C. HEALTH CARE ORGANIZATIONS

1. Introduction

This section updates prior CPE sections on health care organizations and discusses the following areas:

- Current Developments

- Medical Office Buildings (Partnerships)

- Unrelated Business Income of Hospitals

2. Current Developments

Revenue Ruling 83-157, 1983-42 I.R.B. 8, holds that a nonprofit hospital that is not required to operate an emergency room where a state or local health planning agency has found that this would unnecessarily duplicate emergency services and facilities that are adequately provided by another medical institution in the community is exempt under IRC 501(c)(3).

In addition it states that certain specialized hospitals, such as eye and cancer hospitals, offer medical care limited to special conditions that are unlikely to necessitate emergency care and therefore do not normally maintain emergency rooms. These organizations may also qualify under IRC 501(c)(3) if there are present similar, significant factors, including a board of directors drawn from the community, an open medical staff policy, treatment of persons paying their bills with the aid of public programs like medicare and medicaid, and the application of any surplus to improving facilities, equipment, patient care, medical training, education, and research, that demonstrate that a hospital of this type benefits the community.

Revenue Ruling 83-157 amplifies Revenue Ruling 69-545, 1969-2 C.B. 117, in which the operation of an emergency room where no one requiring emergency treatment was denied care was discussed as being an important factor in determining whether a nonprofit hospital benefits the community.

The health care section of the 1982 CPE text contained a paragraph on page 21 concerning the characterization of medicare and medicaid payments for

purposes of the foundation provisions. Revenue Ruling 83-153, 1983-43 I.R.B. 5, formalizes the position outlined in the text that medicare and medicaid payments constitute gross receipts derived from the exercise or performance of a health care organization's exempt activities for purposes of the support tests of IRC 170(b)(1)(A)(vi) and 509(a)(2).

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 includable for purposes of IRC 509(a)(2)(A) to the extent of the greater of $5,000 or 1 percent of an organization's total support for a taxable year. Thus, health care organizations under IRC 501(c)(3) that receive substantially all their funds in payment for services from medicare and medicaid recipients will qualify as public charities under IRC 509(a)(2) unless they qualify as hospitals under IRC 170(b)(1)(A)(iii).

The provision of services by one exempt hospital to other exempt hospitals is referred to as sharing services, and is governed by IRC 513(e). Shared services were discussed in the 1983 CPE text on page 34 and in prior CPE texts.

IRC 513(e) basically excepts the provision of these services from UBI if certain conditions are met. One of these conditions is that the recipient hospital(s) cannot have facilities to serve more than 100 inpatients (beds).

HR 3860, now pending in the House of Representatives would remove this 100 bed inpatient limitation. The liberalizing effect of this bill, if enacted, would be significant.

3. Medical Office Buildings (Partnerships Involving Exempt Hospitals and Their Staff Physicians)

The 1981 CPE text contains an extensive section (beginning on page 1) on the problems associated with financing the construction of medical office buildings by exempt hospitals. The volume of cases and requests for information indicate that this is still a widespread activity.

The cases we have recently seen involve the hospital as the sole general partner in an arrangement to finance construction of medical offices whereby the hospital enters a limited partnership with its staff doctors. The site of the medical

office building is generally adjacent to the hospital on land leased by the hospital to the partnership. The hospital loans the partnership construction funds secured by a mortgage on the building. The rental and interest rates charged are purportedly comparable to prevailing commercial rates. Space in the building is leased primarily to staff doctors, normally at an amount equal to the fair rental value.

The hospital usually can establish that, as a result of having its medical staff practicing adjacent to the hospital, greater use is made of its diagnostic facilities, patient admissions are easier, the services of its staff physicians are more readily available for outpatient and inpatient emergencies, etc.

Our position in these cases has been to scrutinize the facts carefully to determine whether any conflicts of interest exist that prevent the hospital from operating exclusively for charitable purposes. The mere participation by a hospital or any other exempt organization in a partnership will not alone preclude it from qualifying for exemption. However, conflicts may arise between the exempt purposes of the hospital and its partnership responsibilities once it incurs the fiduciary obligations of a general partner. A general partner must exercise prudent business judgment and normally must maintain a basic profit orientation in the interest of the limited partners.

Unless the partnership agreement permits the hospital to act exclusively in furtherance of its exempt purposes, thereby insulating it from those fiduciary principles, the hospital would be in the untenable position, as a general partner, of being obligated to maximize partnership profits and, at the same time, to pursue exempt (i.e., nonprofit) goals in its partnership activities. Thus, the partnership agreement should free the hospital to act exclusively in furtherance of its exempt purposes while, at the same time, fulfilling its fiduciary obligations to the limited partners, other than the obligation to maximize their profits.

We would take exception to a partnership agreement that unduly benefits the hospital's staff doctors, or any other non-exempt investors, in a less than arm's-length transaction. This could occur if a disproportionate allocation of profits and/or losses was granted to the doctors, if commercially unreasonable loans were made by the hospital to the partnership (i.e., inadequately secured, below prevailing interest rates, etc.), if hospital land was sold or leased at less than fair market value, or if the hospital was inadequately compensated for its services.

