an HSO that performed services other than laundry sought exemption directly under § 501(c)(3).

129. 384 F. Supp. 776 (S.D. Ind. 1974).

130. *Id.* at 777.

131. *Id.* at 781. The IRS had argued that the addition of section 501(e) in 1968 clearly showed the intent of Congress to exclude hospital laundry service organizations from being treated as charitable organizations under section 501(c)(3). *Id.* at 780.

132. *See* note 134 *infra*.

133. 384 F. Supp. 776, 780 (S.D. Ind. 1974).

> 501(e) was to enlarge the category of charitable organizations under Section 501(c)(3) to include certain cooperative hospital service organizations, and not to narrow or restrict the reach of Section 501(c)(3). The latter section was not modified by the legislation in any way, and the legislation does not purport to take away charitable status from a corporation which had already acquired it. Insofar as this case is concerned, therefore, Section 501(e) is irrelevant.[134]

This passage was subsequently interpreted to imply that section 501(e) had been intended to be a "safe harbor" of exemption.[135]

The court in *United Hospital Services* analyzed the feeder organization contention within the framework of the unfair competition focus of section 502 and found that the plaintiff did not compete unfairly with commercial laundries, since none was able or willing to provide the specialized laundry service needed by the hospitals.[136] Finding the case completely analogous to *Hospital Bureau*,[137] the court held the plaintiff to be a charitable organization: the plaintiff promoted the public health by lessening general hospital expenses, freeing up money for further services, and making available space normally allocated to laundries.[138] Finally, the court curtly dismissed the applicability of Treasury Regulations section 1.502-1(b): "Charitably put . . . , the court has difficulty in finding any basis in [section 502] for the underlined portion of the regulation."[139]

Despite the court's restrained analysis, *United Hospital Services* was a significant decision. It provided part of the footing upon which five district courts[140] and the Court of Claims[141] subsequently held HSOs exempt under section 501(c)(3). It also further eroded whatever logical and interpretative integrity the IRS's feeder organization argument may have had, perforce substantiating the view that HSOs, whether by virtue of the "promotion of health" or the "integral part" theory, are intrinsically charitable in nature.[142]

In the interim between *United Hospital Services* and the decisions that followed, the American Hospital Association[143] proposed an amendment that

---

134. *Id.* at 781. The penultimate sentence of the quoted passage raised the question whether the *United Hospital Services* decision was somehow dependent upon the fact that the plaintiff was doing business before § 501(e) was adopted. In subsequent cases relying on the decision, the holding was not so narrowed. *See* Metropolitan Detroit Area Hosp. Servs., Inc. v. United States, 445 F. Supp. 857, 860–61 (E.D. Mich. 1978), *rev'd*, 634 F.2d 330 (6th Cir. 1980). That the IRS even put forth the argument, however, attests to its suspicion that the feeder organization argument was logically and practically bankrupt.

135. *See, e.g.*, Metropolitan Detroit Area Hosp. Servs., Inc. v. United States, 445 F. Supp. 857, 860 (E.D. Mich. 1978), *rev'd*, 634 F.2d 330 (6th Cir. 1980); Northern Cal. Cent. Servs., Inc. v. United States, 591 F.2d 620, 624 (Ct. Cl. 1979).

136. 384 F. Supp. 776, 777, 780 (S.D. Ind. 1974).

137. *Id.* at 781.

138. *Id.* at 780–81.

139. *Id.* at 782. The portion of the disputed regulation to which the court referred reads: "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 . . . ." Treas. Reg. § 1.502-1(b) (1952).

140. *See* cases collected in note 13 *supra*.

141. Northern Cal. Cent. Servs., Inc. v. United States, 591 F.2d 620 (Ct. Cl. 1979).

142. 384 F. Supp. 760, 779–81 (S.D. Ind. 1974).

143. In its statement submitted to the Senate Committee on Finance, the American Hospital Association gave the following justification for an amendment:

would have added laundry and clinical services to the enumerated list of section 501(e)(1)(A)[144] and thereby ended the necessity of further litigation to establish the exempt status of HSOs. The word "laundry," however, was stricken from the amendment on the floor of the Senate.[145] The 1976 legislative effort strengthened the contention that Congress did not intend to favor laundry service organizations with tax-exempt status. The question whether section 501(e) was intended to be a "safe harbor" or the exclusive method of exemption assumed central importance, drawing attention away from critical examination of the moribund feeder organization argument.[146]

As noted, *United Hospital Services* preceded and laid the groundwork for a series of lower federal court decisions granting HSOs tax-exempt status under section 501(c)(3). All but one[147] involved a laundry service organization. Although all the courts rejected both IRS arguments, it must be noted that not all did so without reservation. The court in *Chart, Inc. v. United States,* holding that an HSO that provided electronic data processing could obtain tax-exempt status under section 501(c)(3) even though it already qualified for exemption under section 501(e), stated:

> The Court shall follow the unanimous conclusion of the courts that have faced the issue—cooperative service organizations which cannot qualify under section 501(e) may still qualify under section 501(c)(3). Accepting that conclusion, the Court is faced with a dilemma. If the Court holds that organizations which qualify under section 501(e) may not qualify under section 501(c)(3), such organizations

---

> We are confident that excluding laundry services from section 501(e) and the liability for state and local taxes that may accompany this exclusion have slowed the growth of cooperative laundries to serve hospitals. Amending the law to include laundry services, would, in our view, be in the public interest by accelerating the formation of cooperative laundries to serve hospitals and helping them to deliver better health services more economically.
>
> Recommendation: That Section 501(e) of the Internal Revenue Code be amended to include "laundry services" among the activities cooperative hospital service organizations may perform for their members.

