

IN THE SUPREME COURT OF APPEALS OF WEST VIRGINIA

APPEAL NO. 33682

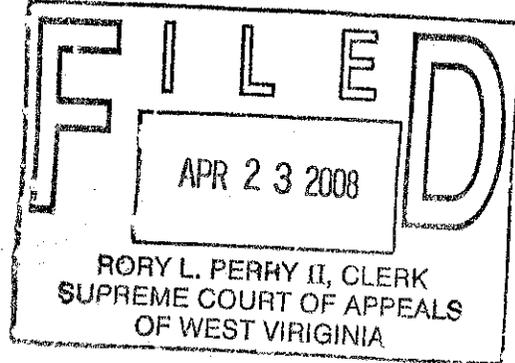
DAVIS MEMORIAL HOSPITAL,

Appellant,

v.

WEST VIRGINIA STATE TAX COMMISSIONER,

Respondent.



TAX DEPARTMENT'S BRIEF

**WEST VIRGINIA STATE TAX
COMMISSIONER,**

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TAX DEPARTMENT'S BRIEF

I. PROCEDURAL HISTORY

Davis Memorial Hospital (hereinafter "Davis Memorial" or "Davis Hospital") filed a claim for refund of West Virginia consumers sales tax and West Virginia use tax on May 9, 2005. Davis Memorial demanded a refund of \$799,501.16 for the 2002 calendar year.¹ The Tax Department denied the requested refund. Davis Memorial filed a timely appeal to the West Virginia Office of Tax Appeals (hereinafter "OTA").

Subsequently, OTA conducted an administrative hearing and both parties submitted legal briefs on the issues. On November 15, 2006 Administrative Law Judge Robert W. Kiefer, Jr., (hereinafter, ALJ Kiefer) issued a decision which affirmed the Tax Department's denial of the refunds. ALJ Kiefer concluded that Davis Memorial Hospital must include receipts from patient

¹Although Davis Memorial requested a refund of both consumers sales tax and use tax, the Tax Department will refer to consumers sales tax only for the sake of brevity. As noted *infra*, the two taxes are complementary. An exemption from one is also an exemption from the other.

revenues in calculating its support for the purposes of claiming the exemption from consumers sales tax set forth in WV Code § 11-15-9(a)(6). Davis Memorial Hospital appealed the OTA decision to the Circuit Court of Randolph County.

The Honorable John L. Henning, Circuit Court of Randolph County, adjudicated the appeal. Judge Henning reviewed the case record, requested both parties to submit legal briefs, and conducted oral arguments on the tax issue on April 18, 2007. Based upon the legal pleadings filed by both parties and the oral arguments heard by the court, Judge Henning issued an order on June 27, 2007 which affirmed the OTA decision and upheld the Tax Department's position. Davis Memorial Hospital is attempting to appeal Judge Henning's decision to the Supreme Court of Appeals.

II. STANDARD OF REVIEW

The standard of review under West Virginia law is not disputed. Interpreting a statute presents a purely legal question subject to *de novo* review. *Appalachian Power Company v. State Tax Department of West Virginia*, 195 W. Va. 573, 466 S.E.2d 424 at Syllabus Point 1 (WV 1995); see also *Shawnee Bank, Inc., v. Paige*, 200 W. Va. 20, 488 S.E.2d 20 at Syllabus Point 1 (citing *Appalachian Power Company, supra*) (WV 1997). The underlying administrative decision is reviewed according to a clearly erroneous standard. *Shawnee Bank, supra*, at Syllabus Point 2 ("Once a full record is developed, both the circuit court and this Court will review the findings and conclusions of the Tax Commissioner under a clearly erroneous and abuse of discretion standard unless the incorrect legal standard was applied." (citing) Syllabus point 5, *Frymier-Halloran v. Paige*, 193 W.Va. 687, 458 S.E.2d 780 (1995)). Both the Office of Tax Appeals and Judge Henning came to the same legal conclusion— patient revenues must be included in calculating a hospital's support for the purposes of claiming an exemption from the West Virginia consumers sales tax.

Absent an abuse of discretion or a clearly erroneous conclusion, the decisions below should be affirmed.

III. STATUTORY ANALYSIS

Davis Memorial Hospital argues that it should be exempt from paying West Virginia consumers sales tax and use tax on all its purchases of tangible personal property and services pursuant to W. Va. Code § 11-15-9(a)(6)(C). The statutory question becomes whether Davis Memorial receives more than half of its support from any combination of gifts, grants, direct or indirect charitable contributions, or membership fees. If you ignore the \$64,180,500.00 which Davis Memorial receives from treating patients in calculating the term "support", then Davis Memorial qualifies for the exemption. However, if you do not ignore the \$64,180,500.00 in patient revenues earned by Davis Memorial Hospital, then Davis Memorial does not qualify for the exemption. Can you ignore the elephant standing in the middle of the room? ²

West Virginia imposes a consumers sales tax and a use tax on all sales of tangible personal property and selected services. West Virginia Code §§ 11-15-3(a) and 11-15A-2(a). The two taxes are intended to be complementary. W. Va. Code §§ 11-15-1 and 11-15A-1a. The consumers sales tax specifically includes the presumption that all sales are taxable. "To prevent evasion, it shall be

² The OTA decision used the figure of \$ 64, 179, 528.00 for patient revenues in the support test based upon Line 2 of Davis Hospital's "Return of Organization Exempt From Income Tax", Internal Revenue Return, Form 990, 2002 calendar year. See Administrative Record, OTA Document Index, at Document No. 25. Judge Henning used the figure of \$ 64, 180, 500.00 based upon Line 104 of Davis Hospital's Internal Revenue return for the year 2002. The Tax Department states that the difference between the two numbers (\$ 972.00) is negligible for purposes of the support test calculation. The Tax Department will employ the figure used by Judge Henning for the sake of simplicity.

presumed that all sales and services are subject to tax until the contrary is clearly established.”

W. Va. Code § 11-15-6.

Davis Memorial Hospital is a Section 501(c)(3) organization under the Internal Revenue Code and claims to be exempt from the consumers sales tax based upon that status as provided by W. Va. Code § 11-15-9(a)(6)(C) and (F). The exemption states, in pertinent part, :

(a) Exemptions for which exemption certificate may be issued....

(6) Sales of tangible personal property or services to a corporation or organization which has a current registration certificate issued under article twelve of this chapter, which is exempt from federal income taxes under Section 501(c)(3) or (c)(4) of the Internal Revenue Code of 1986, as amended, and which is:....

(C) A corporation or organization which **annually receives more than one half of its support** from any combination of gifts, grants, direct or indirect charitable contributions or membership fees;....

(F) For purposes of this subsection:

(i) The term "support" includes, but is not limited to:

(I) Gifts, grants, contributions or membership fees;

(II) Gross receipts from fundraisers which include receipts from admissions, sales of merchandise, **performance of services or furnishing of facilities in any activity which is not an unrelated trade or business within the meaning of Section 513 of the Internal Revenue Code of 1986**, as amended;

(III) Net income from unrelated business activities, whether or not the activities are carried on regularly as a trade or business;

(IV) Gross investment income as defined in Section 509(e) of the Internal Revenue Code of 1986, as amended;

(V) Tax revenues levied for the benefit of a corporation or organization either paid to or expended on behalf of the organization; and

(VI) The value of services or facilities (exclusive of services or facilities generally furnished to the public without charge) furnished by a governmental unit referred to in Section 170(c)(1) of the Internal Revenue Code of 1986, as amended, to an organization without charge. This term does not include any gain from the sale or other disposition of property which would be considered as gain from the sale or exchange of a capital asset or the value of an exemption from any federal, state or local tax or any similar benefit;

(ii) The term "charitable contribution" means a contribution or gift to or for the use of a corporation or organization, described in Section 170(c)(2) of the Internal Revenue Code of 1986, as amended; and

(iii) The term "membership fee" does not include any amounts paid for tangible personal property or specific services rendered to members by the corporation or organization;

(G) The exemption allowed by this subdivision does not apply to sales of gasoline or special fuel or to sales of tangible personal property or services to be used or consumed in the generation of unrelated business income as defined in Section 513 of the Internal Revenue Code of 1986, as amended. The exemption granted in this subdivision applies only to services, equipment, supplies and materials used or consumed in the activities for which the organizations qualify as tax-exempt organizations under the Internal Revenue Code and does not apply to purchases of gasoline or special fuel.

