The exempt status of a hospital will not be jeopardized where, after arm's length negotiations, it enters into an agreement with a hospital-based radiologist to compensate him on the basis of a fixed percentage of the departmental income.

Advice has been requested whether a hospital exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954 jeopardizes its exemption by entering into the contractual relationship described below.

After arm's length negotiations, the hospital entered into a written agreement with a radiologist. Under the contract the hospital provides space, equipment, and supplies, and makes nonmedical personnel available to the department of radiology. The radiologist agreed to manage the department, participate in the hospital's educational program, and perform all radiological services required by hospital patients, employees, and students. While the radiologist serves as the professional and administrative head of the hospital's department of radiology, he has no control over, or management authority with respect to, the hospital itself. The hospital, with approval of the radiologist, established the amounts charged to patients for services rendered. The hospital bills and collects the charges. The hospital pays the radiologist a fixed percentage of the department's gross billings, adjusted by an allowance for bad debts. The agreement remains in full force and effect for a term of years, with each party having the right of cancellation upon prior notice.

The amount received by the subject radiologist under the contract described above is not excessive when compared to the amounts received by radiologists having similar responsibilities and handling a comparable patient volume at other similar hospitals.

Section 501(c)(3) of the Code provides for the exemption from Federal income tax of organizations organized and operated exclusively for charitable, educational, or scientific purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(c)(2) of the Income Tax Regulations provides that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

Under certain circumstances, the use of a method of compensation based upon a percentage of the income of an exempt organization can constitute inurement of net earnings to private individuals. For example, the presence of a percentage compensation agreement will destroy the organization's exemption under section 501(c)(3) of the Code where such arrangement transforms the principal activity of the organization into a joint
venture between it and a group of physicians (Lorain Avenue Clinic v. Commissioner, 31 T.C. 141 (1958)), or is merely a device for distributing profits to persons in control (Birmingham Business College v. Commissioner, 276 F.2d 476 (1960)).

However, under the circumstance described above, the radiologist did not control the organization and the agreement was negotiated at arm's length. The amount the radiologist received was reasonable in terms of the responsibilities and activities that he assumed under the contract. For these reasons, it is held that the arrangement entered into between the hospital and the radiologist does not constitute inurement of net earnings to a private individual within the meaning of section 1.501(c)(3)-1(c)(2) of the regulations.

Accordingly, the organization does not for this reason jeopardize its exemption from Federal income tax under section 501(c)(3) of the Code.