It should also be noted that the use of a wholly-owned subsidiary of the hospital to act as general partner will not insulate the hospital from the partnership

activities if the facts establish that the hospital has used its control over the subsidiary to benefit private individuals.

The following are summaries of private letter rulings issued recently that illustrate the application of these principles by the National Office to various specific fact patterns. They are disclosable under IRC 6110, but may not be cited as authority for other cases, and are presented here for training purposes only. The applicable law sections have been omitted.

Private Letter Ruling # 8325133

A hospital is recognized as exempt under section 501(c)(3) of the Code and is classified as a public charity under sections 509(a)(1) and 170(b)(1)(A)(iii).

A nonprofit corporation has filed an application for recognition of exemption under section 501(c)(3) of the Code and classification as a public charity under section 509(a)(3) based on its relationship to the hospital. The corporation has no shareholders. The hospital is the sole member of the corporation and will appoint its board of directors.

The corporation's stated purposes include serving as a general partner in a limited partnership which will be formed to own and operate a medical office building facility adjacent to the hospital.

The corporation will be the sole general partner in the partnership. Limited partnership interests will be owned by individuals who have staff privileges at the hospital and professional corporations or partnerships composed of staff physicians of the hospital.

In addition, the hospital and/or the corporation will have the right to acquire limited partnership interests in the partnership in the event that binding commitments are not initially secured from qualifying physicians for the purchase of all partnership interests. The hospital or corporation may hold such interests only until a qualified purchaser can be found. Such interests may also be acquired and held by the partnership. During the time that the hospital and corporation hold such partnership interests, they would participate as limited partners to the extent of their interests.

The hospital is in the process of building a new 120-bed hospital on a portion of a site owned by a local hospital district. The hospital will lease the portion of the site needed for the new hospital from the hospital district.

Construction of the new hospital is being financed through a bond issue by the hospital district and the hospital will lease the new hospital from the district.

The hospital has proposed that a medical office building (the "project") be built adjacent to the new hospital on another portion of the site owned by the hospital district (the "project site"). Under this proposal, the hospital would exercise an option it now holds to purchase the project site. The hospital would then sell the project site at its fair market value. The funds to buy the project site and build the project will be obtained through the issuance and sale of industrial development bonds. The project and the project site will be sold to the partnership under an installment contract.

The partnership's obligation under the installment contract will be secured by its interest in the project and the project site, but will otherwise be nonrecourse.

The limited partners will each contribute a sum in cash to the partnership as their capital contribution. The corporation, as the general partner, will not be required to make any contribution to the capital of the partnership. Neither the limited partners nor the corporation will be responsible for any increase in the cost of the project. It is anticipated that if there is any increase in the cost of the project, the partnership will cover the increased cost by borrowing additional money from another organization.

It is anticipated that the principal tenants in the project will be the limited partners in the partnership. The hospital does plan to attempt to attract a pharmacy as a tenant in the project as a convenience for its staff and patients.

In addition, several spaces in the project may be held open to be used to attract new physicians with skills needed for the staff of the hospital. The remaining space in the project will be leased to the limited partners.

The space each limited partner leases in the project will not be directly related to the limited partner's interest in the partnership. Instead, each limited partner will be required to lease at least one suite in the project.

Rates for space in the project will be set at an amount sufficient to pay the partnership's cost in financing and operating the project. For this purpose, partnership costs will include operating and maintenance expenses (including the property management fee, accounting fees and taxes), principal and interest amortization on the loan to the partnership and the establishment of reasonable reserves. It is anticipated that the rates for space as so determined will be comparable to that of similar medical office space in the area.

Ninety-seven percent (97%) of the profits and losses of the partnership and of the distributions by it will be allocated to the limited partners. The remaining three percent (3%) of its profits, losses and distributions will be allocated to the corporation as general partner.

As general partner of the partnership, the corporation will exercise overall supervision of the project and will have the ultimate right to approve the admission of limited partners, the expenditure of funds and the establishment of reserves. Day-to day management of the partnership will be carried out by an unrelated management company selected by the corporation.

The hospital will serve as a catalyst to bring about the formation of the partnership, the issuance of bonds, the sale of limited partnership units and construction of the project. The hospital will be reimbursed by the partnership for its costs in connection therewith.

The hospital's purposes in bringing about the construction of the project are to attract and maintain a quality medical staff for the new hospital by providing convenient office space and support facilities, to increase the quality of patient care by providing office space for its staff immediately adjacent to the new hospital, to increase its efficiency through fuller utilization of its facilities and elimination of duplication of facilities by physicians, and to control costs and conserve energy. In addition, occupancy of the project by its staff will improve the overall quality of health care by easing the administrative burden which would result if its staff were scattered among several medical office buildings.

The information submitted indicated that these arrangements sufficiently protected the interests of the hospital and corporation so that their participation in the medical office building project would not jeopardize the hospital's continued exemption or the corporation's qualifications for exemption. The hospital will not make any capital contributions to the partnership. The limited partners will pay rents comparable to those charged for similar medical office space in the area.