Tax Reform Act of 1976: Hearings Before the Senate Comm. on Finance, 94th Cong., 2d Sess. 2765, 2771 (1976) (Statement of the American Hospital Ass'n).

144. *See* S. REP. NO. 94-938 (part II), 94th Cong., 2d Sess. 76, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 4030, 4100.

145. 122 CONG. REC. 25915 (1976). Sen. Ford proposed the amendment to the bill that deleted the word "laundry" and gave as his reasons therefor the following:

> Mr. President, my amendment simply deletes the word "laundry" from the list of exempted services that may be performed by hospital cooperatives. The amendment proposed by the [Senate Finance] Committee has an objective, the control of the spiraling hospital costs.
>
> I share that concern and commend the members for their effort. I believe that the inclusion of laundry services may have the opposite effect. With the high construction costs, co-op laundries may have a beneficial value over their life cycle. But, initially the cost of providing service may be higher than could be purchased from commercial business.
>
> We must find a solution to rising costs, but the effectiveness of intrusion into the private sector is questionable. We should undertake the expansion in those areas in which services cannot be obtained at comparable costs from the private sector. However, we should assure that real savings will result.
>
> We surely should not approve an action that might increase hospital costs, even next year. Thus, I feel that the investments required by the cooperatives and those that have been incurred by private business, dictate that this service be deleted.

Id. The Senator's rationale, which exhibits a myopic predilection for short-term results, was endorsed by Sen. Curtis, and the amendment was immediately approved by voice vote. *Id.*

146. *See* text accompanying notes 100–27 *supra.*

147. Chart, Inc. v. United States, 491 F. Supp. 10 (D.D.C. 1979).

> can easily avoid the section 501(e) restrictions by altering their form and qualifying under section 501(c)(3). . . . Such a result borders on the absurd. On the other hand, permitting organizations which qualify under section 501(e) to qualify under section 501(c)(3) would render section 501(e) essentially meaningless. However, in view of the unanimity of the laundry cases, the Court is constrained to hold that the latter alternative is the more acceptable option available to the Court. It would be absurd to permit only those organizations which fail to qualify under section 501(e) the advantages of section 501(c)(3).[148]

Then, expressing a sentiment that would be echoed by the appellate courts and the Supreme Court, the court concluded that "this area is ripe for re-examination by the Congress."[149] As will be developed below,[150] the *Chart* court's perceived dilemma was the result of Congress' ambiguous and perhaps ambivalent treatment of the HSO question. It will be argued that the result reached by the *Chart* court, though unsatisfactory in some respects to that court, is by far preferable to the opposite resolution reached by the Supreme Court.

III. *HCSC-LAUNDRY v. UNITED STATES*

A. *The Facts and Decisions Below*

HCSC-Laundry was organized in 1967 to provide laundry and linen services to fifteen nonprofit hospitals and an ambulance service, all exempt from taxation under section 501(c)(3). Before construction began, a local planning council had concluded that quality laundry and linen services could be provided more economically to the member hospitals if performed cooperatively.[151] Upon rejection of its application for exemption by the IRS, HCSC-Laundry filed suit in Federal District Court for the Eastern District of Pennsylvania seeking a refund of the federal income taxes it had paid.[152]

In the District Court the IRS argued that HCSC-Laundry was not entitled to an exemption, both because it was a feeder organization under section 502 and because the denial of an express exemption in section 501(e) for laundry service organizations precluded plaintiff from consideration under section 501(c)(3)—in short, the IRS argued that section 501(e) was the only means by which HSOs could obtain exemption. The District Court ruled against the IRS as to both contentions.[153] The basis for its finding that HCSC-Laundry quali-

148. *Id.* at 14.

149. *Id. Accord*, HCSC-Laundry v. United States, 624 F.2d 428, 435 (3rd Cir. 1980) ("The result reflects the political process in operation. Requests for relief or for change must be directed to Congress."), *aff'd*, 450 U.S. 1, 8 (1981) ("The Congress easily can change the statute whenever it is so inclined."); Metropolitan Detroit Area Hosp. Servs., Inc. v. United States, 634 F.2d 330, 335 (6th Cir. 1980) ("Congress might well wish to reconsider this decision.").

150. *See* text accompanying notes 165–85 *infra*.