W. Va. Code § 11-15-9(a)(6) (emphasis added).

The consumers sales tax exemption employs a "support" test. The key question presented to Judge Henning and the Office of Tax Appeals was, actually, a rather simple question. How does Davis Memorial Hospital support itself?

Ask the typical man on the street in Randolph County that question and he will answer immediately. Assume, for example, that an individual falls down and breaks his leg. The individual

is taken to Davis Memorial Hospital where surgeons, anaesthesiologists, physical therapists, nurses, and other health care professionals, fix his broken leg. After a hospital stay of a few days, the individual leaves Davis Hospital on crutches. The individual's broken leg has been fixed while at the hospital. However, before the individual is discharged from the hospital, he is handed a bill for \$10,000.00 for fixing his broken leg.

How does Davis Memorial Hospital support itself? Davis Memorial Hospital supports itself by charging for medical services provided to sick and injured people. In the 2002 calendar year, Davis Memorial Hospital earned \$64,180,500.00 in patient revenues for providing medical treatment to sick and injured patients. *See* Judge Henning's Order entered June 27, 2007 at P. 8; *see* also Davis Memorial Hospital's 2002 Federal Income Tax Return, Form 990 at L. 104, OTA Document Index, Document Number 25. Davis Memorial Hospital specifically listed \$64,180,500.00 as "Related or exempt function income" on the 2002 Form 990. *Id.*

Nevertheless, Davis Hospital argued that the Tax Department, the Office of Tax Appeals, and Judge Henning, should limit support for the purposes of the calculation required under Section 9(a)(6)(F)(i)(II) only to admissions to fundraisers, sales of merchandise at fundraisers, performance of services related to fundraisers, and furnishing of facilities related to fundraisers. On appeal to the Circuit Court Davis Memorial argued that WV Code § 11-15-9(a)(6)(F)(i)(II) should be read narrowly due to the use of restrictive subordinate clauses. *See* Petition For Appeal at P. 4. While the grammatical analysis was interesting, it was not very helpful. Restrictive and non-restrictive subordinate clauses are useful tools in analyzing sentences. *See eg* Prentice Hall Handbook For Writers, Sixth Edition at PP. 118-126 (Prentice-Hall, Inc. 1974). However, the Legislature did not write a complete sentence. The Legislature issued a list of items to be included in the term "support"

and separated the items with simple commas. It is correct to use commas to separate items in a list.

Id at P. 127.

Judge Henning clearly rejected the grammatical argument proffered by the Appellant. As Judge Henning noted in the Circuit Court decision, Davis Hospital argued that the term “support” should be limited to only to the enumerated activities based upon a grammatical analysis.

Under Petitioner’s theory of this case, W. Va. Code § 11-15-9(a)(6)(F)(i)(II), the lack of comma following “which” requires the phrase to be restrictive. As applied to the statute and Petitioner’s situation, “support” means not any “gross receipts from fund raisers” but *only certain* “gross receipts from fund raisers.” Petitioner’s interpretation of the statute would then have the Court find that “gross receipts from fund raisers” include *only* the enumerated activities listed in the statute: “(1) admissions, (2) sales of merchandise, (3) performance of services or (4) furnishing of facilities in any activity which is not unrelated trade or business. (emphasis added).

Judge Henning’s Order entered June 27, 2007 at PP. 6 & 7 (emphasis in italics included in Judge Henning’s Order; emphasis underlined is added).

The Circuit Court specifically rejected the restrictive reading proffered by the Appellant and adopted a common sense reading of the statutory exemption. *Id* at PP. 9 & 10.

The record established in the OTA Order, in addition to the examination of pertinent West Virginia case law, convinces this Court that a legislative intent was clear, in so much that receipts from *all* activities, including those from admissions, sales of merchandise, performance of service and furnishing of facilities, so long as they are derived from a related trade or business, were to be included as “gross receipts from fund raisers.” (emphasis added) This results in the inclusion of Petitioner’s income from providing services in the amount of \$ 64,180,500.00.

Judge Henning’s Order at PP. 9 & 10 (emphasis in italics included in Judge Henning’s Order; emphasis underlined is added).

The OTA decision also discussed the exemption at great length. The exemption specifically states that the calculation for the term "support" must include gross receipts from any activity which is **not an unrelated trade or business** as defined in the Internal Revenue Code. The consumers sales tax exemption at issue specifically includes income which is **not unrelated** business income in the definition of support.

(F) For purposes of this subsection:

(i) The term "support" includes, but is not limited to:....

(II) Gross receipts from fundraisers which include receipts from admissions, sales of merchandise, performance of services or furnishing of facilities in any activity which is not an unrelated trade or business within the meaning of Section 513 of the Internal Revenue Code of 1986, as amended;

W. Va. Code § 11-15-9(a)(6)(F)(i)(II) (emphasis added).

Clearly, the Legislature intended that gross receipts from business activities which are **not unrelated** business activities must be included in the calculation of support.

If support includes **not unrelated** business income, then the question becomes—What is **not unrelated** business income? The Internal Revenue Code defines the term "unrelated business income" in a rather straightforward manner.

Unrelated trade or business.

(a) General rule.--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 (aside from the need of such organization for income or funds or the use it makes of the profits 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 (or, in the case of an organization described in section 511(a)(2)(B), to the exercise or

performance of any purpose or function described in section 501(c)(3)), except that such term does not include any trade or business--

(1) in which substantially all the work in carrying on such trade or business is performed for the organization without compensation; or

(2) which is carried on, in the case of an organization described in section 501(c)(3) or in the case of a college or university described in section 511(a)(2)(B), by the organization primarily for the convenience of its members, students, patients, officers, or employees, or, in the case of a local association of employees described in section 501(c)(4) organized before May 27, 1969, which is the selling by the organization of items of work-related clothes and equipment and items normally sold through vending machines, through food dispensing facilities, or by snack bars, for the convenience of its members at their usual places of employment; or

(3) which is the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions.

26 USC § 513(a)(emphasis added).

According to Davis Memorial's internal revenue return for an exempt organization, Davis Memorial is exempt from federal income taxes under Section 501(c)(3) of the Internal Revenue Code for the purpose of providing acute and home health care services. *See* 2002 Return of Organization Exempt From Income Tax at Part III, OTA document Index-- Document 25. Davis Memorial Hospital is in the business of providing medical care to sick and injured people. No one can dispute the fact that the activity of Davis Memorial Hospital in treating sick and injured people is an activity which is **not unrelated** to the purposes for which Davis Memorial is exempt from federal income taxation.

At the administrative hearing the Tax Department argued that the receipts earned by Davis Memorial Hospital from providing medical services to patients must be included in the calculation for total support. The Tax Department specifically included the \$64,180,500.00 in patient revenues for 2002 in calculating total support. *See* Tax Department's Reply Brief at PP. 2 & 3, OTA

Document Index– Document 15. ALJ Kiefer concluded that Davis Memorial’s **not unrelated** business activities must be included in the calculation of total support. ALJ Kiefer wrote, “ In considering the language of the statute, it appears that the intention of the Legislature, as clearly expressed in the plain language of the statute, is that gross receipts from the operation of a business by a non-profit organization must be included as part of the organization’s “support.”” See OTA Decision at PP. 13 & 14, OTA Document Index– Document 26. The OTA decision drew the conclusion that the receipts from the operation of the hospital must be included in the term “gross receipts from fund raisers” as the statute defined the term. Id at Conclusions of Law– Conclusion No.4.

In addition, Davis Memorial also argued at the administrative hearing that the West Virginia Legislature adopted the definition of support found in WV Code § 11-15-9(a)(6) from the Internal Revenue Code.