The organizations have shown that the medical office building project will serve the hospital's and corporation's exempt purposes, as in Rev. Ruls. 69-463, 464, and 545. There are factual distinctions between the proposal and the fact patterns described in the Revenue Rulings, of which the major one is the partnership's participation with nonexempt entities in a partnership. However, because of the safeguards built in, this does not result in the hospital's or corporation's activities serving private interests more than incidentally, nor does it modify the conclusion that the medical office building activity is related to the promotion of health. As a general partner, the corporation's liabilities and receipts from the project will be limited. It will share in the profits, losses and distributions to the partnership, but the assets of the hospital will not be liable for partnership debts.

During time periods in which the hospital or corporation temporarily participate as a limited partner, they will share in its income and liabilities and serve as sublesses. This participation also will not result in inurement or private benefit. Partnership receipts will not be taxable under section 513(c) of the Code because the partnership activity is not an unrelated trade or business with respect to the corporation.

Accordingly, based on the information submitted, the National Office ruled as follows:

(1) The hospital's and corporation's participation in the formation and operation of a partnership, described herein, including the corporation's participation as general partner:

(A) Does not create a situation in which the hospital's or corporation's income inures to the benefit of any private shareholder or individual;

(B) Are activities substantially related to the hospital's and corporation's exempt functions and exempt purposes under section 501(c)(3); and

(C) Will not jeopardize the hospital's continued exempt status.

(2) Income the corporation receives as general partner and amounts paid by the corporation and hospital will not subject them to the tax imposed by section 511(a).

(3) The hospital's or corporation's temporary participation as a limited partner will not jeopardize their continued exemption under section 501(c)(3) or subject either organization to the tax imposed by section 511(a).

Private Letter Ruling # 8312129 12/23/82

A hospital is recognized as exempt under section 501(c)(3) of the Internal Revenue Code and classified as a public charity under sections 509(a)(1) and 170(b)(1)(A)(iii).

A recently incorporated, non-stock, non-profit corporation has filed an application for recognition of exemption under section 501(c)(3) based on its relationship to the hospital. It's sole members are the board of directors of the hospital. Its members appoint its board of directors.

A limited partnership that is not presently in existence will be formed to acquire, construct, own, improve, finance, lease, and manage a medical office building adjacent to the hospital.

The corporation's stated purposes include serving as the sole general partner of the partnership. It will purchase a one percent equity interest in it for an amount of money equal to one percent of the initial capital contributions of all partners. Ownership of limited partnership interests will be restricted to individuals who have medical staff privileges at the hospital and professional associations in which all doctors have staff privileges. Under the terms of the limited partnership agreement, the corporation will have the right to acquire up to 20% of the limited partnership interests in the event that binding commitments are not initially secured from qualifying physicians for the purchase of all partnership interests, or if the limited partners are subsequently unable to dispose of their interests, the corporation may hold such interests only until a qualified purchaser can be found. Such interests may be similarly acquired and held by the partnership. The corporation would participate as a limited partner to the extent of such interests the partnership might hold.

The hospital will lease to the partnership real property adjacent to the hospital for the construction of the medical office building. It will have the right to

approve the original plans and specifications for the building and any changes, modifications, or additions. The lease will be for a term of fifty years at a net annual rental equal to the fair rental value of the property. (The hospital represented that an appropriate adjustment of the rental amount will be made at intervals not exceeding two years.) At the end of that term, the property and all improvements thereon will revert to the hospital. Lease payments will include the value of parking rights for lessees in the building at an existing parking deck owned and operated by the hospital (the tenants, employees, customers, patients, and invitees of those occupying space in the medical building will be charged the same rate for parking that the hospital charges the general public.) The lease will give the hospital the option, beginning after ten years, to purchase the building at its then fair market value.

The hospital will finance the construction of the medical office building through the use of industrial development bonds. It is contemplated that the hospital will be required to guarantee the payment of the bonds to make them marketable. However, any payments made by it under such guarantee would represent loans made by it to the partnership, and as such would be repaid to it out of the assets of the partnership. In addition, the limited partners will guarantee to indemnify the hospital pro-rata in accordance with their interest in the hospital.

Leases in the building will be for a term of ten years at a rental rate which will be comparable to that of similar medical office space in the area. Each lessee must provide his own financing for interior improvements to space leased in the building, and for furnishings and equipment placed in the space leased. All items of income, gain, loss, deduction, credit, or tax preference or cash available for distribution entering into the computation of profit or loss shall be considered allocated to each partner in the same proportion as profits and losses are allocated to such partner.

As general partner, the corporation will have full, exclusive and complete discretion in the management and control of the affairs of the partnership. The partnership agreement contains various restrictions on the ability of the limited partners to sell or assign their interests in the partnership, allowing the corporation to control who will become limited partners. However, the corporation will not be permitted (without the affirmative vote of two-thirds in interest of all limited partners) to sell, assign, or otherwise dispose of substantially all of the property of the partnership. In addition, the holders of 51% of the limited partnership may have the corporation removed in the event of gross negligence or fraud by it in its handling of the partnership affairs.

