A. HEALTH CARE ORGANIZATIONS

1. Introduction

This section updates the 1980 EOATRI and 1981 CPE topics on health care organizations.

2. Health Maintenance Organizations

The Service's position on the tax exempt status of health maintenance organizations (HMOs) has been under internal review since the decision of the Tax Court in Sound Health Association v. Commissioner 72 T.C. 158(1978). This topic will review the HMO area in general, including the HMO Act of 1973, as amended, the Sound Health case, and where the Service now stands with respect to the tax exempt status of these organizations.

The Health Maintenance Organization Act of 1973 entitles HMOs that meet the requirements of the Act (qualified HMOs) to receive federal financial assistance in the form of grants, loans and loan guarantees. Recent amendments to the Act, however, have substantially reduced the amount of government assistance available to HMOs and we anticipate that there will now be greater pressure for HMOs to seek exemption under IRC 501(c)(3). There have also been several other significant changes to the Act which we in the National Office are currently evaluating.

The HMO Act recognizes three basic types or models of HMOs. The first is the staff model HMO. It provides hospitalization and physicians' services through its own professional health staff in its centrally located facility. These physicians are paid on a salary or capitation basis.

The second type of HMO is the individual practice association (IPA) model HMO. This type of HMO contracts with an IPA that in turn contracts with individual health professionals who provide health care on a fee-for-service basis. The IPA is often sponsored by local, county, or state medical societies. This type of HMO uses existing facilities of individual providers for providing health care services. (This is done through bonus arrangements, encouraged by HHS, that either reward or penalize physicians for factors such as hospital utilization.)

The third type of HMO is the group practice HMO, that contracts with a medical group composed of health professionals who provide services on a fee-for-service or capitation basis. The medical group is at risk for the providing of care. The extent of the risk depends on the terms of the individual plan.

In G.C.M. 22554, 1941-1 C.B. 243, the Service held that an organization formed to provide prepaid medical and hospital services to its members by making the necessary arrangements with hospitals, physicians and other medical providers, was not exempt under [section 101(6) of the 1939 Code] the predecessor of IRC 501(c)(3). Membership was restricted to civil service employees. This position was elaborated on in Hassett v. Associated Hospital Service Corp., 125 F. 2d 611 (1st Cir. 1942). In Hasset the court held that the plaintiff was not operated for charitable purposes and therefore was not exempt from employment taxes.

These two precedents reflected the Service position prior to the enactment of the HMO Act of 1973. As a result of the HMO Act of 1973, the Service undertook a review of this position. As a result of this review, the Service took the position that HMOs could not qualify for exemption under IRC 510(c)(3) (although they may qualify for exemption under IRC 510(c)(4)) for the following reasons:

(1) HMOs serve the private interest of their members by providing them with health care on a preferential basis.

(2) The prepayment plan operated by HMOs serves the private interests of the members by providing them with a form of health insurance.

This position was successfully challenged in Sound Health Association v. Commissioner, 71 T.C. 158 (November 13, 1978), which held the petitioner-HMO exempt under IRC 510(c)(3). The two arguments listed in the preceding paragraph were addressed by the court as follows:

(1) The class of persons eligible for membership, and hence eligible to benefit from the HMO's activities, is practically unlimited. Therefore, the class of possible members of the HMO is, for all practical purposes, the community itself, and benefit to the members is benefit to the community.

(2) The risk-spreading feature of the HMO's prepayment plan is a substantial benefit to the members, but since the potential class of

membership is so broad, the plan does not serve private interests but rather is serving to benefit the community.

Finally, the court, analyzing Rev. Rul. 69-545, 1969-2 C.B. 117, found little to distinguish Sound Health from the exempt hospital described therein.

The Service has acquiesced in the result of the Sound Health case (I.R.B. No. 1981-31), and because of this case the Service has been reconsidering what its position should be with respect to all federally qualified HMOs. The Sound Health HMO had certain characteristics that are not now required of all federally qualified HMOs. Sound Health's open enrollment and community rating policies led the court to the conclusion that the class of persons eligible for membership was unlimited.

We now believe that certain staff model and group practice HMOs operating in a manner similar to the HMO described in Sound Health may qualify for recognition of exemption under IRC 510(c)(3). We agree with the reasoning of the court that the criteria for the exemption of hospitals and other organizations that directly provide medical care services are relevant in determining the charitable qualifications of HMOs. These criteria are set forth in Rev. Ruls. 56-185, 1956-1 C.B. 202, and 69-545. Basically, in the absence of private benefit or profit an organization may promote the health of a community even though the class of beneficiaries eligible to receive a direct benefit from its activities does not include all members of the community, so long as the class is not so small that its relief is of no benefit to the community.

However, at this time the Service has not formulated a definitive position on the exemption of HMOs that do not resemble Sound Health. Included in this group are the Individual Practice Association HMOs. We hope to announce a position on these organizations in the near future. In the meantime, applications for exemption submitted by HMOs under IRC 501(c) (other than under IRC 510(c)(4)) should be referred to the National Office as per IRM 7664.3.

