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IRS: Revenue From Nonprofit Hospital's Lab Services Isn't Taxable.

In technical advice, the IRS concluded that a tax-exempt hospital's performance of laboratory testing for patients of private physicians located in a city, which is served by the hospital and designated as a "medically underserved population," is not an unrelated trade or business under section 513. The hospital is dedicated to improving the health status of the city's communities by enhancing preventive and primary care and by providing health education. The hospital, which is located in a rural area, describes itself as being committed to improving access to healthcare and to providing services to the underserved.

Rev. Rul. 85-110 provides that while generally a tax-exempt hospital's performance of laboratory testing services for nonpatients constitutes an unrelated trade or business, there may be unique circumstances when those services may further the hospital's exempt function. Those circumstances may exist if other laboratories are not available within a reasonable distance from the area served by the hospital or the laboratories are unable or inadequate to conduct tests needed by nonpatients.

The IRS determined in this case that while other laboratories are available and able to conduct tests for individuals who are not the hospital's patients, they are unable to do so adequately. The nearest full-service, commercial laboratory facility isn't within a reasonable distance of the city and its turnaround time for test results is much slower than the hospital's. The inability of other laboratories to adequately serve the patients of private physicians located in the city and its surrounding communities served by the hospital constitutes a unique circumstance under Rev. Rul. 85-110.

Accordingly, the IRS concluded that the hospital's performance of laboratory testing for the patients of private physicians located in the city and surrounding communities served by the hospital isn't an unrelated trade or business under section 513. The provision of laboratory services for those individuals is substantially related to, and contributes importantly to, the hospital's tax-exempt purpose of improving the health of the city and its surrounding communities. As a result, the hospital's revenue from that activity is not taxable under section 511.

Citations: TAM 201428030

Taxpayer's Name: * * *
Taxpayer's Address: * * *
Taxpayer's ID No.: * * *
Years involved: * * *
Conference held: * * *

UIL: 513.04-00
Release Date: 7/11/2014
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* * * Area Manager, EO Examinations

LEGEND:

A = * * *
B = * * *
C = * * *
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E = * * *
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ISSUE

Is A's performance of laboratory testing for the patients of private physicians located in B and the surrounding communities served by A an unrelated trade or business within the meaning of Section 513 of the Internal Revenue Code?

FACTS

A is a nonprofit corporation formed on F in state C. Its Articles of incorporation state that it was formed to hold title to a hospital building and manage, maintain, and carry on said hospital.

The Internal Revenue Service recognized A as exempt from federal income taxation under [now] section 501(c)(3) of the Code, and as a hospital described in section 170(b)(1)(A)(iii). A is located in the city of B, in state C.

According to A's Bylaws, the hospital is dedicated to improving the health status of the communities of B, G, H, I, J, and K by enhancing preventive and primary care, and by providing health education. A describes itself as being committed to improving access to care and to providing services to the underserved.

B is designated as a "medically underserved population" by the U.S. Department of Health and

Human Services, Hearth Resources and Services Administration, Bureau of Health Professions, Shortage Designation Branch. The United States Census Bureau's Census 2000 data indicate that A is located in a rural area. Residents of B and surrounding communities are eligible to participate in the U.S. Department of Agriculture's Rural Housing Program.

A operates a full-service medical laboratory onsite within the hospital that strives to provide a high level of service to its community. A operates its laboratory 24 hours a day, seven days a week, 365 days a year. One of the laboratory's three pathologists, certified by the American College of Pathologists, is available to provide feedback to physicians 24 hours a day, seven days a week. Depending on the specific test ordered, the laboratory generally provides completed test results to the ordering physician within z-zz hours following receipt of a sample for testing, regardless of the time of day the test is ordered.

The majority of A's laboratory testing services are provided to A's patients. On average, approximately p% of tests performed by the A laboratory have historically involved testing for patients of private physicians (not patients of A) located in B and the surrounding communities of G, H, I, J, and K. A has historically reported income from these tests, for income tax purposes, as giving rise to unrelated business income (UBI). Approximately q% of all A's testing for patients of private physicians represents emergency testing, for which the A laboratory reports results within r hour(s) of receipt of the sample.