151. HCSC-Laundry v. United States, 473 F. Supp. 250, 252 (E.D. Pa. 1979).

152. HCSC-Laundry sought refund of $10,395 in income taxes paid on taxable income of $123,521. *Id.*

153. "We find that plaintiff is not barred from exemption because its activities were not expressly exempted from taxation under § 501(e), that plaintiff is an exempt organization under § 501(c)(3), and that the provisions of § 502(a) do not apply to plaintiff." *Id.* at 255.

fied for exemption under section 501(c)(3) was that the services the laundry performed for its member hospitals were integral and necessary to the function of those charitable organizations.[154] As to the question that would ultimately reach the Supreme Court, the court found that the "purpose of § 501(e) was to enlarge the category of charitable organizations exempt under § 501(c)(3), not to modify or narrow § 501(c)(3)."[155] And as for the exclusion of laundry services from section 501(e), the court observed that "Congress was merely declining to become embroiled in a very sensitive issue."[156]

The Court of Appeals for the Third Circuit, however, found itself constrained to hold in favor of the IRS, counting as persuasive the legislative history of section 501(e). The court began its analysis with the premise that laundry services were intentionally excluded from section 501(e) and concluded that section 501(e) is the exclusive method by which HSOs can gain tax-exempt status since "a review of the legislative history supports the . . . Service's position that the statute reflects an explicit manifestation of legislative judgment and purpose not to afford cooperative hospital laundries tax-exempt status."[157] To reach this broadly styled conclusion, the court was compelled to invoke a rule of statutory construction that in the absence of a contrary legislative intent, "a specific statute controls over a general one."[158]

Noting that the Court of Claims had in *Northern California Central Services, Inc. v. United States*[159] reached an opposite conclusion on the basis of *Hospital Bureau*, the court said:

> As noted in our prior discussion we believe the legislative history to show a contrary legislative intent than that found by the Court of Claims. We believe that it demonstrates that Congress recognized that hospital service organizations were not heretofore encompassed within section 501(c), or that their inclusion . . . was questionable. In order to clarify its position, Congress enacted section 501(e) to specify that certain types of hospital service organizations shall be considered as charitable organizations. If they had already been within section 501(c), the enactment of section 501(e) would have been a totally superfluous undertaking by Congress, an anomalous result which we cannot attribute to it.[160]

The court did not consider the feeder organization contention, deciding the

---

154. *Id.* at 254.

155. *Id.* at 253. The court's conclusion that 501(e) "enlarged" the category of charitable organizations described in § 501(c)(3) suggests that prior to § 501(e), HSOs were *not* charitable organizations described in § 501(c)(3). It is submitted that this is not what the court meant—indeed, it would vitiate the court's argument and conclusion that the exclusion of laundry services from § 501(e) does not preclude laundry service organizations from obtaining exempt status under § 501(c)(3). In light of the court's conclusion, it is evident that the court viewed § 501(e) as a "safe harbor" of exemption for the organizations described therein.

156. *Id.* at 254.

157. 624 F.2d 428, 434 (3rd Cir. 1980), *aff'd*, 450 U.S. 1 (1981).

158. *Id.* at 432–33.

159. 591 F.2d 620 (Ct. Cl. 1979).

160. 624 F.2d 428, 435–36 (3rd Cir. 1980). The same conclusion was reached by the Court of Appeals for the Sixth Circuit in Metropolitan Detroit Area Hosp. Servs., Inc. v. United States, 634 F.2d 330 (1980). That court held that in order for an HSO to be exempt under § 501 it must be among the cooperatives listed in § 501(e). *Id.* at 334. The court based its conclusion on the legislative history of § 501(e), the principle of statutory construction that a specific provision controls a general provision, and its desire not "to attribute to Congress the passing of a superfluous statute." *Id.*

case on the basis of section 501(e) alone because the IRS had not appealed from the lower court's holding on that point.

B. *The Supreme Court Decision*

The Court's analysis is brief and indeed does little more than restate the Third Circuit's opinion. Starting from the introductory premise that every element of gross income is subject to tax unless there is a statute or rule of law exempting it, the Court went on to note that sections 501(a) and (c)(3) provide such an exemption and that section 501(e) is part of section 501. The Court next observed that section 501(e) is expressly concerned with the tax status of HSOs but that it omits laundry services from its enumerated list of services. Thus, the Court concluded, the "issue . . . is whether that omission prohibits petitioner from qualifying under § 501 as an organization exempt from taxation."[161]

Once posited, the issue was easily resolved by the Court. Noting that "it is a basic principle of statutory construction that a specific statute, here subsection (e), controls over a general provision such as subsection (c)(3), particularly when the two are interrelated and closely positioned . . . ,"[162] the Court found the legislative history of section 501(e) dispositive. "It persuades us that Congress intended subsection (e) to be exclusive and controlling for cooperative hospital service organizations."[163] The Court's discussion of the legislative history is unremarkable; it recounts episodically the 1968 enactment of section 501(a), the failed effort to include laundry services in section 501(e)(1)(A), and the failed effort at amendment in 1976. On this basis the Court in its peroration concluded:

> In view of all this, it seems to us beyond dispute that subsection (e)(1)(A) of § 501, despite the seemingly broad general language of subsection (c)(3), specifies the types of hospital service organizations that are encompassed within the scope of § 501 as charitable organizations. Inasmuch as laundry service was deliberately omitted from the statutory list and, indeed, specifically was refused inclusion in that list, it inevitably follows that petitioner is not entitled to tax-exempt status.[164]

Thus, with little imagination and more reliance on geography ("the two are interrelated and closely positioned") than analysis, the Court accepted the IRS position.