3. Cooperative Hospital Service Organizations

Cooperative hospital service organizations have been the subject of a great deal of litigation in recent years. This year the Supreme Court, in HCSC-Laundry v. U.S., (No. 80-338, 2-23-81), held that the organization, a cooperative hospital laundry, was subject to tax. This section will briefly discuss the background of this issue and the HCSC case.

In 1967, Congress first turned its attention to the general problem of tax-exempt status for cooperative organizations established by tax-exempt hospitals to supply themselves with certain commercial services. Prior to that time the Service had taken the position that such a cooperative organization constituted a taxable commercial business and was not a charitable organization entitled to exemption under IRC 510(c)(3). This position was supported by IRC 502, relating to feeder organizations. It was published in Rev. Rul. 54-305, 1954-2 C.B. 127, which held that an organization organized and operated as a purchasing agency for its otherwise unrelated exempt members was not entitled to charitable exemption.

In 1967, the Senate approved legislation that would treat cooperative organizations established by tax-exempt hospitals to provide themselves with commercial services as charitable organizations entitled to tax exempt status. The House refused to pass such legislation. In 1968, the Senate again adopted legislation that would treat virtually all entities established by tax-exempt hospitals to provide commercial services for themselves as charitable organizations. In recommending the adoption of the provision that was added to the Code as IRC 501(e), the House emphasized that only specified service organizations were to be treated as charitable organizations.

Under IRC 501(e), an organization is treated as an IRC 501(c)(3) charity if it is organized and operated solely to perform, on a cooperative basis, one or more of the services enumerated in IRC 501(e). These services, if performed by an exempt hospital on its own behalf, would constitute activities relating to the basis for its exemption. These enumerated services are:

(1) DATA PROCESSING

(2) PURCHASING

(3) WAREHOUSING

(4) BILLING AND COLLECTION

(5) FOOD

(6) CLINICAL (ADDED BY THE TAX REFORM ACT OF 1976)

(7) INDUSTRIAL ENGINEERING

(8) LABORATORY

(9) PRINTING

(10) COMMUNICATIONS

(11) RECORD CENTER, AND

(12) PERSONNEL SERVICES (INCLUDING SELECTION, TESTING, TRAINING, AND EDUCATION OF PERSONNEL)

Laundry services were intentionally omitted from this listing.

IRC 501(e) also places other restrictions on cooperative hospital service organizations. The enumerated services must be performed solely for two or more hospitals, each of which is either exempt under IRC 501(c)(3), or part of a larger complex like a university hospital, or owned and operated by certain governmental entities. The cooperative organization must also be organized and operated on a cooperative basis and allocate or pay, within 8 1/2 months after the close of its taxable year, all net earnings to its patrons on the basis of services performed for them. Capital stock (if any) must be owned by the patrons.

IRC 501(e) thus parallels the rules applicable to other cooperatives and problems arise where these types of organizations seek exemption directly under IRC 501(c)(3) rather than IRC 501(e). There are, several reasons why hospital cooperatives choose to do so.

One situation where a cooperative hospital service organization would seek exemption under IRC 501(c)(3) rather than IRC 501(e) is where the services provided by the cooperative organization to its members are not listed in IRC 501(e). The best-known example of this situation has been litigated in the series of court cases involving cooperative hospital laundries. We lost 5 district court cases and one court of claims case involving these types of organizations. However, the Tax Court, the Third Circuit, the Sixth Circuit, the Ninth Circuit, and finally the Supreme Court have recently ruled in our favor on this issue.

In the HCSC case, the Supreme Court cited the legislative history of IRC 501(e) as being strong support for our position that Congress intended IRC 501(e) to be exclusive and controlling for cooperative hospital service organizations.

Since laundry service was deliberately omitted from the statutory list, and then was specifically refused inclusion in that list, the Supreme Court concluded that these cooperative hospital laundries were not entitled to exemption under either IRC 501(c)(3) or 501(e).

Another situation where a cooperative hospital service organization would seek exemption under IRC 501(c)(3) rather than IRC 501(e) is where the organization either cannot or chooses not to meet the requirements of IRC 501(e), even though the services provided by the organization are listed in IRC 501(e). For example, a cooperative organization may want to have members that are not tax-exempt hospitals (such as proprietary hospitals or tax-exempt educational organizations), or it may wish to provide services to organizations other than its members and not pay them patronage. Neither of these situations would be permissible under IRC 501(e).