As general partner, the corporation will exercise overall supervision of the building. The normal day-to-day management of the building will be carried out by it or by an unrelated management company for compensation comparable to that which would be charged by an unrelated party for such services.

The hospital will serve as a catalyst to bring about the formation of the partnership, sale of partnership interests, and the construction of the building. It will be reimbursed by the partnership for its costs in connection therewith. It's stated purposes for bringing about the construction of the building are to increase its efficiency of operation through fuller utilization of its facilities and elimination of duplication of facilities, to control costs and conserve energy, to improve the overall quality of patient care by attracting more physicians with needed specialties, and to retain existing staff which might otherwise be recruited by other hospitals. In addition, occupancy of the building by staff physicians will improve the overall quality of patient care because of easier administration of hospital staff and patients, and because of increased attendance by physicians at professional activities and staff meetings. Further, the fact that physicians can maintain their private practices close to the hospital will result in improved medical care because physicians will be readily available to handle emergencies arising in the hospital. The hospital would not have been able to build the building based on its own credit alone, and the proposed arrangement presents a method by which it can obtain the above-described benefits of an adjacent medical office building.

The information submitted indicates that adequate steps have been taken to assure that the interests of the hospital and corporation will be adequately protected with respect to the proposed medical office building project. The corporation, as general partner, will manage and control the affairs of the partnership and the operation of the building, including the selection of tenants. The hospital will have the option to buy the building after ten years, or will otherwise become the owner of the building when the fifty year lease expires. The information submitted also indicates that the existence of the building adjacent to the hospital will further the exempt purposes of the hospital and corporation as in Rev. Ruls. 69-463, 464, and 545. It appears that any benefit that physicians or others who will be limited partners might receive as a result of the hospital's leasing of real property to the partnership, or from the corporation guaranteeing obligations of the partnership would be merely incidental to the exempt purposes thereby served. Participating physicians or professional associations will not be able to obtain leased space at amounts below the market rate as a result of the project, and although the hospital is a guarantor on the industrial development bonds, the subrogation rights under

the mortgage and the individual guarantees of indemnification by the limited partners serve as adequate collateral to assure that its assets will not be sacrificed for the benefit of private individuals.

Therefore, based on the information submitted and the representations made therein, the National Office concluded that the proposed medical office building project constitutes an activity that is related to the promotion of health, and that no inurement or private benefit will result therefrom. However, this conclusion is based on the assumption that neither the hospital nor the corporation will loan funds for the operating expenses of the partnership. Accordingly:

1. The lease of real property by the hospital to the partnership is substantially related to the exempt function of the hospital and corporation and will not jeopardize the hospital's continued exempt status or the corporation's qualification for exempt status under section 501(c)(3) of the Code.

2. The hospital's guarantee of partnership obligations with respect to the industrial development bonds will not jeopardize its continued exempt status under section 501(c)(3).

3. The corporation's participation as a general partner will not jeopardize its qualification for exemption or the hospital's continued exemption under section 501(c)(3), nor subject it to the tax imposed under section 511.

4. The corporation's temporary participation as a limited partner will not jeopardize its qualification for exemption or the hospital's continued exemption under section 501(c)(3), nor subject either the hospital or corporation to the tax imposed under section 511.

5. Compensation to the hospital or corporation for the performance of management services for the partnership will not subject either organization to the tax imposed under section 511.

In Private Letter Ruling #8217023, a hospital sold condominium units in a medical office building it owned to its staff doctors, without the involvement of a partnership entity. The sales were to be made at fair market value, and there was no indication that these sales would result in any form of private benefit to the hospital's staff physicians.

Based on these facts, the National Office ruled that the sale of condominium medical offices to staff physicians would not jeopardize the exempt status of the hospital, and any gain from these sales would be excluded as capital gains, excepted by IRC 512(b)(5) from the unrelated business income tax.

The following Private Letter Ruling #8206093, concerns the formation of a joint venture by a hospital and a for-profit partnership of physicians.

The joint venture is composed of a medical center exempt from federal income taxation under section 501(c)(3) of the Internal Revenue Code, and a for-profit partnership of physicians. The joint venture was formed in order to purchase and operate computerized axial tomographic photography equipment (a C.A.T. scanner) to be located at the medical center. The C.A.T. scanner will be used to aid in the diagnosis of diseases of patients of the medical center.

One joint venturer is a partnership of physicians who operate the medical center's radiology department. Through an earlier agreement unrelated to the proposed joint venture, these physicians receive staff privileges at the medical center and the space, equipment, and personnel necessary for the operation of the department.

The medical center and physicians will each supply fifty percent of the funds needed to purchase and operate the C.A.T. scanner. Each will share equally in the net profits and losses and the net cash flow of the joint venture. Each will supply fifty percent of any additional funds needed to operate the C.A.T. scanner.