The history of W.Va. Code §11-15-9(a)(6)(F)(i) plays an important role in determining whether or not the Petitioner is entitled to claim that it meets the support test found at W.Va. Code § 11-15-19(a)(6)(c). The term “support” found at W.Va. Code §11-15-9(a)(6)(F)(i) was adopted by the West Virginia Legislature in April, 1989. This definition of “support” was adopted verbatim from an existing federal definition of “support” found at IRC §509(d).

Petitioner’s Legal Brief at P.7, OTA, Document Index - Document 14.

The Tax Department accepted Appellant’s representation as correct.

As stated *supra*, this case raises the question of whether to include the receipts from medical services–Davis Memorial’s **not unrelated** business activities– in the calculation of support. The administrative regulations for Section 509 of the Internal Revenue Code addressed the issue.

(2) Examples. The application of this paragraph may be illustrated by the examples set forth below. For purposes of these examples, the term "general public" is defined as persons other than disqualified persons and other than persons from whom the foundation receives gross receipts in excess of the greater of \$5,000 or 1 percent of its support in any taxable year, **and the term "gross receipts" is limited to receipts from activities which are not unrelated trade or business (within the meaning of section 513).**

Example (1). For the taxable year 1970, X, an organization described in section 501(c)(3), received support of \$10,000 *{sic}* from the following sources:

Bureau M (a government bureau from which X received gross receipts for services rendered)	\$25,000
Bureau N (a governmental bureau form which X received gross receipts for services rendered)	25,000
General public (gross receipts for services rendered)	20,000
Gross investment income	15,000
Contributions from individual substantial contributors (defined as disqualified persons under section 4946(a)(2)	<u>15,000</u>
Total support	100,000

Since the \$25,000 received from each bureau amounts to more than the greater of \$5,000 or 1 percent of X's support for 1970 (1% of \$100,000=\$1,000) under section 509(a)(2)(A)(ii), each amount is includible in the numerator of the one-third support fraction only to the extent of \$5,000. Thus, for the taxable year 1970, X received support from sources which are taken into account in meeting the one-third support test of section 509(a)(2)(A) computed as follows:

Bureau M	\$5,000
Bureau N	5,000
General public	<u>20,000</u>
Total	30,000

Therefore, in making the computation required under paragraph (c), (d), or (e) of this section, only \$30,000 is includible in the aggregate numerator and \$100,000 is includible in the aggregate denominator of the support fraction.

Federal Tax Regulation 1989-§1.509(a)-3 at P. 978 (emphasis added).

The IRC Regulations clearly included the \$70,000 from gross receipts for services rendered in a **not unrelated** business activity when calculating the total support under IRC Section 509(d). The Tax

Department has conceded that IRC Section 509(d) was the source of the definition of support. Therefore, the Tax Department was correct to include gross receipts for services rendered in the **not unrelated** business activities of Davis Memorial in the calculation. ALJ Keifer was correct to reach the same conclusion of law in the OTA decision as under the Internal Revenue Service regulations reached.

Davis Hospital has argued that “support” under Section 11-15-9(a)(6)(F)(i)(II) should be restricted to fundraising activities only. Davis Hospital argued that patient revenues for a hospital did not meet the statutory definition of support. The consumers sales tax used expansive language in defining the term “support” contrary to Appellant’s argument. Section 11-15-9(a)(6)(F)(i) is clear. The term “support **includes, but is not limited to...**” six enumerated categories of income. *See* W. Va. Code § 11-15-9-(a)(6)(F)(i). Assuming *arguendo* that patient revenues or exempt function income is **not** included in Section 9(a)(6)(F)(i)(II) as argued by Appellant, the term “support” would still not be limited to only the six broad categories listed in Section 9(a)(6)(F). There can be no broader sweep of language than “includes but is not limited to”. It is well settled under West Virginia law that the phrase “includes but is not limited to” may not be used as a term of limitation.

The term ‘including’ in a statute is to be dealt with as a word of enlargement and this is especially so where, as in our Section 10, such word is followed by ‘but not limited to’ the illustrations given. *Pennsylvania Human Relations Commission v. AltoReste Park Cemetery Association*, 453 Pa. 124, 306 A.2d 881 (1973). See *F. P.C. v. Corporation Commission of State of Oklahoma, D. C. Okl.*, 362 F.Supp. 522 (1973); *Phelps v. Sledd, Ky.*, 479 S.W.2d 894 (1972); and *St. Louis County v. State Highway Commission, Mo.*, 409 S.W.2d 149 (1966).

State Human Rights Commission v. Pauley, 158 W.Va. 495 at 501, 212 S.E.2d 77 at 80 (WV 1975).

If the Legislature had intended to use a term of limitation, the Legislature would have employed the phrase “support includes only” or “support shall be limited to the following items” in Section 9(a)(6)(F). Rather, the Legislature chose to employ the phrase “includes, but is not limited to” in reference to support. Therefore, the term “support” is not limited only to the six enumerated categories of income as argued by Appellant. The term “support” is broad enough to include any additional items of support which are not specifically listed in Section 9(a)(6)(F). Since the consumers sales tax uses expansive language, patient revenues or exempt purpose income should be included in the calculation for support even if they don’t fall within Section 9(a)(6)(F)(i)(II) as argued by Davis Hospital.

Finally, adopting Appellant’s argument would create a logical inconsistency which cannot stand scrutiny. Appellant argues that Section 9(a)(6)(F)(i)(II) must be limited to the enumerated items related to fund raisers. Since Section 9 (a)(6)(F)(i)(II) does not specifically include patient revenues as an element of a fund raiser, Appellant concludes that patient revenues must be excluded from the calculation of support. Assume *arguendo* that the Appellant is correct. Section 9(a)(6)(F)(i)(III), the following code provision, specifically includes income from **unrelated business activities** in the calculation of support. Assume, for example, that Davis Hospital decides to own and operate a used car business in Randolph County. Clearly, Davis Hospital would include the net income earned from selling used cars in the calculation of support pursuant to Section 9(a)(6)(F)(i)(III).

However, Appellant argues that income from a **not unrelated business activity** (a related business activity in Judge Henning's phraseology, *infra*) – treating sick and injured people– should be excluded from the calculation of support while the consumers sales tax statute includes **unrelated business activities** in the support test. Related business activities are excluded while unrelated businesses activities are included according to Appellant's theory. Davis Hospital would argue that patient revenues from treating sick and injured people **are excluded** from the support calculation for a hospital while revenues from the operation of a used car lot, a bowling alley, or a movie theater, **are included** in the support calculation for a hospital. Logic precludes such an absurd result.

IV. THE MODIFIED ADOPTED CONSTRUCTION DOCTRINE IS NOT APPLICABLE

Davis Hospital argues that the consumers sales tax exemption should be construed according to the “modified adopted construction doctrine” which is generally applicable in West Virginia. The Appellant argues that when a legislature adopts a statute from another jurisdiction but changes the language of the statute, the legislature intended to change the statute which was adopted. *See* Brief of Appellant at PP. 6 - 8.

Davis Hospital cites several West Virginia cases in support of this position. However, there is a significant factual distinction between the cases cited by the Appellant and the generally accepted view of the “modified adopted construction” doctrine. Davis Hospital bases the argument on *Arnold v. Turek*, 185 W. Va. 400, 407 S.E.2d 706 (WV 1991); *see* Brief of Appellant at P. 7. However, in *Arnold* the West Virginia Legislature amended W. Va. Code §§ 55-7-6 and 55-7-7 in 1989; subsequently, the West Virginia Supreme Court was required to consider the amendments to the West Virginia Wrongful Death Act recently enacted by the West Virginia Legislature. *See*

Arnold at 402-404, 708-710; and Syllabus Point 1. The Supreme Court concluded that the Legislature is presumed to know the former laws and that when the language of a statute is changed, the Legislature intended to change the law. See *Arnold* at 404, 710 (citing *Hall v. Baylous, infra*).

