

The sale of pharmaceutical supplies by an exempt hospital to private patients of physicians with offices in a hospital-owned medical building constitutes unrelated business.

Advice has been requested whether, under the circumstances set forth below, the sale of pharmaceutical supplies by a hospital exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954 is unrelated business within the meaning of section 513 of the Code.

The hospital owns a medical office building located adjacent of the hospital. It lease office space to those members of its medical staff who find it convenient to locate their private practice in proximity to the hospital. The office practice of these physicians is independent of any activities in which they engage as members of the hospital's medical staff. Patients visiting their offices are treated as their private patients. The hospital's governing authority over the treatment of hospital patients by its medical staff does not extend to the services rendered by the physicians in their private offices.

The hospital operates a pharmacy in the office building. It is maintained for the convenience of those persons visiting their private physicians in the building. Income of the pharmacy is primarily from the sale of prescription and nonprescription pharmaceutical supplies to the private patients of the physicians practicing in the building.

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 profits 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 1.513-1(d)(2) of the Income Tax Regulations states that a trade or business is 'related' to exempt purposes only where the conduct of the business activity has a casual relationship to the achievement of an exempt purpose; and is 'substantially related' for purposes of section 513 only if the casual relationship is a substantial one.

Pharmaceutical supplies are purchased from this pharmacy as an incident to the purchaser's visit to his private physician, rather than as an incident to his use of any of the hospital facilities.

The sale of pharmaceutical supplies to these persons cannot therefore be considered a trade or business that is carried on by the hospital primarily for the convenience of its patients within the meaning of section 513(a)(2) of the Code. Furthermore, since these customers are not patients of the hospital, there is no substantial causal relationship between the achievement of the hospital's exempt purposes and the sale of pharmaceutical supplies to them. Therefore, this activity is not substantially related to the exercise or performance of the hospital's exempt functions within the meaning of section 513 of the Code and implementing regulations.

Accordingly, the sale of pharmaceutical supplies to the class of persons and under the circumstances described above constitutes the conduct of unrelated business within the meaning of section 513 of the Code.