The joint venture will be managed by a representative of each joint venturer and will terminate seven years after final payment on the C.A.T. scanner is made, at which time there will be a full accounting and final distribution. The medical center and physicians will each be responsible for providing liability insurance at specified levels for their own interests, and each joint venturer is fully responsible for payment of property and other taxes on their own interests.

The joint venture will be responsible for the billing of all technical component charges and will receive two percent of gross charges for costs associated with preparing, mailing and collection of charges. Technical component charges are those charges exclusive of charges for interpretation of a scan by a radiologist. Technical component charges will be set at the prevailing rate of such services.

The medical center will bill the physicians and be reimbursed for occupancy costs relating to the location of the C.A.T. scanner. These costs will include maintenance and utilities, house-keeping services, and building depreciation and interest.

When an organization exempt under section 501(c)(3) of the Code enters into a joint venture with a for-profit entity, strict scrutiny of the relationship is necessary to ensure that the exempt organization does not serve the private purposes of the for-profit entity at the expense of its public purposes. The provisions of the agreement between the joint venturers satisfied the National Office that the medical center's public purposes, rather than private interests of the physicians, will be served by its participation. Profits and losses of the joint venture will be shared in proportion to the investment of each joint venturer. The joint venture will pay no more than reasonable compensation to the investment of each and will pay no more than reasonable compensation for services performed by each joint venturer. Each joint venturer is responsible for providing its own liability insurance and for paying its own property and other taxes. The relationship of each party in the joint venture appears to be consistent with tax exemption for the medical center under section 501(c)(3) of the Code.

Further, the C.A.T. scanner equipment will only be used to diagnose disorders in persons who are patients of the hospital within the meaning of Rev. Rul. 68-376. Because the activity is performed for the convenience of patients of the hospital within the meaning of section 513(a)(2) of the Code, the medical center will not be engaged in an unrelated trade or business within the meaning of section 513(a) of the Code. Consequently, income received from the operation of the C.A.T. scanner will not be unrelated business taxable income within the meaning of section 511 of the Code and the formation and operation of the joint venture will not jeopardize the medical center's exempt status.

4. Unrelated Business Income of Hospitals

Prior CPE texts (1983 p. 29, 1982 p. 6, 1981 p. 33) have discussed the application of the unrelated business income tax to certain activities of hospitals. We have found this to be an ongoing problem area and therefore we will summarize our current thinking in this area as well as provide the text of a number of representative private ruling letters (omitting the applicable law section) issued by the National Office.

Generally, IRC 513(a) states that a tax-exempt organization will not be subject to the unrelated business income tax if the services it provides are substantially related to 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.

We believe this principle was correctly applied in the case of Carle Foundation v. U. S., 611 F. 2d 1192 (7th Cir. 1979). In that case, an exempt hospital worked closely with a for-profit clinic composed of physicians on the hospital's staff. The hospital pharmacy sold prescription drugs to the clinic and its patients. The court held these sales to be taxable on two separate grounds. First, the sales were not made to the hospital's patients. In reaching this conclusion, it analyzed Rev. Rul. 68-376, which gives examples of "patients" for this purpose. The court correctly concluded that patients of the clinic were not patients of the hospital, since these organizations were separate legal entities. It also correctly stated that the mere fact that the clinic performed outpatient testing for hospital patients did not transform the clinic's patients into hospital patients. Thus, the court held the sales were not related to the hospital's exempt function. The Court also noted that the hospital pharmacy was in competition with taxable pharmacies and had derived substantial profits from these sales, indicating a business rather than an exempt purpose.

We believe the principle was incorrectly applied in another case, St. Luke's Hospital of Kansas City v. U. S., 494 F. Supp. 85 (W.D. Mo. 1980). In that case, the hospital operated a pathology laboratory in which tests were made on specimens received from patients of St. Luke's staff physicians in the course of their private practices. St. Luke's argued that the testing was related because it contributed importantly to its medical education program, and the court agreed, stating that, by increasing the number of tests to study, the outside testing program enriched the available instructional material and improved the hospital's teaching program.

Factually, the case was not developed at the administrative level to deal with the issue of whether the outside sales contributed importantly to the educational program, because that argument was not spelled out in the initial claim for refund. This entered into our decision not to appeal that case. However, we believe it would be a rare situation if a hospital's patients did not supply it with enough testing specimens, including abnormal specimens, for it to conduct a thorough medical education program. Thus, we should scrutinize very carefully any claim based on this theory.

St. Luke's also argued that the convenience exception of IRC 513 applied to except the testing from UBI, stating the testing was performed for the convenience of its staff physicians who were "members" of the hospital for this purpose. The Court agreed.

We believe this conclusion is wrong. Our position is that hospitals are simply not membership organizations within the contemplation of the exception and therefore even if the staff physicians were treating patients of the hospital we would not consider them to be "members" of the hospital for this purpose. Further, even if we concede, for the sake of argument, that staff physicians are "members" of the hospital, we do not accept the conclusion that the tests were done primarily for their convenience, as required by IRC 513. Given the large amount of revenue generated by this category of testing, we believe the tests were done primarily to generate revenue.