Appellant also argues that *Hall v. Baylous* 109 W. Va. 1, 153 S.E.2d 293 (WV 1930), supports their view of the modified adopted construction doctrine. In *Hall* the West Virginia Supreme Court was required to consider changes adopted by the West Virginia Legislature to the West Virginia domestic relations statute in 1915. See *Hall* at ___, 293 - 295. Similarly, the Supreme Court concluded that if the West Virginia Legislature changed the language of a statute, the Legislature had intended to change the law. *Hall* at ___, 296.

The Appellant has overstated the application of the “modified adopted construction” doctrine in this case. Clearly, the West Virginia Legislature knows and understands current West Virginia law. Therefore, when the West Virginia Legislature changes the language of a West Virginia statute, the only logical conclusion is that the West Virginia Legislature intended to change the law. The doctrine simply reflects common sense.

However, when a legislature initially adopts statutory language from another jurisdiction, the conclusion is not as clear. Appellant argues that the omission of a comma or a minor change to the language adopted from the Internal Revenue Code in West Virginia Code §11-15-9(a)(6)(F)(i)(II) -the support test - means that the West Virginia Legislature intended to significantly restrict the support test to **only include fundraising activities**. See Brief for Appellant at PP. 6 and 14, Paragraph 2. In short, Appellant argues that the West Virginia Legislature intended to limit the support test to “fundraisers”— such as car washes and bake sales— and to exclude the *not unrelated*

trade or business activities (related business activities, in Judge Henning's phraseology, *infra*) from the support calculation.

It is clear, therefore, that when our Legislature narrowed the federal definition in the state-law support test to "fundraisers," it intended only the kind of fundraising that everyone thinks of when they see this word—*i.e.*, soliciting contributions, gifts, *etc.* — and *not* the performance of services associated with the hospital's exempt purpose.

Brief of Appellant at P. 14.

Davis Hospital argues that the support test set forth in West Virginia Code § 11-15-9(a)(6)(F)(i)(II) should only include car washes, bake sales, contributions and charitable gifts. No one could seriously argue that Davis Memorial Hospital actually supports itself by car washes, bake sales, contributions and charitable gifts. Davis Hospital and every hospital in this state supports itself by charging patients for providing medical services.

Judge Henning specifically rejected Appellant's argument. In fact, Judge Henning specifically concluded that the West Virginia Legislature intended to include receipts from all activities under the support test.

The record established in the OTA Order, in addition to the examination of pertinent West Virginia case law, convinces this Court that a legislative intent was clear, in so much that receipts from *all* activities, including those from admissions, sales of merchandise, performance of service and furnishing of facilities, so long as they are derived from a related trade or business, were to be included as "gross receipts from fund raisers." (emphasis added) This results in the inclusion of Petitioner's income from providing services in the amount of \$64,180,500.00.

Circuit Court Decision at PP. 9 & 10 (emphasis in original).

As Judge Henning concluded, receipts from all activities should be included in Roman Numeral II, *infra*, of the support test as long as the receipts are from a related trade or business activity. The Circuit Court's conclusion adheres to the long accepted doctrine of adopted construction. Furthermore, Judge Henning specifically refused to adopt the Appellant's argument and to employ the rules of statutory construction to create an ambiguity in the statute. *See* Circuit Court Decision at P. 9, paragraph 2.

The West Virginia Supreme Court has concluded that when a legislative enactment is based upon a statute from another jurisdiction, the logical conclusion is that the Legislature intended to adopt the statutory language and its previous interpretations.

When a statute has been adopted from another state or country, the courts usually follow the construction which it had received by the courts of the state or country from which it is taken.

Rose v. Public Service Commission, 75 W. Va. 1, 83 S.E.85, L.R.A. 1915B (WV 1914).

See also Kessel v. Monongalia County General Hospital, 220 W. Va. 602, 648 S.E.2d 366 (WV 2007) at Syllabus Point 5 (" 'When the Legislature enacts laws, it is presumed to be aware of all pertinent judgments rendered by the judicial branch. By borrowing terms of art in which are accumulated the legal tradition and meaning of centuries of practice, the Legislature presumably knows and adopts the cluster of ideas attached to each borrowed word in the body of learning from which it was taken and the meaning its use will convey to the judicial mind unless otherwise instructed.' Syl. pt. 2, in part, *Stephen L.H. v. Sherry L.H.*, 195 W. Va. 384, 465 S.E.2d 841 (1995).” Syllabus Point 3, *CB&T Operations Company, Inc. v. Tax Commissioner of the State of West Virginia*, 211 W. Va. 198, 564 S.E.2d 408 (2002).) (Note that in *Kessel* the West Virginia

Legislature specifically stated that the West Virginia Anti-Trust Act should be construed in conformity with the Sherman Anti-Trust Act.)

Furthermore, the Appellant has acknowledged that the adopted construction doctrine does not require a state to adopt a foreign statute verbatim. Appellant has stated that if West Virginia were to adopt language that is “substantially similar” to a federal statute, West Virginia would be also adopting the interpretations and constructions of federal law. See Brief of Appellant at P. 8, paragraph 1 citing *State Department of Bus. & Indus., Office of Labor Comm’r v. Granite Construction Co.*, 40 P.3d 423 (Nev. 2002). Regardless of the two minor discrepancies between the West Virginia support test and the Internal Revenue Code support test, both support tests have the same expansive sweep; both tests clearly state that support **includes but is not limited** to the six broad categories of income. Even a cursory review of the support test found in WV Code § 11-15-9(a)(6)(F) will reveal that the support test adopted by West Virginia is substantially similar to the support test found in the Internal Revenue Code.

The best indication of legislative intent is the language of the statute.

(II) Gross receipts from fundraisers which include receipts from admissions, sales of merchandise, performance of services or furnishing of facilities in any activity which is not an unrelated trade or business within the meaning of *Section 513 of the Internal Revenue Code* of 1986, as amended;

(III) Net income from unrelated business activities, whether or not the activities are carried on regularly as a trade or business;

West Virginia Code § 11-15-9(a)(6)(F)(i)(II) and (III).

Appellant argues that the Legislature intended a much narrower definition of support than is found in the support test adopted from the Internal Revenue Code. Roman Numeral III includes net income

from **unrelated business activities** under the support test. Roman Numeral II includes the **not unrelated business activities** in the support test. (Judge Henning's phraseology of *related business activities* is much simpler to articulate than the term of art found in the Internal Revenue Code - *not unrelated business activities* - employed in the exemption.) The intent of the West Virginia Legislature is unmistakable when the Roman Numerals II and III are read together. Support includes both related business activities and unrelated business activities. Including one without the other would not show the full range of support earned by Davis Hospital or any other organization.

As noted *supra*, the West Virginia Legislature employed a term of art in the support test in Roman Numeral II - "not an unrelated trade or business within the meaning of Section 513 of the Internal Revenue Code." The regulations for the Internal Revenue Code are especially instructive. *Unrelated business activities* are those activities which are not substantially related to the charitable purpose of the organization. See Federal Tax Regulations § 1.1513-1(a) 1988 (photocopy attached).

(d) Substantially related.

(4) Application of principles - (i) Income from performance of exempt functions. Gross income derived from charges for the performance of exempt functions does not constitute gross income from the conduct of unrelated trade of business. The following examples illustrate the application of this principle:

Example (1). M, an organization described in section 501(c)(3), operates a school for training children in the performing arts, such as acting, singing, and dancing. It presents performances by its students and derives gross income from admission charges for the performances. The students' participation in performances before audiences in an essential part of their training. Since the income realized from the performances derives from activities which contribute importantly to the accomplishment of M's exempt purposes, it does not constitute gross income from unrelated trade or business. (For specific exclusion applicable in certain cases of

contributed services, see section 513(a)(1) and paragraph (e)(1) of this section.)

Federal Tax Regulations § 1.513-1(d)(4)(1988)(emphasis added).

Consequently, *not unrelated business activities* are substantially related to the exempt purpose of the organization. As noted in the example above, the gross income earned by the performing arts school would be classified as *not constituting unrelated trade or business income*.