An example of a cooperative hospital service organization avoiding the restrictions of IRC 501(e) by applying for exemption directly under IRC 501(c)(3) is Chart, Inc. v. U.S. 72-2 USTC Paragraph 9735 (D.D.C. 1979). In that case, a cooperative data processing organization that qualified for exemption under IRC 501(e) sought exemption under IRC 501(c)(3), apparently for more flexibility. For example, if the organization were to expand into the nursing home field it would be disqualified under IRC 501(e). Similarly, IRC 501(e) requires that the organization distribute its net earnings to its members within 8 1/2 months of the close of each taxable year, while IRC 501(c)(3) does not explicitly impose such a requirement. The District Court for D.C. followed the earlier laundry court decisions and held the organization exempt under IRC 501(c)(3). The court rather forthrightly noted that its interpretation would, "render section 501(e) essentially meaningless." We appealed this decision and the U.S. Court of Appeals for the District of Columbia Circuit, finding the HCSC case to be controlling, reversed the lower court in favor of our position. Chart, Inc. v. U.S. (No. 80-1138, 3-6-81).

4. Shared Services

The term "shared services" refers to the provision of various types of services by a tax-exempt hospital to other organizations (both for-profit and tax-exempt) and to individuals. The Service is currently considering a number of issues involving the application of the unrelated business income tax provisions in the shared services area. Of course, exempt hospitals may provide support services, such as laundry services, exclusively for themselves through the medium of a separate organization, without any tax liabilities. For example, in Rev. Rul. 78-41,

1978-1 C.B. 148, the Service held that a separate trust that was an integral part of a hospital and was set up to fund and otherwise process the hospital's malpractice claims was entitled to exemption under IRC 501(c)(3).

Also, under IRC 513(e), a hospital may provide the services enumerated in IRC 501(e) at cost to certain small hospitals without being subject to the unrelated business income tax. (For purposes of IRC 513(e), cost includes a reasonable amount for return on capital goods used to provide the services.) The legislative history indicates that Congress added IRC 513(e) to the Code to encourage this type of activity because it often results in a cost savings to the hospital and its patients. Moreover, the Congress did not believe that a hospital providing such services competes with for-profit organizations. However, IRC 513(e) applies only to certain limited situations. A question frequently presented to the Service is the application of the unrelated business income tax provisions in situations other than those described in IRC 513(e).

In general, a tax-exempt hospital will not be subject to the unrelated business income tax where the services it provides are substantially related to the performance of one or more of its exempt purposes, or where the services are provided primarily for the convenience of its members, students, patients, officers, or employees.

There are two fairly recent court cases involving the unrelated business income tax liability of hospitals, Carle Foundation v. United States, 611 F. 2d 1192 (7th Cir. 1979) and St. Luke's Hospital of Kansas City v. United States, No. 77-0679-CV-W-5(W.D. No. 1980). In Carle Foundation, a tax-exempt hospital worked closely with a for-profit medical clinic composed of physicians on the hospital's medical staff. The hospital's pharmacy sold pharmaceutical supplies to the clinic and the clinic's patients. The U.S. Court of Appeals for the Seventh Circuit held that these sales constituted unrelated trade or business because they were not made for the convenience of the hospital's patients and were thus not related to the hospital's exempt function. The court attached significance to the fact that the hospital was, in this respect, in direct competition with its non-exempt counterparts and had derived substantial profits from these sales.

In the St. Lukes case, an exempt hospital operated a pathology laboratory in which tests were made on specimens obtained from patients of St. Luke's staff physicians in the course of their private practices. The court held that these tests were substantially related to St. Luke's educational function and that the performance of the tests was primarily for the convenience of physicians on St.

Luke's medical staff, who the court concluded were "members" of the hospital for purposes of the convenience exception.

We believe that this conclusion is wrong for several reasons. For purposes of the convenience exception, the physicians on the hospital's medical staff should not be considered as members of the hospital while treating patients who are not patients of the hospital. Further, even if it is conceded for the sake of argument that staff physicians are "members" of the hospital, we do not accept the court's conclusion that these tests were performed "primarily for the convenience" of these individuals, as required by IRC 513. In order to satisfy this requirement, St. Luke's must establish that its primary objective in conducting these outside pathology tests was for the convenience of its staff physicians. Given the large amount of revenue produced by these tests and the court's previous conclusion that the tests contributed importantly to the hospital's educational function, we believe the court erred in concluding that these tests were performed by the hospital primarily for the convenience of these physicians. Finally, we don't think the facts otherwise demonstrated that performance of the tests provided a convenience for the medical staff.

In the case of a community otherwise lacking laboratory testing facilities, a local hospital exempt from federal income tax under IRC 501(c)(3) and organized for the purpose of promoting community health may benefit the community by providing diagnostic laboratory services to nonpatients. Where, for example, referral of nonpatient specimens to another location would hinder or jeopardize the medical care or diagnosis of nonpatients, the circumstances may indicate that the hospital is providing a needed service to the community. In such a case, diagnostic laboratory testing of nonpatients contributes importantly to the promotion of community health. The following recent technical advice memoranda deal with the operation of this principle. Although these memoranda have no value as precedent, they do provide examples of the kind of analysis involved in this situation.

LTR 8135016, May 1981

Symbol: Not given

NATIONAL OFFICE
TECHNICAL ADVICE MEMORANDUM

[CODE SEC. 513]

Unrelated v. not unrelated trade or business; Lab tests performed by hospital.

