

Circumstances in which an exempt hospital derives unrelated business taxable income from the sale of pharmaceutical supplies to the general public.

Advice has been requested as to the circumstances in which the sale of pharmaceutical supplies to the general public by the pharmacy of a hospital, exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954, results in unrelated business taxable income under section 512 of the Code.

Section 513 of the Code defines the term 'unrelated trade or business' as 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 profit derived) to the exercise or performance by such organization of its exempt functions.

To the extent relevant here, section 513(a)(2) of the Code further states 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 patients.

Section 512 of the Code defines the term 'unrelated business taxable income' as the income as computed in this section derived by organizations from any unrelated trade or business regularly carried on.

Section 1.513-1(c)(1) of the Income Tax Regulations states that in determining whether trade or business from which a particular amount of gross income derives is 'regularly carried on' within the meaning of section 512, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued.

Section 1.513-1(c)(2)(ii) of the regulations states that in determining whether or not intermittently conducted activities are regularly carried on, the manner of conduct of the activities must be compared with the manner in which commercial activities are normally pursued by non-exempt organizations. In general, exempt organization businesses which are engaged in only discontinuously or periodically will not be considered regularly carried on if they are conducted without the competitive and promotional efforts typical of commercial endeavors.

Section 1.513-1(c)(2)(ii) of the regulations further states that where an organization sells certain types of goods or services to a particular class of persons in pursuance of its exempt functions 'primarily for the convenience' of such persons within the meaning of section 513(a)(2), casual sales in the

course of such activity which do not qualify as related to the exempt function involved or as described in section 513(a)(2) will not be treated as regular. On the other hand, where the nonqualifying sales are not merely casual, but are systematically and consistently promoted and carried on by the organization, they meet the section 512 requirement of regularity.

The application of the principles and requirements set forth in the above sections of the Code and regulations to sales by a hospital pharmacy to members of the general public is illustrated in the two situations set out below.

Situation 1. A hospital exempt from Federal income tax under section 501(c)(3) of the Code maintains a facility on the ground floor of its main building for the sale of pharmaceutical supplies. In addition to prescription drugs, the pharmacy also sells nonprescription drugs and a few personal articles. The primary source of the pharmacy's income is sales to patients of the hospital. See Revenue Ruling 68-376, page 246, of this Bulletin, for illustrative descriptions of persons considered 'patients' of a hospital. However, the pharmacy is also open to the general public. A small percentage of its income is from frequent and continuous sales of prescription and nonprescription drugs to persons who are not patients of the hospital, but who walk in off the streets to make purchases from the pharmacy.

The buyer-seller relationship between these off-street patrons and the hospital pharmacy is not, in and of itself, sufficient to classify such persons as 'patients' of the hospital. Therefore, sales to these persons cannot be considered primarily for the convenience of the patients of the hospital within the meaning of section 513(a)(2) of the Code.

Furthermore, there is no substantial causal relationship between the achievement of the hospital's exempt purposes and the sale of pharmaceutical supplies to members of the general public who do not otherwise avail themselves of the hospital's medical or diagnostic facilities. Therefore, this sales activity constitutes the conduct of unrelated trade or business within the meaning of section 513 of the Code.

The hospital pharmacy's facilities are freely available to patients and nonpatients alike. Pharmaceutical sales to the general public are frequent and continuous and are thus regularly carried on within the meaning of section 512 of the Code.

Accordingly, the income derived by the hospital from the sale of pharmaceutical supplies to the general public constitutes 'unrelated business taxable income' as defined in section 512 of the Code.

Situation 2. A hospital exempt from Federal income tax under section 501(c)(3) of the Code maintains a limited number of consultation and examination rooms that are available to its

medical staff for treating their private patients. These rooms are used only when it is mutually convenient for the patient and physician to meet at the hospital. Patients visiting their physicians in these rooms are not patients of the hospital. If, during the course of such visits, the patient receives a prescription from his physician, he may fill it at any pharmacy.

The hospital maintains a pharmacy for the use of its own patients. Sales to non-patients are not ordinarily permitted. However, as a courtesy to its medical staff, the pharmacy will occasionally fill prescriptions written by the physicians for their private patients, but such sales are not promoted by the hospital, do not occur with frequency, and represent only an insignificant portion of the pharmacy's total sales.

Under these circumstances, such sales would constitute unrelated trade or business as defined in section 513, since they are neither primarily for the convenience of the hospital's patients within the meaning of section 513(a)(2) nor substantially related to the exercise or performance of the hospital's exempt purposes. However, in view of the manner in which they are conducted, these nonqualifying sales are considered casual sales within the meaning of section 1.513-1(c)(2)(ii) of the regulations. Income derived from such sales does not constitute income derived from unrelated trade or business that is regularly carried on and, therefore, does not constitute 'unrelated business taxable income' within the meaning of section 512 of the Code.