The relationship between the income producing activity and the exempt purpose of the organization must be examined. See Federal Tax Regulation § 1.513-1(d). Clearly, Davis Hospital is exempt from federal income taxation solely for the purpose of providing medical care to sick and injured people. Therefore, gross revenues from treating hospital patients would not be classified as *unrelated trade or business income* under Section 513 of the Internal Revenue Code. Consequently, the revenues from treating sick and injured people would be classified as *not unrelated trade or business income*. As such, patient revenues would be classified under Roman Numeral II or W. Va. Code § 11-15-9(a)(6)(F)(i)(II) under the support test.

In the instant case, the gross receipts earned by Davis Hospital in treating sick and injured people would be classified as *not unrelated trade or business income*. The related income (to use Judge Henning's phraseology) would be included in Roman Numeral II of the support test. Judge Henning concluded that you cannot ignore the \$64,000,000.00 of gross receipts from treating sick and injured people under the statutory support test.

If the West Virginia Legislature had wanted to restrict the support test to **fundraising activities only** as Davis Hospital argues, the Legislature would not have adopted the Internal Revenue Code language as it did. The Legislature would have rejected the language in the IRC §

509(d)(2) and simply enacted the phrase “Gross receipts from fund raisers;” for W.Va. Code § 11-15-9(a)(6)(F)(i)(II) instead of the lengthy provision in the exemption. The West Virginia Legislature would have also rejected the phrase “not an unrelated trade or business within the meaning of Section 513 of the Internal Revenue Code . . .” from Section 11-15-9(a)(6)(F)(i)(II). In addition, the West Virginia Legislature would not have enacted the expansive phrase “‘support’ includes, but is not limited to” in Section 11-15-9(a)(6)(F)(i).

But, the Legislature did not do so. The Legislature enacted the language in W. Va. Code §§ 11-15-9(a)(6)(F)(i) and -9(a)(6)(F)(i)(II). Consequently, the West Virginia Legislature intended the support test to be as expansive as possible and to include *not unrelated business income* in the support test under Roman Numeral II.

Nor has Davis Hospital cited any state or federal case law to support its primary argument under the “modified adopted construction doctrine” - the addition of the phrase “from fund raisers which include receipts” to the Internal Revenue Code support test was intended to **exclude not unrelated business income** in Roman Numeral II of the support test despite the express language of the consumers sales tax exemption.

**V. THE CONSUMERS SALES TAX EXEMPTION SHOULD
BE STRICTLY CONSTRUED AGAINST THE INDIVIDUAL
CLAIMING THE EXEMPTION**

Davis Hospital argues that the consumers sales tax exemption at issue constitutes “socio-economic legislation.” Consequently, the Appellant argues that the exemption should be liberally construed in favor of the hospital. *See* Brief of Appellant PP.30 - 36. Davis Hospital bases this argument on the West Virginia Supreme Court decision of *Andy Bros. Tire Co., v. W. Va. State Tax Commissioner*, 160 W. Va. 144, 233 S.E.2d 134 (W. Va. 1977).

However, *Andy Bros.* is not applicable to the current situation. *Andy Bros.* dealt with the Business and Occupation Tax Credit set forth in West Virginia Code §11-13-1 *et. seq.* The Supreme Court noted that the West Virginia Legislature explicitly stated that the purpose in enacting the tax credit was to further industrial expansion in West Virginia.

W. Va. Code 11-13C, titled "Business and Occupation Tax Credit for Industrial Expansion", states in its first section:

In order to encourage the location of new industry within this State and order to encourage the expansion of existing industry within this State and thereby increase employment, there is hereby provided a business and occupation tax credit for industrial expansion.

Andy Bros., at 145, at 135.

Clearly, by prefacing the tax credit with the explicit purpose of attracting new industries to West Virginia, expanding existing industries and creating additional jobs, the Legislature designated the tax credit as socio-economic legislation. *Andy Bros.*, at 136, 147.

The West Virginia Legislature has also clearly stated the purpose behind adopting the consumers sales tax. "The purpose of this article is to impose a general consumers sales and service tax." W. Va. Code § 11-15-1. The consumers sales tax is not socio-economic legislation as argued by Davis Hospital. The consumers sales tax is legislation aimed squarely at generating tax revenue for the State. Consequently, the sales tax exemption must be strictly construed against the individual claiming the exemption.

The distinction between the two situations has been noted by this Court in a subsequent case.

Andy Bros. Tire concludes that the industrial expansion credit against the business and occupation tax, as a species of socioeconomic legislation, is to be liberally construed in favor of the taxpayer. 160 W. Va. at 147, 233 S.E.2d at 136. For this reason this case is materially distinguishable from *Pennsylvania & West Virginia Supply*

Corp. v. Rose, 179 W.Va. 317, 368 S.E.2d 101 (1988). That case involved a use tax exemption for purchases used in a retail sales business. We applied the rule of statutory construction that an exemption statute is construed strictly against the taxpayer. Syl. pt. 5. In the present case, however, a tax credit, not a tax exemption, statute is involved, and *Andy Bros. Tire* is authority for liberally construing tax credit legislation in favor of the taxpayer.

Brockaway Glass Company, Inc., v. Caryl, 183 W.Va. 122 at 125, 394 S.E. 2d 524 at 527 (WV 1990).

There is a long history that clearly states an individual who claims an exemption from a tax has the burden of proving that he is entitled to the tax exemption. The Supreme Court has recently reaffirmed that rule of law in *CB&T Operations Company v. Tax Commissioner*, 211 W.Va. 198, 564 S.E.2d 408 at Syllabus Point 5 (“Where a person claims an exemption from a law imposing a license or tax, such law is strictly construed against the person claiming the exemption.” Syl. pt. 2, *State ex rel. Lambert v. Carman, State Tax Comm’r*, 145 W. Va. 635, 116 S.E.2d 265 (1960).’ Syl. pt. 5, *Pennsylvania & West Virginia Supply Corp. v. Rose*, 179 W. Va. 317, 368 S.E.2d 101 (1988).” Syl. pt. 2, *Tony P. Sellitti Constr. Co. v. Caryl*, 185 W. Va. 584, 408 S.E.2d 336 (1991)) (WV 2002). See also *Shawnee Bank, Inc., v. Paige*, 200 W. Va. 20, 488 S.E.2d 20 at Syllabus Point 4 (WV 1997).

It is a basic premise of tax law that exemptions from taxation must be narrowly construed. The individual claiming the exemption must prove that he is entitled to the exemption. Furthermore, exemptions and deductions from tax must be strictly construed against the person claiming the exemption or deduction. See *RGIS v. Palmer*, 209 W. Va. 152, 544 S.E.2d 79 at Syllabus Point 1 (WV 2001) (“Where a person claims an exemption from a law imposing a license or tax, such law is strictly construed against the person claiming the exemption.” quoting Syllabus Point 4, *Shawnee*

Bank, Inc. v. Paige, 200 W. Va. 20, 488 S.E.2d 20 (1997)); *see also Owens-Illinois Glass Company v. Battle*, 151 W.Va. 655, 154 S.E.2d 854 at Syllabus Point 3 (WV 1967) (Where a person claims an exemption from a law imposing a tax, such law must be construed strictly against the person claiming the exemption.).

Under West Virginia law Davis Memorial Hospital carries the burden of proving that it is entitled to claim the exemption from consumers sales tax. Contrary to Davis Hospital's assertion, Davis Hospital must prove that it is entitled to claim the exemption from the consumers sales tax. Davis Hospital has not met that burden of proof.

IV. CONCLUSION

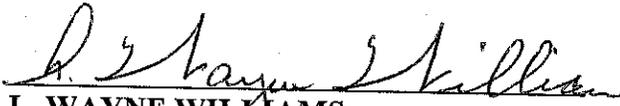
Davis Memorial claims to be exempt from consumers sales tax for all its purchases under WV Code § 11-15-9(a)(6) because it claims to receives more than half of its support from any combination of gifts, grants, direct or indirect charitable contributions or membership fees. Davis Memorial has failed to show that it is entitled to claim the exemption from consumers sales tax. The only way Davis Memorial can meet the fifty percent support test imposed by statute is to ignore \$64,180,500.00 in gross receipts from health care services rendered to patients when calculating its support. Section 11-15-9(a)(6) clearly includes gross receipts from **not unrelated** business activities in the definition of support. Davis Memorial does not meet the statutory requirements of the exemption. Therefore, the Tax Department was correct to deny the tax refund. The Office of Tax Appeals was correct to affirm the Tax Department's decision to deny the claim for refund. The Circuit Court of Randolph County was correct to affirm the OTA decision. The Supreme Court of

Appeals should reject Davis Hospital's argument as well. Patient revenues of \$ 64,180,500.00 cannot be ignored in calculating the term "support". Both common sense and the man on the street can explain this point.