ISSUE

Whether a hospital exempt from federal income tax under the provisions of section 501(c)(3) of the Internal Revenue Code is subject to tax on unrelated business income on revenues derived from laboratory services on specimens taken by physicians at their private offices and sent to the hospital's laboratory for testing.

FACTS

M was organized in 1895, to erect, establish, maintain and operate a hospital. It was held exempt from federal income tax under section 501(c)(3) of the Code. M has also been classified as a hospital described in section 170(b)-(1)(A)(iii) of the Code.

M's facilities include those commonly found in hospitals offering general medical care, including a Pathology Department. This department performs a wide range of tests essential to the diagnosis and treatment of patients of the hospital including cytology, pregnancy, chemistry, urinalysis, hematology and serology tests.

During the years 1976 and 1977, M provided laboratory testing services to nonpatients of the hospital. The revenue generated by the nonpatient pathology tests was .0356 of the total revenue in the pathology department in 1976 and .0362 in 1977. These tests generated .0041 of total hospital revenues in 1976 and .0047 in 1977.

Several commercial laboratories operate in the same general area. The commercial laboratories provide pickup service, charge less for services than M, and provide overnight service, which generally is more quickly [sic] than that provided by M.

M has taken the position that the nonpatient services were an integral part of its proper operations as an exempt hospital and, in any event, were de minimis in relation to its overall operation. M further maintains that tests performed on

specimens submitted by staff physicians are carried on primarily for the convenience of the physicians.

APPLICABLE LAW

Section 511(a)(1) of the Internal Revenue Code imposes a tax on the unrelated business taxable income of certain organizations including those described in section 501(c)(3). Under section 512(a)(1), the term "unrelated business taxable income" is defined as the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions directly connected with the carrying on of such trade or business.

Section 513(a) provides that the term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis of its exemption under section 501.

Section 513(a)(2) of the Code provides that the term "unrelated trade or business" does not include any trade or business which is carried on by an organization described in section 501(c)(3) primarily for the convenience of its members, students, patients officers, or employees.

Section 1.513-1(d)(1) of the Income Tax Regulations provides that the determination of whether gross income derives from unrelated trade or business within the meaning of section 513(a) necessitates an examination of the relationship between the business activities which generate the particular income in question - the activities, that is, of producing or distributing the goods or performing the services involved -and the accomplishment of the organization's exempt purposes.

Section 1.513-1(d)(2) of the regulations provides that trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income); and it is "substantially related," for purposes of section 513, only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is

granted, the production or distribution of goods or the performance of the services from which gross income is derived must contribute importantly to the accomplishment of those purposes. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends, in each case, upon the facts and circumstances involved.

Section 1.513-1(d)(3) provides that in determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function which they purport to serve. If such activities are in part related to exempt functions which are conducted on a larger scale than is reasonably necessary for the performance of such functions, the activities in excess of the needs of the exempt functions will not be considered to contribute importantly to the accomplishment of any exempt purpose of the organization.

Section 1.513-1(d)(4)(iii) provides that where an asset or facility necessary to the conduct of exempt functions may also be employed in a commercial endeavor, the mere fact of the use of the asset or facility in exempt functions does not, by itself, make the income from the commercial endeavor gross income from related trade or business. The test, instead, is whether the activities productive of the income in question contribute importantly to the accomplishment of exempt purposes.

Section 1.513-1(d)(4)(iv) provides that in certain cases, activities carried on by an organization in the performance of exempt functions may generate good will or other intangibles which are capable of being exploited in commercial endeavors. If such exploitation does occur, the mere fact that the resultant income depends in part upon an exempt function of the organization does not make it gross income from related trade or business. In such cases, unless the commercial activities themselves contribute importantly to the accomplishment of an exempt purpose, the income which they provide is gross income from the conduct of unrelated trade or business.

Rev. Rul. 68-375, 1968-2 C.B. 245, holds that an exempt hospital's sales of pharmaceutical supplies to persons who are not patients of the hospital constitutes the conduct of unrelated trade or business within the meaning of section 513 of the Code.

Rev. Rul. 68-376, 1968-2 C.B. 246, Situation 3, states that a person directly referred to the hospital's outpatient facilities by his private physician for specific diagnostic procedures, which procedures are administered by a hospital-based practitioner affiliated with the hospital, is a "patient" of the hospital, as the availability of these diagnostic procedures is an integral part of the services offered by the hospital.

In Carle Foundation v. United States, 611 F. 2d 1192 (7th Cir. 1979) the Circuit Court applied the position taken by the Service in Rev. Rul. 68-375 to pharmaceutical sales by a hospital to other than patients of the hospital. The court also emphasized the fact that the hospital derived substantial profits from the pharmacy. These substantial profits appeared to contribute importantly to a business rather than an exempt purpose.