However, there may be special circumstances where the testing of referred specimens may fulfill an important community medical need and thus serve the hospital's exempt purposes. For example, if commercial testing facilities are otherwise unavailable in the community in general or for a particular type of test, and where treatment of a patient would be delayed by referral of the specimen to another location, the testing of that specimen by the hospital is not unrelated. The facts of each case must be examined closely. However, it is safe to say that we should rarely consider the testing of non-patient specimens related if commercial testing facilities exist within the community that are capable of performing the same testing.

One of these rare situations is illustrated by the case of Hi-Plains Hospital v. U. S., 670 F. 2d 528 (5th Cir. 1982). There the court found pharmacy sales to private patients of staff physicians to be related. Dealing with the fact that the hospital was located in a rural community that had lacked medical services before the hospital was established, the court accepted the hospital's contention that the pharmacy sales were part of a benefit package for staff physicians used to attract and maintain them in the community.

Recently, the sale of hearing-aids by exempt hospitals has been called to our attention as being in direct competition with sales by commercial sellers. Revenue Ruling 78-435 provides an example of a situation in which the sale of hearing aids by an exempt hospital was held to be not subject to the unrelated business income tax. However, that result may change in a given situation if the facts indicate a

hospital is engaging in a commercial venture through the use of advertising and other promotions.

The following private letter rulings represent the application of the above principles to various fact patterns. The applicable law sections of the rulings have been omitted for the sake of brevity.

Private Letter Ruling # 8305115

The Service was asked for a ruling concerning the provision of laboratory and radiological services by an exempt hospital to physicians and other health care providers.

The hospital, exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code and a non-private foundation as described in section 170(b)(1)(A)(iii), is a 148 bed facility and serves as a regional health center for a large isolated rural area. It has a laboratory and radiology department, the size of which is commensurate with its function.

In addition to the services the laboratory and radiology department perform for patients of the hospital, they also provide services to the patients of a variety of other health care providers, including clinics, private physicians and one local hospital of less than 100 beds. Some of the clinics and the other hospital are exempt from tax under section 501(c)(3) and are described in section 170(b)(1)(A)(iii) and others are not. The hospital does not advertise or otherwise promote its services.

In 1981, the gross receipts from outside services performed in the laboratory and the radiology department were approximately 10% and 16% of the total gross receipts generated by the departments. Each department earned a net profit from the outside services of less than one-half of one percent of the gross from those activities, but in the two years prior to 1981 there was an aggregate loss from outside work. The nearest commercial facilities offering laboratory or radiology services are 125 miles from the hospital, so, although it would not be impossible for local providers to use commercial services, it would be inconvenient and expensive.

The hospital provides laboratory and radiology services at cost to two categories of entities. To the extent that these organizations are described in section 170(b)(1)(A)(iii) of the Code and have less than 100 beds, the provision of such

services by the hospital in the manner described above will not generate income subject to tax under section 511 due to the operation of section 513(e). However, at least one of the purchasers of services is not in this category, and, therefore, that income must be exempt from tax for another reason, if at all.

The exempt purpose of a hospital is to provide health care to the community it serves. In pursuit of this purpose it usually performs activities directly related to its patient population only. Therefore, providing laboratory and radiology services for a fee to outside health care providers for the benefit of persons who are not patients of the hospital is normally not substantially related to the hospital's exempt purpose and puts it in direct competition with for profit businesses. However, in isolated rural areas, where the health needs of the community cannot be conveniently met by commercial operations, and an exempt hospital has unique facilities, such as is the case here, it may use the facilities to serve the community. In that case the provision of such services would be substantially related to the hospital's exempt purpose and would not be taxable under section 511.

The National Office ruled that the provision by the hospital of laboratory and radiology services to unrelated health care providers in the manner described above will not generate unrelated business income taxable under section 511.

Private Letter Ruling #8317003

In a request for technical advice, the National Office was asked whether a hospital recognized as exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code was engaged in an unrelated trade or business within the meaning of section 513 of the Code by performing diagnostic laboratory tests on specimens referred by private physicians, where the individual whose specimen is being tested is not physically present in the hospital.

The hospital, a teaching institution located in a metropolitan area, has a diagnostic laboratory and a pathology department and performs lab tests for in-patients, out-patients and a specimen service for staff physicians. The hospital does not advertise its laboratory services, but does maintain a courier service which picks up specimens directly from the physicians. The patients are billed directly.

As part of its mission as a teaching hospital, it has a certified program for both pathology and medical technician training. During the period in question, there were no medical technician students involved in the pap smear testing program, but there were three residents in pathology.

In the metropolitan area, there are three commercial laboratories that perform tests. There is also a hospital of comparable size which also has a lab, and performs lab tests for its staff physician's patients who are not patients of that hospital.