Respectfully submitted,

WEST VIRGINIA STATE TAX COMMISSIONER,
By Counsel

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IN THE SUPREME COURT OF APPEALS OF WEST VIRGINIA

APPEAL NO. 33682

DAVIS MEMORIAL HOSPITAL,

Appellant,

v.

WEST VIRGINIA STATE TAX COMMISSIONER,

Respondent.

APPENDIX

**WEST VIRGINIA STATE TAX
COMMISSIONER,**

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EXHIBITS

1. Federal Tax Regulations 1988 in Force January 1, 1988, Volume 2

FEDERAL
TAX REGULATIONS

1988

IN FORCE JANUARY 1, 1988

Kept To Date

Through

U. S. Code Congressional and
Administrative News

Volume 2

ST. PAUL, MINN.
WEST PUBLISHING CO.

EXHIBIT

§ 1.512(b)-1

nization. A trustee or director is controlled by an exempt organization if such organization has the power to remove such trustee or director and designate a new trustee or director.

(ii) **Gain or loss of control.** If control of an organization (as defined in subdivision (i) of this subparagraph) is acquired or relinquished during the taxable year, only the interest, annuities, royalties, and rents paid or accrued to the controlling organization in accordance with its method of accounting for that portion of the taxable year it has control shall be subject to the tax on unrelated business income.

(5) **Amounts taxable under other provisions of the Code—(i) In general.** Except as provided in subdivision (ii) of this subparagraph, section 512(b)(13) and this paragraph do not apply to amounts which are included in the computation of unrelated business taxable income by operation of any other provision of the Code. However, amounts which are not included in unrelated business taxable income by operation of section 512(a)(1), or which are excluded by operation of section 512(b)(1), (2), or (3), may be included in unrelated business taxable income by operation of section 512(b)(13) and this paragraph.

(ii) **Debt-financed property.** Rents deprived from the lease of debt-financed property by a controlling organization to a controlled organization are subject to the rules contained in section 512(b)(13) and this paragraph. Thus, if a controlling organization leases debt-financed property to a controlled organization, the amount of rents includible in the controlling organization's unrelated business taxable income shall first be determined under section 512(b)(13) and this paragraph, and only the portion of such rents not taken into account by operation of section 512(b)(13) are taken into account by operation of section 514. See example (3) of § 1.514(b)-1(b)(3).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6939, 32 FR 17661, Dec. 12, 1967; T.D. 7177, 37 FR 7089, April 8, 1972; T.D. 7183, 37 FR 7885, April 21, 1972; T.D. 7229, 37 FR 28142, Dec. 21, 1972; T.D. 7261, 38 FR 5466, March 1, 1973; 38 FR 6387, March 9, 1973; T.D. 7632, 44 FR 42681, July 20, 1979; T.D. 7767, 46 FR 11265, Feb. 6, 1981]

§ 1.512(c)-1 Special rules applicable to partnerships; in general.

In the event an organization to which section 511 applies is a member of a partnership regularly engaged in a trade or business which is an unrelated trade or business with respect to such organization, the organization shall include in

computing its unrelated business taxable income so much of its share (whether or not distributed) of the partnership gross income as is derived from that unrelated business and its share of the deductions attributable thereto. For this purpose, both the gross income and the deductions shall be computed with the necessary adjustments for the exceptions, additions, and limitations referred to in section 512(b) and in § 1.512(b)-1. For example, if an exempt educational institution is a partner in a partnership which operates a factory and if such partnership also holds stock in a corporation, the exempt organization shall include in computing its unrelated business taxable income its share of the gross income from the operation of the factory, but not its share of any dividends received by the partnership from the corporation. If the taxable year of the organization differs from that of the partnership, the amounts included or deducted in computing unrelated business taxable income shall be based upon the income and deductions of the partnership for each taxable year of the partnership ending within or with the taxable year of the organization.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.513-1 Definition of unrelated trade or business.

(a) **In general.** As used in section 512 the term "unrelated business taxable income" means the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less the deductions and subject to the modifications provided in section 512. Section 513 specifies with certain exceptions that the phrase "unrelated trade or business" means, in the case of an organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits 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 (or, in the case of an organization described in section 511(a)(2)(B), to the exercise or performance of any purpose or function described in section 501(c)(3)). (For certain exceptions from this definition, see paragraph (e) of this section. For a special definition of "unrelated trade or business" applicable to certain trusts, see section 513(b).) Therefore, unless one of the specific exceptions of section 512 or 513 is applicable, gross income of an exempt organization subject to the tax imposed by section 511 is includible in the computation of

unrelated business taxable income if: (1) It is income from trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

(b) **Trade or business.** The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete. On the other hand, where an activity does not possess the characteristics of a trade or business within the meaning of section 162, such as when an organization sends out low-cost articles incidental to the solicitation of charitable contributions, the unrelated business income tax does not apply since the organization is not in competition with taxable organizations. However, in general, any activity of a section 511 organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute "trade or business" within the meaning of section 162—and which, in addition, is not substantially related to the performance of exempt functions—presents sufficient likelihood of unfair competition to be within the policy of the tax. Accordingly, for purposes of section 513 the term "trade or business" has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services. Thus, the term "trade or business" in section 513 is not limited to integrated aggregates of assets, activities and good will which comprise businesses for the purposes of certain other provisions of the Internal Revenue Code. Activities of producing or distributing goods or performing services from which a particular amount of gross income is derived do not lose identity as trade or business merely because they are carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. Thus, for example, the regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose identity as trade or business merely because the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purposes or in compliance with the terms of section 513(a)(2). Similarly, activities of soliciting, selling, and publishing commercial advertising do not lose identity as a trade or business even though the advertising is

published in an exempt organization periodical which contains editorial matter related to the exempt purposes of the organization. However, where an activity carried on for the production of income constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit.

(c) **Regularly carried on—(1) General principles.** In determining whether trade or business from which a particular amount of gross income derives is "regularly carried on," within the meaning of section 512, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued. This requirement must be applied in light of the purpose of the unrelated business income tax to place exempt organization business activities upon the same tax basis as the nonexempt business endeavors with which they compete. Hence, for example, specific business activities of an exempt organization will ordinarily be deemed to be "regularly carried on" if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations.

(2) **Application of principles in certain cases—**
 (i) **Normal time span of activities.** Where income producing activities are of a kind normally conducted by nonexempt commercial organizations on a year-round basis, the conduct of such activities by an exempt organization over a period of only a few weeks does not constitute the regular carrying on of trade or business. For example, the operation of a sandwich stand by a hospital auxiliary for only 2 weeks at a state fair would not be the regular conduct of trade or business. However, the conduct of year-round business activities for one day each week would constitute the regular carrying on of trade or business. Thus, the operation of a commercial parking lot on Saturday of each week would be the regular conduct of trade or business. Where income producing activities are of a kind normally undertaken by nonexempt commercial organizations only on a seasonal basis, the conduct of such activities by an exempt organization during a significant portion of the season ordinarily constitutes the regular conduct of trade or business. For example, the operation of a track for horse racing for several weeks of a year would be considered the regular conduct of trade or business because it is usual to carry on such trade or business only during a particular season.