Private physicians who refer their patients to A for testing generally have admitting privileges at A. They typically draw the samples in their private offices. The samples are then picked up by an A employee for testing at the A laboratory. Depending on the location of the particular doctor's office or facility being served, the A courier may pick up samples for testing as many as s times per day.

A neither advertises its laboratory testing services nor employs salespeople or marketing professionals. Instead, physicians typically learn about A's laboratory services through A's new physician orientation process and through talking with other physicians.

There are no full-service, commercial or noncommercial laboratories in B or in any of B's surrounding communities. The nearest noncommercial laboratories are those of community Hospital N, which lies to the west of A and its surrounding communities, and community Hospital O, which lies to the east of A and its surrounding communities. The service areas of these other hospitals' laboratories do not overlap with A's laboratory service area.

The nearest full-service, commercial testing laboratory is D, located in E, in state C, approximately t miles from B. The round trip driving time between the D laboratory and B is generally u hours.

D operates drawing stations in both L and M (each approximately v miles from B), each of which is located between B and D's laboratory in E. The drawing stations perform no testing services on-site. Rather, these stations draw samples which are transported to the D facility in E for testing and analysis. The samples drawn at the stations are generally picked up by D near the end of the day. In comparison, A picks up samples as frequently as s times per day.

D offers medical testing services to B-area physicians by providing a courier service which picks up samples from physicians' B-area offices and transports the samples to D's laboratory in E for testing. A indicated that D's courier generally picks up samples from physicians' offices located in B and its surrounding communities after the close of the physicians' normal business hours. The D courier then completes its route and delivers the samples to D's laboratory. Commonly ordered tests may be processed during the night, whereas less commonly ordered tests may be batched for processing later. Results of completed tests may be reported to the ordering physician w or more times per day

depending upon D's arrangement with the specific physician.

The turnaround time for B-area physicians who send samples to D varies depending on whether the samples are drawn before or after D's daily pick up, and whether the laboratory tests are completed before or after D's scheduled delivery of test results. A B-area physician who draws a sample in his or her office in the morning for a commonly processed test would generally anticipate receiving laboratory test results from D the following morning (a turnaround time of up to x hours). In contrast, A's test result delivery in such a scenario is generally z-zz hours.

A states that D also offers emergency testing services. D typically performs each emergency test and provides the results of the test within y hours of receipt of the sample by D's courier. In comparison, A's emergency service generally provides a maximum turnaround of r hour(s).

D does not advertise in the B telephone book or actively market its laboratory work in the B area. Furthermore, the president of A's medical staff reported that neither he nor A have ever been solicited by D.

A states that most physicians in B and its surrounding communities use A's laboratory to test samples from their patients. A believes that the consensus of the private physicians in the B area is that A's laboratory services are adequate for their patients, whereas D's laboratory services are inadequate.

A represents that B-area doctors view the substantial difference in laboratory turnaround times between the A laboratory and the D as a critical distinction that may have important medical consequences for their patients, particularly for those who are elderly. A emphasizes the importance of timely information to doctors' medical decision making. Timing is critical, as several hours difference in receiving test results can make a significant difference in patient diagnosis and treatment. A states that that the recent trend toward reduced inpatient hospitalization and shorter inpatient stays has generally reduced the ability of physicians to physically observe patients and increased physicians' dependence upon outpatient, post-hospitalization laboratory testing. Consequently, physicians are required to make quicker medical decisions with respect to their patients. The need to order further tests, the need to modify medication levels, and the need to refer patients for emergency room care, inpatient check-in, or surgery are all vital medical decisions which frequently depend upon timely results of laboratory tests, according to A. For example, the results of a complete blood count test could indicate whether a patient is bleeding internally, suffering from coronary heart disease, or experiencing a heart attack, and could indicate the need for immediate medical intervention.

APPLICABLE LAW

Section 511 of the Code imposes a tax on the unrelated business taxable income (defined in section 512) of organizations exempt from tax under section 501(c).
Section 512 of the Code provides that the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (defined in section 513) regularly carried on by it, less the allowable deductions which are directly connected with the carrying on of such trade or business.

Section 513(a) of the Code provides that the term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption.

Section 1.513-1(d)(2) of the regulations provides that a trade or business is "related" to exempt purposes only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income). Further, it is "substantially related," for purposes of section 513 of the Code, only if the causal relationship is a substantial one. For this relationship to exist, the production or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of exempt purposes. Whether the activities productive of gross income contribute importantly to such purposes depends in each case upon the facts and circumstances involved.