In St. Luke's Hospital of Kansas City v. United States, 494 F. Supp. 85 (W.D. Mo. 1980), a hospital's pathology department conducted a variety of tests, including analysis of Pap smears, on specimens taken from nonpatients. The District court found that the referred specimen testing contributed importantly to this particular hospital's medical education program. The Court also noted that the relatively small size of the referred specimen program indicated the non-commercial nature of the activity. This view was further supported by the fact that there was no advertising or solicitation program. The specimens submitted came from patients of the doctors on the medical staff of the hospital.

ANALYSIS

The general rule followed by the Service in determining the relatedness of furnishing goods or service by an exempt hospital has been on the basis of whether there is any nexus to patient recovery or convenience. The patient versus non-patient approach is illustrated by the case of the sale of pharmaceutical supplies by an exempt hospital discussed in Rev. Rul. 68-375, 1968-2 C.B. 245. This approach was approved by the Seventh Circuit in the Carle case. Examples of relationships that determine whether a person is a patient are set forth in Rev. Rul. 68-376, 1968-2 C.B. 246.

However, there are cases where it is proper to look beyond the fact of sales to nonpatients and to examine the other facts and circumstances surrounding a particular sales activity. The regulations under section 513 specifically provide for such an analysis. The St. Luke's Hospital case is an example of the type of case requiring this broader approach.

In the St. Luke's case the hospital was able to demonstrate that there were special facts and circumstances surrounding its sales of laboratory testing services. After examining those facts and circumstances, the District Court concluded that the testing activity contributed importantly to medical education. Therefore, the activity was related to advancing an exempt purpose and thus not subject to the unrelated business income tax.

The St. Luke's case does not suggest that a mere recital of facts removes a hospital's nonpatient testing activities from the category of trade or business. The facts and circumstances must support the inference that the nonpatient testing contributes to the advancement of an exempt purpose. In such a case all of the other surrounding facts and circumstances must also be considered in determining whether or not the inference is correct. If, based upon that consideration, the activity is found to be related to the advancement of an exempt purpose, the involvement of nonpatients will not destroy the exempt character of the activity.

In general, the facts and circumstances that may warrant exceptions to the general rule include (1) educational or scientific purposes of the exempt hospital that may be served by the referred specimen testing services, (2) any unique testing facilities possessed by the hospital, and (3) any special needs of the community.

Based on the evidence submitted in brief and at the National Office conference, we find that there was no basis to warrant exceptions to the general rule. Specifically, we find that there were no educational or scientific purposes of M served by the referred specimen testing services, there were no unique testing facilities possessed by the hospital, and that the specimen testing services did not advance any special needs of the community.

M argues that the amount of nonpatient testing, and the income generated therefrom, was de minimis and otherwise carried on in a noncommercial manner. The determination of what is unrelated business is never a question of the amount of business carried on but rather is an activity carried on that produces income and is not related to the organization's exempt purposes.

M's final argument is that the nonpatient testing is not unrelated trade or business because the activity is within the convenience exception of section 513(a)(2). It is undoubtedly an inconvenience for a person to have to go to the hospital in order to have a laboratory test, but this is not the import of the hospital's

argument. M's argument is that its method of operation is a convenience to the physicians, most of whom are members of the hospital's medical staff.

The flaw in the approach is that "members" of the hospital's medical staff does not refer to physician-employees of the hospital, but rather to physicians in private practice who have been granted the privilege of using the hospital's facilities in the treatment of their patients. We do not believe that these private practitioners can be viewed as included within any of the categories specified in section 513(a)(2) --"members, students, patients officers, or employees" -- even though they have an important role in hospital operations. Therefore, providing for their convenience does not bring the nonpatient testing activities within the ambit of section 513(a)(2).

CONCLUSION

Under the circumstances described above, the performance of laboratory tests for nonpatients by an exempt hospital constitutes unrelated trade or business.

LTR 8131010, No date given Symbol: None given

NATIONAL OFFICE
TECHNICAL ADVICE MEMORANDUM

[CODE SEC. 513]

Unrelated v. not unrelated trade or business; Sales and service to the public; Laboratory tests for physicians' private patients; Testing relative to hospital's exempt purpose.

ISSUE

Whether a hospital exempt from federal income tax under the provisions of section 501(c)(3) of the Internal Revenue Code is subject to tax on unrelated business income on revenues derived from performing Pap smears on specimens taken by physicians at their private offices and sent to the hospital's laboratory for testing.

FACTS

X was founded in 1889 and incorporated as a hospital under its present name on January 10, 1977. It was recognized as exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code on May 6, 1955. As a hospital it has been classified as an organization described in section 170(b)(1)(A)(iii) of the Code.

X has a capacity of approximately 158 beds, plus about another 30 beds between its skilled nursing and nursery facilities. The hospital is equipped to provide just about all types of patient care. It has an emergency room, an intensive care unit, pharmacy, laboratory, etc., and appears to be adequately staffed. The organization owns a physicians office building adjacent to the hospital. Offices are rented to staff physicians at reasonable rates. The building serves to provide convenient facilities for doctors and patients and is of particular value as an incentive to attract new physicians to the local area. The office building was originally used for nurses quarters but was converted for this purpose a number of years ago. So far as can be determined, there are no commercial medical laboratories and/or other health care facilities within a 30 mile radius of the hospital.

