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Executive Director

March 19, 1997

**Re: Revenue and Taxation Code, Section 214¹
Hospital Laboratory/Nonhospital Use**

Dear Mr. :

This is in response to your letter of December 19, 1996, in which you presented the following facts:

Your client (HOSPITAL) is a nonprofit tax exempt Internal Revenue Code section 501(c)(3) organization with a section 214 welfare exemption. It maintains and operates a clinical laboratory which performs various clinical tests and services for its inpatients and its outpatients; this laboratory is underutilized and can accommodate additional volume. It is considering establishing a "reference laboratory" in which it will accept referrals from private physicians to provide services to nonpatients of HOSPITAL.

The reference laboratory will generate revenue. It is anticipated that this revenue will be used by HOSPITAL to meet its various exempt purposes.

You inquire as to the effect of this new operation on the section 214 welfare exemption and ask specifically:

1. Will this affect HOSPITAL's welfare exemption from real and personal property taxes (property taxes), in whole or in part?

¹ All statutory references are to the Revenue and Taxation Code.

2. If HOSPITAL can demonstrate that the operation of a reference laboratory augments its ability to fulfill its hospital/charitable purpose, will the welfare exemption remain unaffected?
3. If there is some assessment, how will it be determined?

Briefly, it is our opinion that HOSPITAL would lose that portion of its tax exemption attributable to the reference laboratory; use of hospital property for a reference laboratory is a non-exempt use and if a reference laboratory is established, HOSPITAL property used therefor will not be used exclusively for exempt hospital purposes and activities. This is true even though a functioning laboratory is necessary for hospital purposes and even though profits from the reference laboratory operations augment HOSPITAL's income and its ability to meet its hospital purpose. The local county assessor would make a field inspection to determine what portion of the hospital property was used for the reference laboratory; the portion of property used for that non-exempt purpose and activity would be ineligible for the property tax welfare exemption. If the operations and space of the reference laboratory were indistinguishable from the hospital laboratory, the entire laboratory would be non-exempt.

Further, you state that this request is made pursuant to section 5909. Section 5909 relates to letters written by local county assessors and hence, is not relevant to your inquiry.

LAW AND ANALYSIS

As background, we note that all property is subject to taxation unless it is exempt. The California Constitution, article XIII, section 4 provides for eligibility for welfare exemption and states in subdivision (b):

[The Legislature may exempt from property taxation in whole or in part:]

(b) Property used exclusively for religious, hospital, or charitable purposes and owned or held in trust by corporations or other entities (1) that are organized and operating for those purposes, (2) that are nonprofit, and (3) no part of whose net earning inures to the benefit of any private shareholder or individual. (Emphasis added.)

Section 214, subdivision (a), exclusive use.

The Legislature exercised its authority pursuant to the state constitution and enacted section 214 which provides for an exemption known as the "welfare exemption"; HOSPITAL is

now exempt from the payment of property taxes based on this exemption. Section 214, subdivision (a) has a threshold requirement that the qualifying property be used exclusively for hospital purposes. (Subsection (3) of subdivision (a) of section 214 addresses the requirement of use for the actual operation of an exempt activity and also occasional nonqualifying use, and will be discussed below.) Section 214, subdivision (a) provides in part:

(a) Property used exclusively for religious, hospital, scientific, or charitable purposes owned and operated by community chests, funds, foundations or corporations organized and operated for religious, hospital, scientific, or charitable purposes is exempt from taxation, . . . if [certain requirements are met]:

That the property be "used exclusively" for hospital purposes is required by the state constitution and section 214. The term "used exclusively" is not defined by statute; there is case law defining that term in a property tax case involving an educational institution. Although not specific to the welfare exemption, the definition of "used exclusively" as used in the public schools exemption was construed by the Court of Appeal in *Honeywell Information Systems, Inc. v. County of Sonoma* (1974) 44 C.A.3d 23, 118 Cal.Rptr.422. That construction of "used exclusively" has been applied by the State Board of Equalization in its application of the welfare exemption. Citing *Cedars of Lebanon Hosp. v. County of L.A.* (1950) 35 Cal.2d 729, 221 P.2d 31 and other cases, the court in *Honeywell* held:

[O]ur Supreme Court laid down the rule that the phrase in question ["used exclusively for"] should be held to include any property which is used exclusively for any facility which is *incidental to and reasonably necessary for the accomplishment of hospital purposes*, or in other words, for any facility which is *reasonably necessary for the fulfillment of a generally recognized function of a complete modern hospital*. (Emphasis in original.) *Honeywell, supra* at p. 28.

