

26 CFR 1.513-1: Definition of unrelated trade or business. (Also Sections 501, 6001, 6033: 1.501(c)(3)-1, 1.6001-1, 1.6033-2.)

Unrelated income; hospital; laboratory services for private patients of staff physicians. The performance of diagnostic laboratory testing on referred specimens from private patients of hospital staff physicians, by a hospital exempt under section 501(c)(3) of the Code, is unrelated trade or business if such services are otherwise available in the community.

ISSUE

Under the circumstances described below, does the performance of diagnostic laboratory testing, by a hospital exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code, upon specimens from private office patients of the hospital's staff physicians constitute unrelated trade or business within the meaning of section 513?

FACTS

The hospital is located in a metropolitan area and is organized for the purpose of promoting community health. It is exempt from federal income tax under section 501(c)(3) of the Code and is described in section 170(b)(1)(A)(iii). Among its activities, the hospital performs diagnostic laboratory testing upon specimens from private office patients of its staff physicians and upon specimens from patients of medical clinic not connected with the hospital. These services are performed for a fee. Commercial laboratories that perform testing identical to that performed by the hospital are available in the area.

Specimens from private patients of the hospital's staff physicians are collected by the physician at the physician's office and transmitted to the hospital for analysis. Likewise, specimens from patients of medical clinic are transmitted by the clinics to the hospital. Patients of staff physicians and of the clinics do not themselves enter the hospital for diagnostic testing. Thus, referral of specimens to the commercial laboratories would not hinder or jeopardize the diagnosis or care of patients either of private physicians or of medical clinics. The diagnostic testing does not involve equipment or procedures unique to the hospital. Moreover, the commercial laboratories are sufficiently close by so that testing services can be provided on a timely basis.

LAW

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for charitable purposes.

Section 1.501(c)(3)-1(d)(2) of the Income Tax Regulations provides that the term 'charitable' is used in section 501(c)(3) of the Code in its generally accepted legal sense.

In the general law of charity, the promotion of health is considered to be a charitable purpose. Restatement (Second) of Trusts, section 368, 372; Bogert, Trusts and Trustees, section 374 (rev. 2d ed. 1977); IV Scott on Trusts section 368, 372 (3rd ed. 1967). See also Rev. Rul. 69-545, 1969-2 C.B. 117.

Section 513(a) 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 an organization for income or funds or the use it makes of the profits derived) to the exercise or performance by an organization of the purposes or functions constituting the basis for its exemption under section 501. However, section 513(a)(2) further states that such term 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 members, officers, patients, or employees.

Rev. Rul. 68-376, 1968-2 C.B. 246, provides six examples of persons considered 'patients' of a hospital for purposes of section 513(a)(2) of the Code: 1) a person admitted to the hospital as an inpatient; 2) a person receiving general or emergency diagnostic, therapeutic, or preventive health services from outpatient facilities of a hospital; 3) a person directly referred to the hospital's outpatient facilities by his private physician for specific diagnostic or treatment procedures; 4) a person refilling a prescription written during the course of his treatment as a patient of the hospital; 5) a person receiving medical services as part of a hospital administered home care program; and 6) a person receiving medical care and services in a hospital-affiliated extended care facility.

Rev. Rul. 85-109, page 17, this Bulletin, holds that the Internal Revenue Service will not follow the decision in *St. Luke's Hospital of Kansas City v. United States*, 494 F. Supp. 85 (W.D. Mo. 1980), to the extent that it holds that a tax-exempt hospital's performance of diagnostic laboratory testing upon specimens of patients of the hospital's staff physicians is not unrelated trade or business because the activity is performed primarily for the convenience of the members of the hospital under section 513(a)(2) of the Code.

Section 1.513-1(d)(2) of the regulations provides that a trade or business is 'related' to an organization's exempt purposes, in the relevant sense, only where the conduct of the business activities has a causal relationship to the achievement of its exempt purposes (other than through the production of income); and that it is 'substantially related,' for purposes of section 513 of the Code, only if the causal relationship is a substantial one. Thus, the conduct of trade or business is substantially related to the purposes for which exemption is

granted only if the performance of the service provided in such trade or business contributes importantly to the accomplishment of those purposes. Whether an organization's business activities contribute importantly to the accomplishment of its exempt purposes depends in each case upon the facts and circumstances involved.