IV. ANALYSIS

A. *The Legislative History of Section 501(e)*

All the legislative history cited and discussed by the Court relates to and amply demonstrates the fact that Congress did not intend the benefit of the

---

161. HCSC-Laundry v. United States, 450 U.S. 1, 6 (1981).
162. *Id.*
163. *Id.*
164. *Id.*

section 501(e) exemption to be available to laundry service organizations. When the Court says that "it inevitably follows that petitioner is not entitled to tax-exempt status,"[165] one is tempted to add: "under section 501(e)."

It cannot be denied that Congress' tentative treatment of the issues presented by the dispute over the tax-exempt status of HSOs makes the legislative history of section 501(e), and the subsection itself, unnecessarily ambiguous. Therefore, this writer does not argue that the conclusion reached by the Court, based on its reading of Congress' intentions, is categorically wrong: when dealing with judicial interpretation of legislative intent—a notoriously imprecise art[166]—one must accept that ambiguous language is susceptible of different interpretations. Nonetheless, it will be argued that the legislative history of section 501(e), when read in conjunction with the policy considerations behind the section, can support the conclusion that section 501(e) was meant to be a "safe harbor" of exemption for HSOs. As Justice Stevens noted in dissent, after a discussion of the history of the present state of the law with respect to the tax status of cooperative HSOs, "When the statute is read against [that] background—indeed, even when it is read in isolation—its plain language unambiguously entitles this petitioner to an exemption."[167]

1. *The Underlying Policy Objective*

One commentator, writing in 1975, said that "[s]ince its passage, § 501(e) has remained in as much obscurity as it did in the committee reports."[168] Indeed, as the divergent judicial interpretations attest,[169] the legislative history does not announce in unambiguous terms the precise purpose and role of section 501(e).[170] Thus, to draw an inference of congressional ambivalence toward HSOs from the legislative history alone is ill-advised. The purpose and role of section 501(e) can be better ascertained in light of policy objectives discerned broadly.

The policy objective that seems to have influenced Congress in its enactment of section 501(e) is readily discerned. Congress sought by its enactment to encourage the development of HSOs as a part of the effort to contain health care costs. As stated in the report accompanying the Senate's first effort at amendment:

> A number of hospitals have formed organizations to perform various services such as data processing, diagnostic laboratory services, laundering, purchasing, and recordkeeping, etc., for the hospitals as a group. In addition, others desire to form such organizations. The committee wishes to encourage the formation of such

---

165. *Id.*

166. *See* text accompanying notes 169–75 *infra.*

167. 450 U.S. 1, 9 (1981).

168. Tuthill, *Qualifying As a Tax Exempt Cooperative Hospital Service Organization,* 50 NOTRE DAME LAW. 448, 449 (1975).

169. *See* text accompanying notes 82–89, 129–39, and 147–50 *supra.*

170. Or as the Supreme Court noted in a different context: "[T]he legislative history of [the] Act hardly speaks with that clarity of purpose which Congress supposedly furnishes courts in order to enable them to enforce its will." Universal Camera Corp. v. NLRB, 340 U.S. 474, 483 (1951).

joint service organizations because the performance of services in a joint operation can be expected to keep down the cost of hospital care, a matter of great concern to your committee at the present time.[171]

The same objective was reiterated in 1968 when the Senate proposed amendment of section 501,[172] which proposal was ultimately accepted. Again the emphasis was on the "seriousness of the ever-rising cost of hospital care."[173] The overriding congressional policy objective was obviously the containment of health care costs, a policy consistent with concerns being expressed both at that time and later.[174]

2. *The Vitality of* Hospital Bureau

The proponents of HSOs sought legislative amendment of section 501 in order to make attainment of tax-exempt status *easier* in light of the IRS's refusal to follow the *Hospital Bureau* holding.[175] The Senate demonstrated its awareness of the situation by acknowledging in a report that *Hospital Bureau* was the "leading case in point."[176] Moreover, the case was neither criticized nor repudiated in that report, nor in any subsequent legislative report or enactment. At the least, it can be inferred from the express acknowledgement that *Hospital Bureau* was the "leading case in point" and from the reasonableness of its holding that Congress did not intend legislatively to overrule that case.

The legislative history also contains references to the IRS position regarding the tax-exempt status of HSOs. The report in which *Hospital Bureau* is acknowledged makes the following statement: "If two or more tax-exempt hospitals join together in creating an entity to perform services for the hospitals, the . . . Service takes the position that the entity constitutes a 'feeder organization' and is not entitled to income tax exemption. . . ."[177] One year later, Senator Carlson, discussing the amendment that, with changes, became section 501(e), said, "The proposed amendment . . . is necessitated by the inability of the Treasury or the Internal Revenue Service to find authority in the present statute to grant the exemption required."[178] He then recounted the tax problems encountered by HSOs and remarked that "unfortunately, tax exemption is denied to the entity conducting the joint activity."[179] Congress knew of the IRS's position, but expressed neither approval of nor acqui-

---

171. S. REP. NO. 744, 90th Cong., 1st Sess. 201, *reprinted in* [1967] U.S. CODE CONG. & AD. NEWS 2834, 3039-40.

172. 114 CONG. REC. 7516 (1968) (remarks of Sen. Carlson); *id.* at 8111-12 (remarks of Sen. Carlson & Sen. Tydings).