§ 1.513-1

(ii) **Intermittent activities; in general.** In determining whether or not intermittently conducted activities are regularly carried on, the manner of conduct of the activities must be compared with the manner in which commercial activities are normally pursued by nonexempt organizations. In general, exempt organization business activities which are engaged in only discontinuously or periodically will not be considered regularly carried on if they are conducted without the competitive and promotional efforts typical of commercial endeavors. For example, the publication of advertising in programs for sports events or music or drama performances will not ordinarily be deemed to be the regular carrying on of business. Similarly, where an organization sells certain types of goods or services to a particular class of persons in pursuance of its exempt functions or "primarily for the convenience" of such persons within the meaning of section 513(a)(2) (as, for example, the sale of books by a college bookstore to students or the sale of pharmaceutical supplies by a hospital pharmacy to patients of the hospital), casual sales in the course of such activity which do not qualify as related to the exempt function involved or as described in section 513(a)(2) will not be treated as regular. On the other hand, where the nonqualifying sales are not merely casual, but are systematically and consistently promoted and carried on by the organization, they meet the section 512 requirement of regularity.

(iii) **Intermittent activities; special rule in certain cases of infrequent conduct.** Certain intermittent income producing activities occur so infrequently that neither their recurrence nor the manner of their conduct will cause them to be regarded as trade or business regularly carried on. For example, income producing or fund raising activities lasting only a short period of time will not ordinarily be treated as regularly carried on if they recur only occasionally or sporadically. Furthermore, such activities will not be regarded as regularly carried on merely because they are conducted on an annually recurrent basis. Accordingly, income derived from the conduct of an annual dance or similar fund raising event for charity would not be income from trade or business regularly carried on.

(d) **Substantially related—(1) In general.** Gross income derives from "unrelated trade or business," within the meaning of section 513(a), if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted. The presence of this requirement necessitates an exami-

nation of the relationship between the business activities which generate the particular income in question—the activities, that is, of producing or distributing the goods or performing the services involved—and the accomplishment of the organization's exempt purposes.

(2) **Type of relationship required.** Trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is "substantially related," for purposes of section 513, only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes. Where the production or distribution of the goods or the performance of the services does not contribute importantly to the accomplishment of the exempt purposes of an organization, the income from the sale of the goods or the performance of the services does not derive from the conduct of related trade or business. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

(3) **Size and extent of activities.** In determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function which they purport to serve. Thus, where income is realized by an exempt organization from activities which are in part related to the performance of its exempt functions, but which are conducted on a larger scale than is reasonably necessary for performance of such functions, the gross income attributable to that portion of the activities in excess of the needs of exempt functions constitutes gross income from the conduct of unrelated trade or business. Such income is not derived from the production or distribution of goods or the performance of services which contribute importantly to the accomplishment of any exempt purpose of the organization.

(4) **Application of principles—(i) Income from performance of exempt functions.** Gross income

derived from charges for the performance of exempt functions does not constitute gross income from the conduct of unrelated trade or business. The following examples illustrate the application of this principle:

Example (1). M, an organization described in section 501(c)(3), operates a school for training children in the performing arts, such as acting, singing, and dancing. It presents performances by its students and derives gross income from admission charges for the performances. The students' participation in performances before audiences is an essential part of their training. Since the income realized from the performances derives from activities which contribute importantly to the accomplishment of M's exempt purposes, it does not constitute gross income from unrelated trade or business. (For specific exclusion applicable in certain cases of contributed services, see section 513(a)(1) and paragraph (e)(1) of this section.)

Example (2). N is a trade union qualified for exemption under section 501(c)(5). To improve the trade skills of its members, N conducts refresher training courses and supplies handbooks and technical manuals. N receives payments from its members for these services and materials. However, the development and improvement of the skills of its members is one of the purposes for which exemption is granted N; and the activities described contribute importantly to that purpose. Therefore, the income derived from these activities does not constitute gross income from unrelated trade or business.

Example (3). O is an industry trade association qualified for exemption under section 501(c)(6). It presents a trade show in which members of its industry join in an exhibition of industry products. O derives income from charges made to exhibitors for exhibit space and admission fees charged patrons or viewers of the show. The show is not a sales facility for individual exhibitors; its purpose is the promotion and stimulation of interest in, and demand for, the industry's products in general, and it is conducted in a manner reasonably calculated to achieve that purpose. The stimulation of demand for the industry's products in general is one of the purposes for which exemption is granted O. Consequently, the activities productive of O's gross income from the show—that is, the promotion, organization and conduct of the exhibition—contribute importantly to the achievement of an exempt purpose, and the income does not constitute gross income from unrelated trade or business. See also section 513(d) and regulations thereunder regarding sales activity.

(ii) **Disposition of product of exempt functions.** Ordinarily, gross income from the sale of products which result from the performance of exempt functions does not constitute gross income from the conduct of unrelated trade or business if the product is sold in substantially the same state it is in on completion of the exempt functions. Thus, in the case of an organization described in section 501(c)(3) and engaged in a program of rehabilitation of handicapped persons, income from sale of articles made by such persons as a part of their rehabilitation training would not be gross income from conduct of unrelated trade or business. The income in such case would be from sale of products, the production of which contributed importantly to the accomplishment of purposes for which exemption is granted the organization—

namely, rehabilitation of the handicapped. On the other hand, if a product resulting from an exempt function is utilized or exploited in further business endeavor beyond that reasonably appropriate or necessary for disposition in the state it is in upon completion of exempt functions, the gross income derived therefrom would be from conduct of unrelated trade or business. Thus, in the case of an experimental dairy herd maintained for scientific purposes by a research organization described in section 501(c)(3), income from sale of milk and cream produced in the ordinary course of operation of the project would not be gross income from conduct of unrelated trade or business. On the other hand, if the organization were to utilize the milk and cream in the further manufacture of food items such as ice cream, pastries, etc., the gross income from the sale of such products would be from the conduct of unrelated trade or business unless the manufacturing activities themselves contribute importantly to the accomplishment of an exempt purpose of the organization.

(iii) **Dual use of assets or facilities.** In certain cases, an asset or facility necessary to the conduct of exempt functions may also be employed in a commercial endeavor. In such cases, the mere fact of the use of the asset or facility in exempt functions does not, by itself, make the income from the commercial endeavor gross income from related trade or business. The test, instead, is whether the activities productive of the income in question contribute importantly to the accomplishment of exempt purposes. Assume, for example, that a museum exempt under section 501(c)(3) has a theater auditorium which is specially designed and equipped for showing of educational films in connection with its program of public education in the arts and sciences. The theater is a principal feature of the museum and is in continuous operation during the hours the museum is open to the public. If the organization were to operate the theater as an ordinary motion picture theater for public entertainment during the evening hours when the museum was closed, gross income from such operation would be gross income from conduct of unrelated trade or business.

(iv) **Exploitation of exempt functions.** In certain cases, activities carried on by an organization in the performance of exempt functions may generate good will or other intangibles which are capable of being exploited in commercial endeavors. Where an organization exploits such an intangible in commercial activities, the mere fact that the resultant income depends in part upon an exempt function of the organization does not make

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it gross income from related trade or business. In such cases, unless the commercial activities themselves contribute importantly to the accomplishment of an exempt purpose, the income which they produce is gross income from the conduct of unrelated trade or business. The application of this subdivision is illustrated in the following examples:

Example (1). U, an exempt scientific organization, enjoys an excellent reputation in the field of biological research. It exploits this reputation regularly by selling endorsements of various items of laboratory equipment to manufacturers. The endorsing of laboratory equipment does not contribute importantly to the accomplishment of any purpose for which exemption is granted U. Accordingly, the income derived from the sale of endorsements is gross income from unrelated trade or business.

Example (2). V, an exempt university, has a regular faculty and a regularly enrolled student body. During the school year, V sponsors the appearance of professional theater companies and symphony orchestras which present drama and musical performances for the students and faculty members. Members of the general public are also admitted. V advertises these performances and supervises advance ticket sales at various places, including such university facilities as the cafeteria and the university bookstore. V derives gross income from the conduct of the performances. However, while the presentation of the performances makes use of an intangible generated by V's exempt educational functions—the presence of the student body and faculty—the presentation of such drama and music events contributes importantly to the overall educational and cultural function of the university. Therefore, the income which V receives does not constitute gross income from the conduct of unrelated trade or business.