In applying the definition set out in *Cedars of Lebanon Hosp.* and *Honeywell*, the question in the case at hand is this: considering that a laboratory is reasonably necessary for the fulfillment of a generally recognized hospital function, does a hospital laboratory still meet the "exclusive use" requirement when laboratory operations are expanded to include a reference laboratory which provides fee services to individuals who are not hospital patients. Phrased another way, is a reference laboratory, operated for reasons other than direct patient care, used exclusively for hospital purposes. In considering this question, one must ask - what is the recognized function of this nonprofit hospital. We assume that the primary purpose is to provide medical services to HOSPITAL's patients. A reference laboratory has a different purpose; it provides medical services to nonhospital patients and generates income for HOSPITAL's use.

Laboratory services are analogous to the computer services at issue in the *Honeywell* case. In that case, the court held that the county use of leased computers for educational services was an exempt activity; however, the use of leased computers by noncounty entities for a fee was not

an exempt activity because it was "not reasonably necessary to further the primary purpose of the public schools, but was merely a revenue generating device." *Honeywell, supra* at p. 29.

Using this same reasoning and assuming that HOSPITAL's purpose is to serve its patients, it is our opinion that the operation of a reference laboratory is not reasonably necessary to further HOSPITAL's hospital purpose and therefore, the use of the laboratory for reference patients would mean that HOSPITAL property used for the reference laboratory would not be used exclusively for hospital purposes within the meaning of section 214.

In addition to a hospital purpose of providing direct services to its patients, HOSPITAL probably has, as one of its purposes, the goal to provide medical services to people in the community in which it is located. Notwithstanding this, the reference laboratory would function similarly to any private laboratory. It would accept referrals from private physicians to provide services to those physicians and to those physicians' patients who are not hospital patients. "It follows that if the property of a tax-exempt institution competes in the common business with the property of other owners, it must bear the tax as much as theirs bears; and when it is used to raise money it becomes taxable." *Honeywell, supra* at p. 30.

Use of revenue for HOSPITAL purposes.

That the income generated by the reference laboratory would be used to augment HOSPITAL resources is not a basis for finding the reference laboratory to be exempt. A cornerstone case for this proposition is *Cedars of Lebanon Hosp., supra*, where thrift shop operations were not eligible for the welfare exemption even though the revenues generated by the thrift shop were used for hospital purposes. The same result was found in *Honeywell* where the court rejected the argument that the use of the revenue should be considered rather than the source of the revenue.

It has been repeatedly said that it is the use of the property which renders it exempt or nonexempt, not the use of income derived from it. [citations] As the court put it in *Y.M.C.A. v. County of L. A.* [citation]: "But conceding the praiseworthy motives underlying the establishment of these respective facilities as outlined by plaintiff, it must be remembered that the test for the ... exemption is not the number of good purposes to which plaintiff's property may be put nor the amount of benefit that may be derived therefrom by plaintiff's members as well as the general public, but whether the property may reasonably be regarded as 'exclusively used' for exempt purposes. ... That the money derived therefrom may be used exclusively for plaintiff's operational upkeep as a charitable organization [citation] or that such facilities may be desirable in the promotion of plaintiff's general service plan does not alter the fact that they involve the use of portions of

plaintiff's property for facilities which are not merely incidental to and reasonably necessary for the accomplishment of exempt purposes." *Honeywell, supra* at p. 29-30.

Thus, based on *Cedars of Lebanon Hosp., Honeywell* and other cases, use of property for a reference laboratory is not exclusive use for hospital purposes and activities; if HOSPITAL were to operate a reference laboratory, based on the above analysis, HOSPITAL property used for the reference laboratory would not be used exclusively for hospital purposes and activities. The welfare exemption would not apply to that portion of the property used therefor.

Section 214, subdivision (a)(3), use for the actual operation of an exempt activity.

Section 214, subdivision (a)(3) requires use for the actual operation of an exempt (hospital) activity, as discussed above. The general rule is set out in this subdivision which provides:

[Property used exclusively for hospital purposes is exempt from taxation, if:]

(3) The property is used for the actual operation of the exempt activity, and does not exceed an amount of property reasonably necessary to the accomplishment of the exempt purpose.

* * *

As discussed above regarding exclusive use for hospital purposes and activities, fundraising activities are not considered to be within the rubric of hospital purposes and activities; thus, property used for fundraising is not "used in the actual operation of an exempt activity" and does not meet the general requirement of exclusive use as set forth in subdivision (a)(3) of section 214.

Section 214, subdivision (a)(3)(A) and (B), occasional use.