173. *See id.* at 8111 (remarks of Sen. Carlson).

174. *See* text accompanying notes 31-35 *supra.*

175. *See* text accompanying note 89 *supra.*

176. S. REP. NO. 774, 90th Cong., 1st Sess. 201, *reprinted in* [1967] U.S. CODE CONG. & AD. NEWS 2834, 3039.

177. *Id.*

178. 114 CONG. REC. 7516 (1968) (remarks of Sen. Carlson).

179. *Id.*

escence in it. Nor, it must be added, did Congress explicitly criticize it, though Senator Tydings did refer at one point to "unforeseen rigidities in the law,"[180] a comment that may suggest that the IRS interpretation of section 502 differed to some degree from that entertained by Congress.

As noted, section 501(e) and the available evidence of Congress' intent in enacting it are ambiguous. The exact purpose Congress intended section 501(e) to serve is regrettably obscured by the atmosphere that surrounded its enactment. But given the previously articulated congressional commitment to measures that control the cost of health care,[181] it is plausible to argue the continued vitality of *Hospital Bureau* and its rule that HSOs are within the definition of section 501(c)(3). Absent congressional approval of the IRS position, the *Hospital Bureau* decision, which, as noted above,[182] was not expressly overruled, seems unaffected by the enactment of section 501(e). It can stand, therefore, as an authoritative statement of the law in regard to the tax-exempt status of HSOs under section 501(c)(3). As the *Northern California Central Services*[183] court said, "[N]owhere in the legislative history of § 501(e) is there a reference to an intent to amend § 501(c)(3), or to alter the then-present interpretation."[184] Justice Stevens makes the same point. He argues that section 501(a) and 501(c)(3) contain no language to indicate that section 501(e) was designed to limit their effect. Criticizing the Court for its reliance on the spatial and topical proximity of sections 501(a), 501(c)(3), and 501(e) to conclude that the last limits the first two, he states:

> Apart from their proximity to one another, the only express relationship between these statutes is that certain entities described in § 501(e) are to be treated as charitable organizations under § 501(c)(3) for federal income tax purposes. Nothing in any of the relevant statutes suggests that § 501(e) is to have the effect of denying an exemption to organizations that satisfy the requirements of § 501(c)(3). When Congress wanted a statute to have such an effect, it had no difficulty making its intention unmistakably plain, as is evident from § 501(a)'s reference to §§ 502 and 503.[185]

The absence of such an intention to limit section 501(c)(3) can be laid to

180. *Id.* at 8112 (remarks of Sen. Tydings).

181. *See* text accompanying notes 31-35 *supra.*

182. *See* text accompanying notes 177-80 *supra.*

183. Northern Calif. Cent. Servs., Inc. v. United States, 591 F.2d 620 (Ct. Cl. 1979).

184. *Id.* at 624.

185. 450 U.S. 1, 18 (1981). The court in *Northern California Central Services* drew the same conclusion:

> When Congress passed the present § 501(e) in 1968, though, it did exclude shared laundry services from its list of exempt service organizations, but made no attempt to alter *Hospital Bureau of Standards'* interpretation of § 501(c)(3) or that section's applicability to shared laundry services, despite the fact . . . that the Congressmen were aware of *Hospital Bureau of Standards*, and its holding. Thus, the interpretation of § 501(c)(3) as rendered by this court in *Hospital Bureau of Standards* remains intact.

591 F.2d 620, 624 (Ct. Cl. 1979). The Court of Claims' view that the enactment of § 501(e) does not nullify the holding of *Hospital Bureau* accords with that courts' applicable precedent. The Court of Claims has continued to give effect to preexisting judicial interpretations in areas where Congress has specifically legislated but has not given clear indication that it intended to limit the effect of the judicial interpretation. *See* American Potash & Chem. Corp. v. United States, 399 F.2d 194 (Ct. Cl. 1968); 1 S. WEITHORN, TAX TECHNIQUES FOR FOUNDATIONS AND OTHER EXEMPT ORGANIZATIONS § 37.03, at 37-17; B. HOPKINS, THE LAW OF TAX EXEMPT ORGANIZATIONS 149 n.17 (3rd ed. 1979).

sloppy draftsmanship—but that contention cuts in both directions. It may have been careless of Congress not to declare clearly its intention to limit section 501(c)(3) and *Hospital Bureau*, but it may also have been careless of Congress to draft a statute that has the unintended effect of limiting section 501(c)(3).

B. *Would a "Safe Harbor" Reading Render Section 501(e) Superfluous?*

1. *The Purpose of Section 501(e)*

In view of the foregoing, one is left with the argument made expressly by the Third Circuit in *HCSC-Laundry*[186] and impliedly by the Court[187] that if HSOs were already within section 501(c)(3), the enactment of section 501(e) would have been superfluous. The rejoinder to this argument is straightforward: the enactment of section 501(e) was not superfluous because it was compelled by the refusal of the IRS to follow the *Hospital Bureau* decision holding HSOs exempt as charitable organizations. One commentator noted that the principal disadvantage of section 501(c)(3) status was "simply the difficulty in obtaining it,"[188] owing, of course, to the IRS position. It can be argued, therefore, that in view of the difficulties faced by HSOs in their quest for tax-exempt status, Congress enacted section 501(e) to enable those performing enumerated services to avoid prolonged and costly litigation by invoking its limited provisions—as to them it was certainly a safe harbor. This argument is supported by Congress' treatment of the *Hospital Bureau* decision. Justice Stevens writes in his *HCSC-Laundry* dissent: "In my opinion § 501(e) unambiguously granted a tax exemption to certain entities that arguably already were entitled to an exemption under § 501(c)(3). There is absolutely no evidence that the 1968 statute was intended to withdraw any benefits that were already available under the 1954 Act."[189] He therefore suggests that the proper question is whether the laundry service organization is exempt under section 501(c)(3).[190]