Rev. Rul. 85-110, 1985-1 C.B. 166, addresses whether the performance of diagnostic laboratory testing by a tax exempt hospital upon specimens from patients of private physicians (who are not patients of the hospital) constitutes unrelated trade or business within the meaning of section 513 of the Code. The hospital laboratory performed diagnostic laboratory testing upon specimens obtained by non-employee staff physicians at non-hospital facilities from members of the public who were not Hospital patients. The revenue ruling stated that commercial laboratories that performed testing identical to that performed by the hospital were available in the area and provided testing services on a timely basis. As such, the hospital laboratory's testing for the patients of private physicians who were not Hospital patients constituted a separate trade or business.

Rev. Rul. 85-110 provides that the provision of diagnostic laboratory testing to a private physician's patients (who are not Hospital patients) normally constitutes an unrelated trade or business for a tax-exempt hospital The revenue ruling also provides an exception to the general rule, stating in part.

. . . 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.

ANALYSIS

Rev. Rul. 85-110 provides that although the general rule is that the providing of laboratory testing services by a tax exempt hospital to nonpatients constitutes unrelated trade or business, unique circumstances may exist whereby such services may further the hospital's exempt function. Such "unique circumstances" may exist if other laboratories are (1) not available within a reasonable distance from the area served by the hospital, or (2) clearly unable or inadequate to conduct tests needed by Hospital Nonpatients. See Rev. Rul. 85-110. Here, although other laboratories are available and able to conduct tests needed by A's nonpatients, they are unable to do so adequately, for the reasons described below. Thus, unique circumstances exist whereby A's laboratory services to nonpatents in B and its surrounding communities further its tax exempt purpose.

The tax-exempt purpose of A is to improve the health status of B and its surrounding communities. A is located in B, which is designated as a "medically underserved population" by the U.S. Department of Health and Human Services. A is located in a rural area, according to the U.S. Census Bureau.

The nearest full-service, commercial laboratory facility to the A laboratory is D, which is approximately t miles and a u-hour round trip from A's laboratory. The general turnaround time for results from A's laboratory, z-zz hours, is considerably faster than D's turnaround time. A estimates the average differential in turnaround time to be between xx and yy hours.

A believes that the consensus of the private physicians in the B area is that A's laboratory services

are adequate for their patients, whereas D's laboratory services are inadequate. A indicates that most physicians in B and the surrounding communities utilize A's laboratory for speedier results, primarily because of the substantial difference in turnaround time between A's laboratory and D. The difference in turnaround time can have important medical consequences for patients. A difference of several hours in receiving test results can make a significant difference in patient diagnosis and treatment, as test results may indicate the need for immediate medical intervention, including modifying medication levels, providing further testing or treatment, or conducting surgery. For instance, the results of a complete blood count test could indicate whether a patient is bleeding internally, suffering from coronary heart disease, or experiencing a heart attack, and could indicate the need for immediate medical intervention.

Therefore, although D's laboratory is available for use by physicians and patients in B and its surrounding communities, D is not within a reasonable distance of those communities to adequately serve their health care needs, particularly the needs of patients for timely laboratory testing. See Rev. Rul. 85-110. Because A provides adequate laboratory services to B and its surrounding communities, A promotes the health of the community, and its laboratory services contribute importantly to the accomplishment of A's tax exempt purpose of improving the health of its community. See section 1.513-1(d)(2) of the regulations.

Accordingly, the inability of other laboratories to adequately serve the patients of private physicians located in B and the surrounding communities served by A constitutes "unique circumstances" under Rev. Rul. 85-110. Thus, A's provision of laboratory services to such patients furthers A's tax exempt purpose of improving the health of B and its surrounding communities.

CONCLUSION

A's performance of laboratory testing for the patients of private physicians located in B and the surrounding communities served by A is not an unrelated trade or business within the meaning of section 513 of the Code. The provision of laboratory services for such persons is substantially related to, and contributes importantly to. As tax exempt purpose of improving the health of B and its surrounding communities, consistent with section 1.513-1(d)(2) of the regulations and the "unique circumstances" test of Rev Rul. 85-110. Accordingly. A's revenues from such activity is not taxable under section 511 of the Code.

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