Example (3). W is an exempt business league with a large membership. Under an arrangement with an advertising agency, W regularly mails brochures, pamphlets and other commercial advertising materials to its members, for which service W charges the agency an agreed amount per enclosure. The distribution of the advertising materials does not contribute importantly to the accomplishment of any purpose for which W is granted exemption. Accordingly, the payments made to W by the advertising agency constitute gross income from unrelated trade or business.

Example (4). X, an exempt organization for the advancement of public interest in classical music, owns a radio station and operates it in a manner which contributes importantly to the accomplishment of the purposes for which the organization is granted exemption. However, in the course of the operation of the station the organization derives gross income from the regular sale of advertising time and services to commercial advertisers in the manner of an ordinary commercial station. Neither the sale of such time nor the performance of such services contributes importantly to the accomplishment of any purpose for which the organization is granted exemption. Notwithstanding the fact that the production of the advertising income depends upon the existence of the listening audience resulting from performance of exempt functions, such income is gross income from unrelated trade or business.

Example (5). Y, an exempt university, provides facilities, instruction and faculty supervision for a campus newspaper operated by its students. In addition to news items and editorial commentary, the newspaper publishes paid advertising. The solicitation, sale, and publication of the advertising are conducted by students, under the supervision and instruction of the university. Although the services rendered to

advertisers are of a commercial character, the advertising business contributes importantly to the university's educational program through the training of the students involved. Hence, none of the income derived from publication of the newspaper constitutes gross income from unrelated trade or business. The same result would follow even though the newspaper is published by a separately incorporated section 501(c)(3) organization, qualified under the university rules for recognition of student activities, and even though such organization utilizes its own facilities and is independent of faculty supervision, but carries out its educational purposes by means of student instruction of other students in the editorial and advertising activities and student participation in those activities.

Example (6). Z is an association exempt under section 501(c)(6), formed to advance the interests of a particular profession and drawing its membership from the members of that profession. Z publishes a monthly journal containing articles and other editorial material which contribute importantly to the accomplishment of purposes for which exemption is granted the organization. Income from the sale of subscriptions to members and others in accordance with the organization's exempt purposes, therefore, does not constitute gross income from unrelated trade or business. In connection with the publication of the journal, Z also derives income from the regular sale of space and services for general consumer advertising, including advertising of such products as soft drinks, automobiles, articles of apparel, and home appliances. Neither the publication of such advertisements nor the performance of services for such commercial advertisers contributes importantly to the accomplishment of any purpose for which exemption is granted. Therefore, notwithstanding the fact that the production of income from advertising utilizes the circulation developed and maintained in performance of exempt functions, such income is gross income from unrelated trade or business.

Example (7). The facts are as described in the preceding example, except that the advertising in Z's journal promotes only products which are within the general area of professional interest of its members. Following a practice common among taxable magazines which publish advertising, Z requires its advertising to comply with certain general standards of taste, fairness, and accuracy; but within those limits the form, content, and manner of presentation of the advertising messages are governed by the basic objective of the advertisers to promote the sale of the advertised products. While the advertisements contain certain information, the informational function of the advertising is incidental to the controlling aim of stimulating demand for the advertised products and differs in no essential respect from the informational function of any commercial advertising. Like taxable publishers of advertising, Z accepts advertising only from those who are willing to pay its prescribed rates. Although continuing education of its members in matters pertaining to their profession is one of the purposes for which Z is granted exemption, the publication of advertising designed and selected in the manner of ordinary commercial advertising is not an educational activity of the kind contemplated by the exemption statute; it differs fundamentally from such an activity both in its governing objective and in its method. Accordingly, Z's publication of advertising does not contribute importantly to the accomplishment of its exempt purposes; and the income which it derives from advertising constitutes gross income from unrelated trade or business.

(e) Exceptions. Section 513(a) specifically states that the term "unrelated trade or business" does not include—

(1) Any trade or business in which substantially all the work in carrying on such trade or business is performed for the organization without compensation; or

(2) Any trade or business carried on by an organization described in section 501(c)(3) or by a governmental college or university described in section 511(a)(2)(B), primarily for the convenience of its members, students, patients, officers, or employees; or, any trade or business carried on by a local association of employees described in section 501(c)(4) organized before May 27, 1969, which consists of the selling by the organization of items of work-related clothes and equipment and items normally sold through vending machines, through food dispensing facilities, or by snack bars, for the convenience of its members at their usual places of employment; or

(3) Any trade or business which consists of selling merchandise, substantially all of which has been received by the organization as gifts or contributions.

An example of the operation of the first of the exceptions mentioned above would be an exempt orphanage operating a retail store and selling to the general public, where substantially all the work in carrying on such business is performed for the organization by volunteers without compensation. An example of the first part of the second exception, relating to an organization described in section 501(c)(3) or a governmental college or university described in section 511(a)(2)(B), would be a laundry operated by a college for the purpose of laundering dormitory linens and the clothing of students. The latter part of the second exception, dealing with certain sales by local employee associations, will not apply to sales of these items at locations other than the usual place of employment of the employees; therefore sales at such other locations will continue to be treated as unrelated trade or business. The third exception applies to so-called "thrift shops" operated by a tax-exempt organization where those desiring to benefit such organization contribute old clothes, books, furniture, et cetera, to be sold to the general public with the proceeds going to the exempt organization.

(f) Special rule respecting publishing businesses prior to 1970. For a special rule for taxable years beginning before January 1, 1970, with respect to publishing businesses carried on by an organization, see section 513(c) of the Code prior to its amendment by section 121(c) of the Tax Reform Act of 1969 (83 Stat. 542).

(g) Effective date. This section is applicable with respect to taxable years beginning after December 12, 1967. However, if a taxpayer wishes to rely on the rules stated in this section for taxable years beginning before December 13, 1967, it may do so.

[T.D. 6939, 32 FR 17657, Dec. 12, 1967; 32 FR 17890, Dec. 14, 1967; 32 FR 17938, Dec. 15, 1967; T.D. 7107, 36 FR 6421, April 3, 1971; T.D. 7392, 40 FR 58642, Dec. 18, 1975; T.D. 7896, 48 FR 23817, May 27, 1983]

§ 1.513-2 Definition of unrelated trade or business applicable to taxable years beginning before December 13, 1967.

(a) In general. (1) As used in section 512(a), the term "unrelated business taxable income" includes only income from an unrelated trade or business regularly carried on, and the term "trade or business" has the same meaning as it has in section 162.

(2) The income of an exempt organization is subject to the tax on unrelated business income only if two conditions are present with respect to such income. The first condition is that the income must be from a trade or business which is regularly carried on by the organization. The second condition is that the trade or business must not be substantially related (aside from the need of the organization for income or funds or the use it makes of the profits 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, or in the case of an organization described in section 511(a)(2)(B) (governmental colleges, etc.) to the exercise or performance of any purpose or function described in section 501(c)(3). Whether or not an organization is subject to the tax imposed by section 511 shall be determined by the application of these tests to the particular circumstances involved in each individual case. For certain exceptions from the term "unrelated trade or business," see paragraph (b) of this section.

(3) A trade or business is regularly carried on when the activity is conducted with sufficient consistency to indicate a continuing purpose of the organization to derive some of its income from such activity. An activity may be regularly carried on even though its performance is infrequent or seasonal.

(4) Ordinarily, a trade or business is substantially related to the activities for which an organization is granted exemption if the principal purpose of such trade or business is to further (other than

IN THE SUPREME COURT OF APPEALS OF WEST VIRGINIA

APPEAL NO. 33682

DAVIS MEMORIAL HOSPITAL,

Appellant,

v.

WEST VIRGINIA STATE TAX COMMISSIONER,

Respondent.

CERTIFICATE OF SERVICE

I, L. Wayne Williams, Assistant Attorney General for the State of West Virginia, do hereby certify that a true and exact copy of the foregoing "*Tax Department's Brief*" was served by United States Mail, postage prepaid, this 23rd day of April 2008, addressed as follows:

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