Leases of office space by an exempt hospital to members of its medical staff who contribute importantly to the performance of hospital functions are not considered business leases within the meaning of section 514 of the Code.

Advice has been requested whether the leases described below are excepted from the definition of the term 'business lease' in section 514(b) of the Internal Revenue Code of 1954 by the provisions of section 514(b)(3)(A)(i) of the Code.

A community hospital exempt from Federal income tax under section 501(c)(3) of the Code built an adjacent office building for doctors in order to encourage members of its medical staff to maintain their private medical practices near the hospital. The building is subject to a mortgage incurred at the time of its construction. The hospital leases office space in the building to doctors to carry on their private medical practices. Only members of the hospital's active or courtesy medical staff may lease space, with active staff members given preference. Doctors who do not have staff privileges in the hospital are not accepted as tenants. The usual term of the leases, including options to renew, is for more than five years. However, the lease may be terminated sooner by the hospital in the event that a tenant ceases to be a member of the medical staff. Only janitorial and maintenance services are provided to the tenants by the hospital.

The hospital has established that (1) as a result of having members of its medical staff practicing medicine in offices adjacent to the hospital, greater use is made of the hospital's diagnostic facilities and patient admissions are easier, and (2) the physical presence of the members of the medical staff on the hospital's grounds makes the services of these doctors more readily available for outpatient and inpatient emergencies, facilitates carrying out their everyday medical duties in the hospital, makes their attendance at staff meetings easier, and serves to increase their participation in the hospital's medical education and research programs. While these leasing arrangements are also a convenience to the lessees, many of the benefits are passed on to the hospital and its patients in the form of greater efficiency and better overall medical care.

A charitable organization exempt under section 501(c)(3) of the Code is subject to the unrelated business income tax imposed by section 511 on income received from business leases. See sections 512(b)(4), 514(a)(1), and 514(a)(2) of the Code. The term 'business lease' is defined in section 514(b) of the Code as a lease of real property for a term of more than five years if at the close of the lessor's taxable year there is a business lease indebtedness, as defined in section 514(c) with respect to such property. However, section 514(b)(3)(A)(i) of the Code provides that no lease shall be considered a business lease if such lease is entered into primarily for purposes which are substantially
related (aside from the need of such organization for income or funds or the use it makes of the rents derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.

The leasing of office space adjacent to the hospital to members of the medical staff under the circumstances described contributes importantly to the hospital functions by increasing the hospital's efficiency, encouraging fuller utilization of its facilities, and improving the overall qualify of its patient care. By leasing only to doctors who have staff privileges, the hospital is leasing the premises on the basis of a criterion that furthers hospital functions. Benefits thus derived from these leases by the hospital and its patients indicate that such leases are entered into primarily for purposes that are substantially related to the performance of hospital functions. Based on the facts presented, it is held that the leases described above come within the provisions of section 514(b)(3)(A)(i) of the Code and are not business leases.