In addition to the various services rendered at the hospital's facilities mentioned above for its inpatients and outpatients, the organization has made a practice of testing specimens taken by physicians from their private patients at their own offices and sent to the hospital's laboratory for the required tests. At issue, are the Pap smears which were taken by physicians during routine periodic examinations of their patients at their own private offices and sent to the hospital's lab for the tests. In general, these tests are taken as part of an early cancer detection program and not necessarily because the female patients are experiencing any physical or medical problems at the time the tests in question are performed. The administrative file does not establish whether every doctor submitting specimens for lab tests is a member of the hospital staff. After the tests are performed in the hospital's lab, the results are transmitted to the respective physicians. Records of these tests are also retained at the hospital. The patient is billed for these services by the hospital.

X estimates that about 45 percent of the Pap smears tests are for patients that are either in the hospital or have been or will be in the hospital within 30 days of the test date. About 17 percent of the Pap smears are done for inpatients and 83 percent for out patients. X does not intend to generate a profit or to charge more

than the cost for the services. The laboratory Pap smear revenue constitutes less than one percent (i.e. .0046%) of X's revenue. During the year involved, X operated at a loss of $37,025.00 which included all the laboratory operations.

APPLICABLE LAW

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Section 513(a) provides that the term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis of its exemption under section 501.

Section 1.513-1(d)(1) of the Income Tax Regulations provides that the determination of whether gross income derives from unrelated trade or business within the meaning of section 513(a) necessitates an examination of the relationship between the business activities which generate the particular income in question - the activities, that is, of producing or distributing the goods or performing the services involved - and the accomplishment of the organization's exempt purposes.

Section 1.513-1(d)(2) of the regulations provides that trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income); and it is "substantially related," for purposes of section 513, only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of goods or the performance of the services from which gross income is derived must contribute importantly to the accomplishment of those purposes. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an

organization is granted exemption depends in each case upon the facts and circumstances involved.

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availability of these diagnostic procedures is an integral part of the services offered by the hospital.

In Carle Foundation v. United States, 611 F. 2d 1192 (7th Cir. 1979), the Circuit Court applied the position taken by the Service in Rev. Rul. 68-375 to pharmaceutical sales by a hospital to other than patients of the hospital. The court also emphasized the fact that the hospital derived substantial profits from the pharmacy. These substantial profits appeared to contribute importantly to a business rather than an exempt purpose.

In St. Luke's Hospital of Kansas City v. United States, 494 F. Supp. 85 (W.D. Mo. 1980), a hospital's pathology department conducted a variety of tests, including analysis of Pap smears, on specimens taken from nonpatients. The District Court found that the referred specimen testing contributed importantly to this particular hospital's medical education program. The Court also noted that the relatively small size of the referred specimen program indicated the non-commercial nature of the activity. This view was further supported by the fact that there was no advertising or solicitation program. The specimens submitted came from patients of the doctors on the medical staff of the hospital.

ANALYSIS

The general rule followed by the Service in determining the relatedness of furnishing goods or service by an exempt hospital has been on the basis of whether there is any nexus to patient recovery or convenience. The patient versus non-patient approach is illustrated by the case of the sale of pharmaceutical supplies by an exempt hospital discussed in Rev. Rul. 68-375, 1968-2 C.B. 245. This approach was approved by the Seventh Circuit in the Carle case. Examples of relationships that determine whether a person is a patient are set forth in Rev. Rul. 68-376, 1968-2 C.B. 246.

This same approach is generally applicable in the case of an exempt hospital performing diagnostic laboratory tests on specimens referred by private physicians, where the individual whose specimen is being tested is never physically present at the hospital and such testing is not preparatory to becoming a patient at the hospital. However, it is necessary in each case to determine if special circumstances exist that would constitute exceptions to the general rule. Circumstances that may warrant exceptions to the general rule include (1) educational or scientific purposes of the exempt hospital that may be served by the

referred specimen testing services, (2) any unique testing facilities possessed by the hospital, and (3) any special needs of the community.

In the present case services are being performed for non-patients, but there are some circumstances suggesting that the testing may be related to the hospital's exempt purpose. One of these circumstances is the nature of Pap smear testing.

In general, Pap smear testing is an aid to the early detection of certain kinds of cancer among women. A Pap smear is generally obtained by the patient's physician as part of a routine gynecological examination. The procedure is performed in the physician's examining room. There is no need for hospital facilities or personnel to be used. After the physician has obtained the specimen, it is sent to a laboratory for analysis. The pathologist examines the specimen under a microscope and advises the physician of any abnormal condition among the cells observed. Cell abnormalities may be detected far in advance of the appearance of any symptomatic evidence which might alert the patient and/or her physician to the presence of a dangerous, or potentially dangerous, condition. The early detection afforded by Pap smear testing enhances the success rate for treatment of a potentially fatal illness, thereby contributing directly and importantly to the promotion of health.