The district office contended that the hospital is not unique in furnishing lab services in the area, that the testing is not in furtherance of an educational endeavor, that there are licensed commercial medical testing facilities readily available, and that there is another hospital of comparable size two miles away. Thus, the district believed that the specimen service provided for the patients of the hospital staff physicians is an unrelated trade or business and requested technical advice on this issue.

Since the hospital waived its right to a conference and agreed to concede the issue "without prejudice", the National Office responded to the request for technical advice in the form of general information only. The National Office response was as follows:

The hospital states that it only accepts on a regular and recurring basis abnormal pap smears and tissue samples that have been abnormal in the past from certain private physicians on its staff. Non-suspect or normal pap smears and tissue samples are referred to commercial laboratories by the same physicians that refer samples to the hospital. Because of the specialized nature of the abnormal pap smears and tissue samples which are referred to the hospital, it deems the testing of these specimens a necessary procedure for effectively carrying out its health care mission to the community. It also contends that because of its training program in pathology there is a need for a higher volume of specimens to insure adequate training in the profession, and, thus, outside specimens are necessary. The hospital also points out that a very small amount of the laboratory's revenue and an even smaller percentage of its income is derived from the specimen service.

The Service has historically tested the relatedness of sales activities of exempt hospitals on the basis of whether there is any nexus to patient recovery or convenience. This approach was upheld in the case of pharmaceutical sales in Carle Foundation v. United States, 611 F. 2d 1192 (7th Cir. 1979). In the case of referred specimen laboratory services, we believe that this same approach is generally applicable. However, each case must be examined to determine if special circumstances exist that would constitute exceptions to the general approach. These circumstances include whether the exempt hospital has educational or

scientific purposes that may be served by the referred specimen testing services, any unique testing facilities possessed by the hospital, and any special needs of the community.

Thus, if a hospital provides specimen testing services for the mere convenience of its staff physicians, such testing would clearly not be a related activity. Conversely, the mere fact that competent, commercial testing facilities are conveniently available would not make the provision for testing services an unrelated activity per se for an exempt hospital. In the case of a teaching hospital, such testing services may advance necessary educational and scientific purposes. Depending on the nature of the equipment that a hospital has acquired, it may be able to provide specialized and unique tests not otherwise available that contribute to the overall health of the community. Thus, the facts and circumstances are determinative in each case.

Private Letter Ruling #8325007

In this case the National Office entertained a request for technical advice that presented a detailed fact pattern that allowed the application of a facts and circumstances test regarding unrelated business income from laboratory services.

The subject organization (hereinafter referred to as the "hospital") was organized for the purposes of providing hospital services, appropriate medical education programs, and promoting the general health of the community. The hospital is recognized as exempt under section 501(c)(3) of the Code and is classified as an organization described in section 170(b)(1)(A)(iii).

The hospital maintains a program whereby it provides laboratory services to other hospitals, medical institutions, and the patients of staff doctors who were not admitted inpatients at the time the service was rendered (hereinafter collectively referred to as "outside" laboratory services). As a result of an examination of the hospital, the District Director has concluded that such "outside" services constitute an unrelated trade or business and are subject to tax under section 511 of the Code.

For the year in question, the hospital's financial records indicate that revenues from "outside" laboratory services constituted approximately 9.6% of total laboratory revenues, and approximately 1.2% of total hospital revenues. Based on indicated revenues, the "outside" services can be broken down as follows:

Medical Staff	32%
Other Hospitals	54%
Other Medical Facilities	14%

Expenses attributable to the "outside" services amounted to about 87% of the revenues generated from such services. The resulting profit constituted approximately 2% of the hospital's net income.

The hospital indicates that the operations of the laboratory services program is motivated by various factors including:

1. The convenience of its staff physicians, and to assist such physicians by having the pathologist and laboratory which performed pre-admission tests readily available to them.

2. The continuity of pathology testing by having the same pathologist perform the initial preadmission tests as well as subsequent inpatient tests.

3. The convenience of its pathologists, some of whom serve as pathologists at other hospitals or facilities which have less sophisticated equipment and a smaller medical staff available for consultation.

4. All laboratory services, regardless of the customer, are intricately involved in its teaching program. Two pathology residents are in training at all times. In addition, residents other than pathology residents are rotated through the laboratory as part of their training. Also, the hospital carries on a baccalaureate level training program in medical technology, which involves a practical "bench" training in the laboratory. Finally, the laboratory is used in the teaching of certified laboratory assistants in affiliation with an adult education center.

The hospital believes that its "outside" laboratory services further its exempt purposes, and therefore, do not constitute an unrelated trade or business. The hospital cited the case of St. Lukes Hospital of Kansas City v. United States, 494 F. Supp. 85 (W.D. Mo. 1980), in support of its position. The hospital contends that the educational value of its laboratory-related training activities is heavily dependent on the amount, variety, and complexity of the tests performed therein,

and that it is necessary to accept specimens from other than inpatients in order to provide a sufficient number of tests so that a complete and varied teaching experience can be offered.