Section 1.513-1(b) of the regulations provides that for purposes of section 513 the term 'trade or business' generally includes any activity carried on for the production of income from the performance of services. Section 513(c) of the Code provides that an activity does not lose its identity as a trade or business merely because it is carried on within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. In Rev. Rul. 68-374, 1968-2 C.B. 242, Situation 1, a hospital pharmacy selling pharmaceuticals to the general public was held to be engaged in a trade or business unrelated to the hospital's exempt purposes. No substantial causal relationship was found between the achievement of the hospital's exempt purposes and the sale of pharmaceuticals to members of the general public who did not otherwise avail themselves to the hospital's medical and diagnostic facilities. Such sales were also found not to be primarily for the convenience of patients of the hospital within the meaning of section 513(a)(2) of the Code. See also *Carle Foundation v. United States*, 611 F.2d 1192 (7th Cir. 1979).

ANALYSIS

The hospital receives gross income from its diagnostic laboratory testing upon specimens from members of the public who do not otherwise avail themselves of the hospital's medical or diagnostic facilities. This activity does not lose its identity as a trade or business merely because the hospital also provides medical and diagnostic services to its own patients in furtherance of its exempt purposes or for the convenience of its patients within the meaning of section 513(a)(2) of the Code. See also section 513(a) of the Code and section 1.513-1(b) of the regulations. Moreover, there is no substantial causal relationship between the achievement of the hospital's exempt purposes and the provision of such testing to nonpatients. See Rev. Rul. 68-374, Situation 1. Also see *Carle Foundation v. United States*.

Further, the hospital's provision of diagnostic laboratory testing services on specimens from persons who are not its patients is not an activity carried on primarily for the convenience of its patients within the meaning of section 513(a)(2) of the Code. The private office patients of the hospital's staff physicians are not the hospital's own patients; likewise, the patients of medical clinic unrelated to the hospital are not patients of the hospital. To determine which persons are 'patients' of a hospital for purposes of section 513(a)(2), see Rev. Rul. 68-376.

In addition, because the physicians are not 'members' of the hospital, the activity is not that one that is carried on primarily for the convenience of members of the hospital for purposes of section 513(a)(2). See Rev. Rul. 85-109. Even if the staff physicians were characterized as members of the hospital, the facts indicate that the convenience to them in their capacity as private physicians rather than in their capacity as members of the hospital.

Although the general rule is that the providing of diagnostic laboratory testing services to nonpatients constitutes unrelated trade or business for a tax-exempt hospital, unique circumstances may exist whereby such services may further the exempt function of the hospital. For example, emergency laboratory diagnosis of blood samples from nonpatient drug overdose or poisoning victims in order to identify specific toxic agents is a necessary community service the absence of which would hinder or jeopardize the medical care of patients of other health care institutions lacking such diagnostic facilities. If referral of these specimens to other locations would be detrimental to the health of hospital nonpatients, a hospital may provide such emergency services in furtherance of its exempt function of promoting community health. Similarly, if other laboratories are not available within a reasonable distance from the area served by the hospital or are clearly unable or inadequate to conduct tests needed by hospital nonpatients, a hospital's testing services may further its exempt function of promoting community health. Whether such unique circumstances exist will be decided by the Internal Revenue Service on a case-by-case basis.

HOLDING

Under the circumstances described above, the performance of diagnostic laboratory testing, otherwise available in the community, by a hospital exempt from federal income tax under section 501(c)(3) of the Code, upon specimens from private office patients of the hospital's staff physicians constitutes an unrelated trade or business within the meaning of section 513.

RECORDKEEPING REQUIREMENTS

Under sections 6001 and 6033 of the Code and the regulations thereunder, a hospital providing diagnostic laboratory services on specimens of nonpatients of the hospital in the manner described above is required to keep records by patient and nonpatient classification in order to establish the portion of income subject to unrelated trade or business income tax under section 511.