The promotion of health can result from such activities even where the primary purpose is to produce a profit. In many instances commercial laboratories are competitively involved in similar testing services. However, several facts in the present case indicate that the nonpatient testing involved here is not motivated by the same considerations as the testing conducted by commercial laboratories.

(1) The hospital does not advertise or promote its testing services.

(2) The hospital derives a minimal portion of its gross revenue, less than one percent, from nonpatient Pap smear testing.

(3) The hospital states that it does not intend to generate a profit, or to charge more than the actual cost for the services rendered.

(4) There are no commercial medical laboratories and/or other health care facilities within a 30 mile radius of the hospital.

In view of these facts and circumstances, it is apparent that the goals of a commercial enterprise are not well-served by X's nonpatient Pap smear testing. It is

also clear that an important aspect of the health of the community is promoted by the testing activity. Therefore, we conclude that the nonpatient Pap smear testing promotes health in a charitable manner and that the testing is relative to X's exempt purpose.

CONCLUSION

Under the circumstances described above, X is not subject to tax on unrelated business income on revenues derived from performing Pap smears on specimens taken by physicians at their private offices and sent to the hospital's laboratory for testing.

LTR 8130015, Date not given

Symbol: Not given

NATIONAL OFFICE
TECHNICAL ADVICE MEMORANDUM

[CODE SEC. 513]

Unrelated v. not unrelated trade or business; Sales and service to public; Hospital laboratory.

ISSUES

1. Whether M's performance of certain laboratory tests for nonpatients constitutes unrelated trade or business under section 513 of the Internal Revenue Code.

2. Whether M's performance of certain laboratory tests for other exempt hospitals constitutes unrelated trade or business under section 513 of the Internal Revenue Code.

FACTS

M is an 82-bed hospital recognized as exempt under section 501(c)(3) of the Internal Revenue Code. It serves an area having a 20-mile radius and a population of approximately 25,000; a relatively remote and isolated area.

M has entered into an agreement with three other hospitals whereby each performs only particular laboratory tests. All laboratory tests of a particular type are referred to the appropriate outside hospitals.

The other hospitals who are parties to the agreement are also exempt under section 501(c)(3) of the Code and are located in relatively remote and isolated areas. Each has less than 100 beds.

Although the tests performed by M and the other hospitals are routine, they require special equipment and specially-trained personnel. Because of the relatively low volume of any given test, M believes the cost of performing all tests would be prohibitive for it and the other hospitals. Thus, rather than perform each type of test at a prohibitive cost or send specimens to the nearest facility, which is 200 miles away, the hospitals entered into the agreement described above. M maintains that this arrangement enables it to save costs on the tests it performs while requiring it to send specimens only 20 miles to obtain the service it does not perform. M indicates that the volume of laboratory work it does as a result of the arrangement enables it to maintain its educational affiliation with a university that is a major source of M's laboratory technicians.

In addition to performing laboratory tests for its patients and for the other hospitals, M also performs laboratory tests for staff doctors who send their patients' specimens to M. These patients are never formally admitted as either inpatients or outpatients of M. Rather, the specimens are collected at the individual physicians's office and sent to M for testing. M charges the same amount for such tests as it charges its own patients.

M charges the other hospitals a lesser amount than it charges its patients because the billing procedure is not as costly, there are no bad debts to take into consideration, and payment is quicker so M's cash flow is enhanced.

M did not change its operating procedures, personnel, or equipment as a result of the arrangement. It does not engage in any advertising or other promotion activities. Only x% of M's charges are tests performed for other hospitals or non-patients. M's Controller states that fees charged by commercial laboratories may be lower than M's, but he attributes the difference to economies of scale that are not

available to a small hospital. We have found nothing in the facts submitted that indicates that M's laboratory testing services are more profitable than its other activities.

LAW

Section 511(a)(1) of the Code provides, in part, for the imposition of a tax on the unrelated business taxable income of certain organizations, including those described in section 501(c)(3) of the Code.

Section 512(a)(1) of the Code provides, in part, that the term unrelated business taxable income means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less certain deductions.

Section 513(a) of the Code provides, in part, that the term "unrelated trade or business" means in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization as its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.

Section 1.513-1(d)(2) of the Income Tax Regulations provides, in part, that a trade or business is "substantially related" to exempt purposes only if the production or distribution of goods or the performance of services from which the gross income is derived contributes importantly to the accomplishment of those purposes. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends, in each case, on the particular facts and circumstances.

Section 1.513-1(b) of the regulations provides, in part that the primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete.

Revenue Ruling 68-374, 1968-2 C.B. 242, holds, in part, that income derived by a hospital from the sale of pharmaceutical supplies to the general public

constitutes unrelated business taxable income as defined in section 512 of the Code.