2. *Statutory Construction*

Nonetheless, the ambiguity, especially as to *Hospital Bureau*'s fate, lends weight to the Court's view that section 501(e) alone grants exemption to HSOs on the ground that, as a matter of statutory construction, "a specific statute, here subsection (e), controls over a general provision such as subsection (c)(3), particularly when the two are interrelated and closely positioned, both in fact being parts of § 501 relating to exemption of organizations from tax."[191]

---

186. 624 F.2d 428 (3rd Cir. 1980).
187. HCSC-Laundry v. United States, 450 U.S. 1, 5–8 (1981) (Stevens, J., dissenting).
188. 1 R. BROMBERG, *supra* note 22, ¶ 9.2[2], at 9-5.
189. HCSC-Laundry v. United States, 450 U.S. 1, 20 (1981) (Stevens, J., dissenting).
190. *Id.*
191. *Id.* at 6.

Justice Frankfurter once cautioned that rules of construction "give an air of abstract intellectual compulsion to what is in fact a delicate judgment, concluding a complicated process of balancing subtle and elusive elements."[192] In this regard, then, it must be noted that rules of construction alone do not reveal and are not substitutes for congressional intent, although they can put an "intellectually respectable gloss on decisions that are basically arbitrary choices among competing policies."[193] To conclude, as the Court seemed to do, that section 501(e) narrows the scope of section 501(c)(3) merely because the former is more specific than the latter, without—as Justice Stevens was quick to point out[194]—citing any language to that effect in the statute itself or in the legislative history, is to lend dubious substantive force to a rule of statutory construction. By accepting this view the Court applies principles of construction without regard to underlying circumstances and legislative objectives.[195] Niceties of statutory construction ought not be applied to defeat an overriding policy objective of Congress and the federal government.[196]

3. *The Significance of the Exclusion of Laundry Services from Section 501(e)*

Undue significance was attached by the Court to the exclusion of laundry services from section 501(e).[197] The IRS had contended that the explicit congressional action in 1968 and 1976 with respect to laundry service organizations and the efforts of various lobbies, including the American Hospital Association, in seeking or preventing the amendment of section 501(e) provided ample indication that Congress did not intend to accord such organizations tax-exempt status. The Court said this "inevitably" led to the conclusion that neither HCSC-Laundry nor any other laundry service organization was entitled to an exemption.[198]

It is submitted that, except as it may be indicative of a more general and otherwise unarticulated congressional purpose, the exclusion of laundry services is irrelevant to a resolution of the question whether section 501(e) was

---

192. Frankfurter, *Some Reflections on the Reading of Statutes*, 47 COLUM. L. REV. 527, 544 (1947).

193. *How the Supreme Court Reads Congress' Mind*, N.Y. Times, June 14, 1981, § 4, at 8E, col. 1.

194. HCSC-Laundry v. United States, 450 U.S. 1, 16–19 (1981) (Stevens, J., dissenting).

195. If a statute is to make sense, it must be read in the light of some assumed purpose. A statute merely declaring a rule, with no purpose or objective, is nonsense.

> If a statute is to be merged into a going system of law, moreover, the court must do the merging, and must in so doing take account of the policy of the statute—or else substitute its own version of such policy. Creative reshaping of the net result is thus inevitable.

Llewellyn, *Remarks on the Theory of Appellate Decision and the Rules or Canons About How Statutes Are to be Construed*, 3 VAND. L. REV. 395, 400 (1950).

196. *See* E. CRAWFORD, THE CONSTRUCTION OF STATUTES § 176, at 284–85 (1940). The author notes: "It has wisely been stated that the construction of statutes is 'eminently a practical science.' As a result, too much reliance upon the various maxims or principles of interpretation may operate to defeat the legislative intention rather than assist in its ascertainment and effectuation." *Id.* (footnotes omitted). *See also* Frankfurter, *Some Reflections on the Reading of Statutes*, 47 COLUM. L. REV. 527, 544–45 (1947).

197. *See* text accompanying notes 162–65 *supra*.

198. 450 U.S. 1, 8 (1981). For the Court's language, *see* text at note 165 *supra*.

intended to be a safe harbor. For the omission to affect section 501(c)(3), it must be unambiguously established that Congress accepted the IRS position that HSOs are section 502 feeder organizations and that Congress intended thereby to reverse the *Hospital Bureau* holding that such organizations are exempt under section 501(c)(3).[199] As noted, neither possibility seems likely upon examination of the legislative history.[200] It is important not to impute to each congressional act or omission broad policy implications where none was intended. It is argued that the omission of laundry services from section 501(e) is one such instance.