In addition, the hospital believes that its sophisticated laboratory fulfills a community health need which would otherwise be unsatisfied, because the laboratory provides 24 hour emergency services, a wide array of which are believed to be otherwise unavailable on an emergency basis within the area. The hospital represented that the nearest equivalent commercial laboratory is in a city about 35 miles from the area served by the hospital. The hospital pointed out that most of the "outside" laboratory services were performed for smaller hospitals and other medical facilities, rather than for its staff physicians. In many cases, the performance of the services was related to the fact that some of the hospital's pathologists also serve as pathologists for other hospitals and medical facilities. The hospital believes that if its sophisticated laboratory were not available in such cases, the smaller hospitals would be forced to make large expenditures for their own equipment or send their samples to comparable commercial laboratories a significant distance away. It is felt that if the latter option were chosen, the pathologists would be prevented from performing their professional duties in regard to the smaller hospitals.

The hospital also contends that its "outside" laboratory services fall generally within the convenience exception of section 513(a)(2) of the Code. The hospital likens its staff physicians and/or pathologists to "members," and feels that the availability of its laboratory serves as a convenience to them.

The hospital represents that it has never solicited or advertised for customers for its laboratory services. The examining agent takes issue with such representation on the basis of the fact that the hospital's laboratory services are listed in the yellow pages of the local telephone directory. In addition, based on responses from an inquiry to a commercial laboratory, the examining agent concluded that comparable commercial laboratory services are available in the immediate area of the hospital. The hospital furnished comments with respect to the capabilities and services provided at the various commercial laboratories in the area.

It is possible that the hospital's overriding motive for conducting the "outside" services may be to provide a convenience for its staff physicians and/or pathologists. In this regard, we emphasize that the Service's position is that physicians in private practice who have been granted the privilege of using the

hospital's facilities in the treatment of their patients would not be viewed as included within any of the categories specified in section 513(a)(2) of the Code ---" members, students, patients, officers, or employees." Pathologists serving in their professional roles on behalf of other medical facilities would, likewise, not be included within any of the specified categories. Thus, the provision of laboratory services for their convenience would not cause such services to be excluded from the definition of unrelated trade or business pursuant to section 513(a)(2).

The general rule followed by the Service in determining the relatedness of furnishing goods or services 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 as 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 in section 1.513(d). The St. Luke's case is an example of the type of case requiring this broader approach.

In the St. Luke's case the hospital was able to determine 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 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 unrelated trade or business. The facts and circumstances must support the inference that the nonpatient testing contributes to the advancement of an exempt purpose. If 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.

In this case the information available is inconclusive with respect to the question of whether the hospital's laboratory facility offers unique services or otherwise fulfills a special need of the community. The hospital and the examining agent have reached opposite conclusions with respect to whether comparable laboratory services are available in the immediate area. Thus, if the question of relatedness were to be resolved on such grounds, more precise information would have to be obtained regarding the availability of certain services on an emergency basis only at the hospital's laboratory.

However, there is sufficient evidence to support the conclusion that the "outside" laboratory services contribute importantly to the hospital's educational function. The hospital has listed and described the educational programs that involve the laboratory. Some of the programs relate to the actual training of pathologists. As the hospital pointed out, the overall quality of such training would be directly related to the amount, variety, and complexity of the tests performed in the laboratory. Based on revenue received in the year in question, it appears that about two-thirds of the "outside" services were in response to the needs of other hospitals and medical facilities. This indicates that much of the "outside" service involves testing that is somewhat complex or requires sophisticated equipment because the more routine tests could be conducted by the recipient medical facility in its own laboratory. (On the other hand, it is likely that staff physicians would generally perform no tests themselves and would refer all their specimens, routine or otherwise, in the laboratory offering the greatest convenience and expediency.) Thus, although the hospital's overriding motive for making the "outside" service available is not certain, it appears that the effect of providing such services would be to enhance the overall quality of the training experiences offered in the laboratory, and would broaden the practical experience of the pathologists working therein.

The unrelated business income tax provisions of the Code were aimed primarily at organizations that exploited their tax exempt status for commercial purposes. In the present case we see no such abuse or exploitation. There is no evidence of any significant marketing or advertising campaigns with respect to the laboratory services. Although the laboratory is listed in the yellow pages, there is no commercial hue to the listing. Only the name, address, and telephone number of the laboratory are listed, unlike the ads of many commercial laboratories which have additional space highlighting the types of services they perform. In many

cases, the need for the "outside" services arose because of the fact that the hospital and the recipient facility utilized the same pathologist, and not because of any effort on the part of the hospital to expand laboratory clientele or generate additional revenue. The relative size and extent of the "outside" services (compared to both total hospital revenues and total laboratory revenues) is not large enough to indicate a commercial intent.

All of the facts and circumstances indicate that the "outside" laboratory services contribute importantly to the accomplishment of the hospital's educational function, and the extent of such activities do not appear excessive. Thus, the National Office concluded that the "outside" laboratory services were substantially related to an exempt purpose of the hospital, and were not conducted as a commercial endeavor. Accordingly, the provisions of section 1.513-1(a) of the Regulations were satisfied.