RATIONALE

As provided in section 1.513-1(d)(2) of the regulations, the ultimate question is whether M's testing activities contribute importantly to the accomplishment of one or more of M's exempt purposes. In making this determination, it is important to bear in mind that the purpose of the unrelated business income tax is to prevent exempt organizations from competing unfairly against commercial enterprises. See section 1.513-1(b) of the regulations. If the potential for competition is slight and the activity lacks the earmarks of a commercial endeavor, it is probable that the activities are not an unrelated trade or business.

From the facts presented, we do not believe M's laboratory testing for other hospitals and for its staff doctors is being carried on for commercial purposes. The percentage of M's fees received from this activity is quite small, there is no commercial advertising or solicitation, M made no changes in operating procedures, personnel, or equipment in order to do the testing, and there is no indication that the activities are unusually profitable.

Previous rulings, such as Rev. Rul. 68-374, 1968-2 C.B. 242, have focused on the patient-nonpatient distinction in determining whether a given activity of an exempt hospital is an unrelated trade or business. Generally, an activity was treated as an unrelated trade or business unless there was a connection between that activity and the recovery, or convenience of the hospital's patients. We think this approach is appropriate in most cases.

In the case of laboratory testing, however, we believe it is necessary to go beyond the patient/nonpatient approach. In certain cases a hospital's laboratory testing program may contribute importantly to its health care or educational functions even though the persons whose specimens are tested are not patients of the hospital.

On the facts presented, we believe M's laboratory testing program contributes importantly to both its health care and educational functions. The program contributes importantly to its educational mission because the program permits M to maintain the volume necessary to continue its educational affiliation with the university.

The program also contributes to M's function of serving the health of the community. Although the tests are routine, all laboratory tests are vital in diagnosing and treating illness. If M did not perform the tests, specimens would have to be sent two hundred miles away for testing. M thus provides the community with a vital service by its laboratory testing.

In summary, we believe that M's laboratory testing contributes importantly to its educational and health care functions and does not compete with any commercial endeavors.

CONCLUSION

N's laboratory testing for nonpatients and for other hospitals is not an unrelated trade or business within the meaning of section 513 of the Code.

A copy of this technical advice memorandum is to be given to the organization. Section 6110(j)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent.

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5. Faculty Group Practice Organizations

The 1980 EOATRI and 1981 CPE text contained discussions of faculty group practice organizations. Briefly, a faculty group practice plan is a membership organization of doctors on the staff of a medical school. The organization bills patients for services provided by the members, collects the fees, and distributes the funds in accordance with a plan mutually agreed upon by the medical school, the related university, and the physician-members.

The Services has lost three court cases on this subject, and is conceding a fourth. The most recent decision occurred in University of Maryland Physicians, P.A., T.C. Memo 1981-23, 1-26-81. The particular problem that now concerns us in these cases involves the organizational test. At least one state, and probably others, requires these professional corporations to issue stock redeemable by the physician-members on dissolution. In the Maryland Physicians case, medical school faculty members on the hospital's clinical staff were allowed to own one share of the organization's one dollar par value common stock. The Tax Court brushed this issue aside stating that the repayment of one dollar per shareholder upon dissolution is an insubstantial and permissible distribution. The Service has

not acquiesced in this case because we believe the organizational problem is significant. However, because of litigating hazards, we may have to issue favorable rulings where the amounts in question are de minimis. Cases involving this issue should be forwarded to the National Office for consideration, as we continue to look for an appropriate case to litigate.

6. PSROs

Recent amendments to the provisions governing the funding of PSROs are designed to phase-out the federal support for these organizations. After fiscal year 1983, PSROs, if they continue to operate, will receive their funding from sources such as nursing homes, hospitals, state governments or insurance companies. The National Office has recently published a revenue ruling discussing the exemption of PSROs premised on the existence of federal funding (Rev. Rul. 81-276, 1981-47 I.R.B. 9). This revenue ruling remains valid for fiscal years 1982 and 1983.

7. Characterization of Medicare and Medicaid Payments for the Treatment of Patients for Purposes of the Foundation Provisions

The National Office has recently concluded that for purposes of determining whether an IRC 501(c)(3) health care organization is a private foundation, medicare and medicaid payments made to organizations such as hospitals and nursing homes for the treatment of their patients constitute gross receipts derived from the exercise or performance of exempt functions. In computing the amount of support received from gross receipts under IRC 509(a)(2)(A)(ii), for purposes of the one-third support test of IRC 509(a)(2)(A), it is appropriate to regard the individual patients rather than the governmental agencies as the payor of medicare and medicaid payments. Consequently, medicare and medicaid receipts for services provided each patient would be includible for purposes of IRC 509(a)(2)(A) to the extent of the greater of $5000 or one percent of an organization's total support for a taxable year. See Reg. 1.509(a)-3(b) [ILLEGIBLE] Thus, health care organizations exempt under IRC 501(c)(3) that receive substantially all their funds in payment for services from medicare and medicaid recipients would qualify as public charities under IRC 509(a)(2) unless they were described as hospitals under IRC 170(b)(1)(A)(iii).