In light of this caveat, it is important to place in perspective the implications of the IRS argument as ultimately adopted by the Court. The argument in effect draws upon an isolated political phenomenon—the exclusion of laundry services from section 501(e)—and attaches to that phenomenon an ostensible legal and political significance that exaggerates its importance. To argue from the narrow premise that Congress disfavored laundry service organizations by denying them *specific* legislative relief in order to reach the conclusion that Congress intended therefore to deny them tax-exempt status altogether, is to misconceive the political processes and policies underlying congressional decision making. "The result," the Third Circuit in *HCSC-Laundry* asserted, "reflects the political process in operation."[201] Nonetheless, it is within the province of the court to discern and interpret the significance of relatively discrete products of the political process, not all of which are of equal import. It is argued, therefore, that of itself the exclusion of laundry services represents a narrow congressional decision based on comparatively insignificant political, not policy, considerations, and that the exclusion should be read in this light. This is not to say that the initial congressional decision to amend section 501 to allow for the specific exemption of certain HSOs was not itself based on political considerations—it was. That is the nature of a process by which policy decisions are made—through conflict and negotiation among groups with varying interests.[202] But unlike the decision to create subsection (e), the decision to exclude laundry services from the ambit of the subsection was devoid of policy underpinnings independent of the political considerations. The Court, in ascertaining congressional purpose and intent, should have accounted for this distinction and read the omission as representing a limited amendment of the policy that compelled Congress to act in the first instance. This is all the more true in view of the silence in both section 501(e) and its legislative history regarding section 501(c)(3).

199. In his dissent in *HCSC-Laundry*, Justice Stevens also noted that the legislative history might support the Court's position if it showed that "Congress in 1968 believed that cooperative hospital service organizations were at least arguably entitled to tax exemption under § 501(c)(3) and it enacted § 501(e) to withdraw this exemption from some, but not all, of these entities." 450 U.S. 1, 19–20 (1981).

200. *See* text accompanying notes 165–80 *supra*. *See also* HCSC-Laundry v. United States, 450 U.S. 1, 19–20 (1981) (Stevens, J., dissenting).

201. 624 F.2d 428, 435 (3rd Cir. 1980).

202. *See* Benedict, *To Secure These Rights: Rights, Democracy, and Judicial Review in the Anglo-American Constitutional Heritage*, 42 OHIO ST. L.J. 69, 73 (1981).

The District Court in *HCSC-Laundry* appreciated this: "In declining to include shared laundry service within the express exemption provisions of § 501(e) Congress was merely declining to become embroiled in a very sensitive issue."[203] This view, it is argued, comports with the congressional policy ascertained from section 501(e)'s legislative history[204] and legislative enactments concerned with health care.[205]

The judicially imposed significance given by the Supreme Court to the narrow decision to exclude laundry services thus distorts the political power of a parochial, insignificant special interest.[206] The dangers of imputing exaggerated political leverage to special interests have long been recognized,[207] but the Court in *HCSC-Laundry* nonetheless ignored political reality, overlooked the critical distinction between policy determinations and short-lived political concessions, and consequently chose not to give effect to a well-defined policy to encourage the development of HSOs—including those performing laundry services.[208]

The Court's reliance on the inconclusive legislative history and the principle of statutory construction betrays inadequate analysis. It is submitted that given the paucity of congressional discussion of the purpose and effect of section 501(e), the Court should have considered and given decisive weight to the policy considerations that underlay the issue by taking into account congressional attitudes towards health care and its rising costs. If this were done, particularly here where the result is not really "beyond dispute,"[209] the issue of the tax-exempt status of HSOs could have been resolved by reference to the view that better serves the policy considerations—writ large—of Congress, an approach preferable to the mechanical application of principles of statutory construction. HSOs represent an institutional and structural reform within the nonprofit hospital industry that militates toward greater cost-efficiency without a concomitant decrease in the quality of care and therefore comports with the broad policy of Congress. Every step should have been taken to encourage them, including the step of ensuring their tax-exempt status. This the Court declined to do. Instead it put the burden on Congress to rewrite the law, glibly stating that Congress can change the result any time it wants.[210] Perhaps judicial deference in requiring the legislature to clarify its own ambiguities reflects a pragmatic approach to the issue. But, by such undue deference in this situation, the Court bestows a political windfall upon

---

203. 473 F. Supp. 250, 254 (E.D. Pa. 1979); *cf.* Northern Cal. Cent. Servs., Inc. v. United States, 591 F.2d 620, 624–25 (Ct. Cl. 1979). *But see* HCSC-Laundry v. United States, 624 F.2d 428, 434–35 (3rd Cir. 1980).

204. *See* text accompanying notes 168–74 *supra.*

205. *See* text accompanying notes 31–35 *supra.*

206. HCSC-Laundry v. United States, 624 F.2d 428, 435 (3rd Cir. 1980).

207. *See generally* THE FEDERALIST No. 10 (J. Madison); *see also,* in a more current vein, Roberts, *Congressional Fear of Lobbies Evokes Moves to Make Hearings Less Visible,* N.Y. Times, Jan. 17, 1981, at 11, col. 3.