Notwithstanding the general rule that "property is used for actual operations of the exempt activity" in order to qualify for the welfare exemption, it is recognized that there are situations when exempt property is used for non-exempt purposes and activities such as fundraising. Section 214, subdivision (a)(3)(A) and (B) basically sets out "exceptions" to the general rules of exclusive use and use for actual operations; non-exempt use will not thwart exemption eligibility if the criteria set out in section 214, subdivision (a)(3)(A) and (B) is met; those subsections provide:

[Property used exclusively for hospital purposes is exempt from taxation, if:]

(3) The property is used for the actual operation of the exempt activity, and does not exceed an amount of property reasonably necessary to the accomplishment of the exempt purpose.

(A) For the purposes of determining whether the property is used for the actual operation of the exempt activity, consideration shall not be given to use of the property for either or both of the following described activities if that use is occasional:

(i) [Fundraising activities by the owner]

(ii) [Fundraising activities by other organizations meeting certain requirements]

(B) For purposes of subparagraph (A):

(i) "Occasional use" means use of the property on an irregular or intermittent basis by the qualifying owner or any other qualifying organization described in clause (ii) of subparagraph (A) that is incidental to the primary activities of the owner or the other organization.

(ii) "Fundraising activities" means both activities involving the direct solicitation of money or other property and the anticipated exchange of goods or services for money between the soliciting organization and the organization or person solicited. (Emphasis added.)

Thus, the next question is: would the non-exempt use of the reference laboratory fall within "occasional use" as defined by subsection (B)(i) of section 214, subdivision (a)(3).

You have provided general information regarding the proposed operation of the reference laboratory: it will accept referrals from private physicians; a uniform fee schedule will be used and a business plan has been approved by the Health Care Financing Administration, Region IX. Based on this information, it would appear that the use of the reference laboratory would be a regular, ongoing business and would not fall within the definition of "occasional use" as set forth in section 214, subdivision (a)(3)(A) and (B)(i). Thus, the "leeway" in section 214, subdivision (a)(3) to "not consider" certain nonexempt activities would not be applicable in this case.

The area and equipment used for nonexempt activity is not eligible for exemption. The local county assessor will determine what portion of the property is not exempt.

The task of allocating that portion of HOSPITAL property used for the reference laboratory and no longer eligible for the welfare exemption would be a task for the local county assessor. A field inspection would be made and an allocation made, as appropriate. If the

operations and space of the reference laboratory were mingled with the operations and space of the hospital laboratory, the local county assessor and the Board would find the entire laboratory ineligible for the exemption based on the non-exclusive use of that area. Additionally, other commonly used portions of the hospital property would be ineligible for the exemption.

Section 214.05 is not applicable.

You inquire as to how a partial assessment will be determined and refer to section 214.05; this section provides guidelines on the calculation of partial assessments for exempt properties generating unrelated business taxable income. This section is inapplicable because it contains a threshold condition of exclusive use which would not be met by HOSPITAL with regard to the reference laboratory. Subdivision (a) of section 214.05 begins:

If the property of an organization is granted an exemption pursuant to Section 214, that property is deemed to be used exclusively for the organization's exempt purposes. . . . (Emphasis added.)

Again, because a condition of the statute is not met, the statute is inapplicable.

Section 5909 is not applicable.

Section 5909 provides that county assessors may respond to taxpayer's written requests for written rulings on the tax consequences of particular tax transactions. The statute provides that county assessors may consult with the Board staff for purposes of statewide uniformity and provides some relief from penalties and interest under specified circumstances. Please note that this response is not a section 5909 writing; it is directly from the Board of Equalization staff as part of our function to advise both local county assessors and the public on various tax matters.

For your general information, please note that section 254.5 provides for a review of welfare exemption claims by the Board. However, please also note that a local county assessor may impact or offset a decision by the Board regarding welfare exemption eligibility if the Board grants eligibility but the local county assessor subsequently denies eligibility. Further, a local county assessor may not grant the claim of an applicant if the Board finds the applicant ineligible.

CONCLUSION

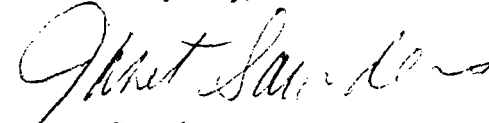
Based on the above facts and analysis, HOSPITAL's use of its property for a reference laboratory as described would be a nonqualifying use of the portion of the property used therefor and would constitute a use other than for hospital purposes and activities, as section 214 requires. If such laboratory is established, that portion of the hospital property used for the reference

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laboratory, together with any common areas of the hospital property used by the reference laboratory, would not be eligible for the exemption.

Our intention is to provide timely, courteous and helpful responses to inquiries such as yours. Suggestions that help us to accomplish this goal are appreciated.

Yours very truly,



Janet Saunders
Tax Counsel

JS:sao

cc:

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