208. But it must be noted that Congress did not help matters much.

209. HCSC-Laundry v. United States, 450 U.S. 1, 8 (1981).

210. *Id.*

a vocal lobby, without furthering the national effort to contain health care costs.

V. Conclusion

Throughout, references have been made to the policy considerations underlying the issue of the tax-exempt status of HSOs. These considerations do not exist merely in the abstract as well-intentioned but diffuse fulminations emanating from Congress. Rather, they are products of substantial federal legislation[211] and national concern over the cost of health care.

A study[212] conducted by the federal government asked the question: "Can the upward trend in health costs be slowed by encouraging greater efficiency in the health system's use of resources?"[213] The answer is yes—provided that the encouragement is the product of well-formulated policy that is consistently and effectively applied. The nonprofit hospital industry's unique relationship with the federal government and its isolation from institutional and competitive pressures to contain costs indicate the need for a consistent policy.[214] The position the Court has taken with respect to HSOs prevents the total commitment of tax policy to the effort to control health care costs. The Court's restrictive reading of sections 501(e) and 501(c)(3) will, as did IRS's original antipathy, inhibit voluntary efforts of the nonprofit hospital industry to effect institutional and organizational reforms that promise much in the way of long-term cost containment.[215]

The cost can be great. In fiscal year 1980, for example, Americans spent approximately $217.9 billion for personal health care, or $940.62 per capita, of which hospital care accounted for $429.80.[216] Health care expenditures continue to increase at a rate greater than the GNP.[217] Congress has remarked that "[e]very saving will not only benefit the consumer directly but also the Government, to the extent that health care costs are covered by Government programs of payment, such as medicare and medicaid."[218] To take the obverse of this proposition, every increase in cost or *failure to reduce costs* works to the detriment not only of the consumer directly, but also of the

---

211. *See, e.g.*, National Health Planning and Resource Development Act of 1974, Pub. L. No. 93-641, 88 Stat. 2225, 42 U.S.C. §§ 300e-4, 300k-1 to 300m-5, 300n to 300s-5, 300t (1975), as amended by the Health Planning Resource Development Act of 1979, Pub. L. No. 96-79, 93 Stat. 592, 42 U.S.C. §§ 300k-1 to 300k-3, 300l-1 to 300n-1, 300n-3, 300n-5 to 300s-1, 300s-3, 300s-5 to 300t-14 (1979).

212. DEP'T HEALTH, EDUCATION, AND WELFARE, HEALTH UNITED STATES (1978).

213. *Id.* at 3–4.

214. *See* text accompanying notes 20–22 *supra*.

215. *See* text accompanying notes 23–30 *supra*. *See also* H. REP. NO. 538, 90th Cong., 1st Sess. 32–33 (1967).

216. Gibson & Waldo, *National Health Expenditures, 1980*, HEALTH CARE FIN. REV., Sept. 1981, at 1, 7, 20–21 (table 2A).

217. Price, *Health Systems Agencies and Peer Review Organizations: Experiments in Regulating the Delivery of Health Care*, in LEGAL ASPECTS OF HEALTH POLICY 359, 362 (R. Roemer & G. McKray eds. 1980); *see* note 16 *supra*.

218. S. REP. NO. 724, 90th Cong., 1st Sess., *reprinted in* [1967] U.S. CODE CONG. & AD. NEWS 2076, 2086.

goverment, that is, the tax-paying public, for whom "health care has come to represent an increasingly crushing monetary burden. . . ."[219] When tax policy—in this instance made by the IRS and acquiesced in by the Supreme Court—operates to inhibit the development and expansion of HSOs, especially laundry service organizations, it is not consonant with congressional intent, whether viewed narrowly in terms of sections 501(c)(3), 501(e), or 502 or viewed broadly in terms of national health care policy.[220]

This counterproductive effect need not have occurred. The position taken by the Supreme Court reflects neither an inevitable interpretation of section 501(e) and its legislative history nor an accurate assessment of congressional policy in the areas of tax and health care.

It appears, however, that the only alternative is reexamination of the issue by Congress. This is an unfortunate result of administrative and judicial rigidity in the interpretation of the tax laws, but one which could perhaps eliminate the ambiguity of sections 501(c)(3) and 501(e) as they relate to the tax-exempt status of HSOs and thereby remove an obstacle to the effort to contain health care costs. Admittedly, some fault rests with Congress: it did enact the law that, as interpreted, dealt only partially with the issue of the tax-exempt status of the HSOs. But it must be emphasized that congressional reexamination of the issue need not have been the inevitable resolution.

This Comment has sought to demonstrate that an analysis of section 501(e) as a safe harbor of exemption is indeed compatible with the law prior to its enactment, the legislative history, and subsequent congressional action. More important, perhaps, the analysis set forth is compatible with the underlying policy considerations. As the tax-exempt status of HSOs now stands, it is up to Congress to rectify the succession of short-sighted interpretations of the tax laws that resulted in the Court's decision in *HCSC-Laundry*.

Richard Mancino

---

219. Price, *Health Systems Agencies and Peer Review Organizations: Experiments in Regulating the Delivery of Health Care*, in LEGAL ASPECTS OF HEALTH POLICY 359, 362 (R. Roemer & G. McKray eds. 1980).

220. *See* notes 211 and 215 *supra*.