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Mergers, Acquisitions, and Conversions in the Context of Nonprofit Organizations

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IN BRIEF

- Nonprofit organizations engaging in corporate restructuring present federal tax law considerations beyond those of for-profit entities
- Various restrictions are involved of which nonprofits should be aware to avoid such common

problems as inurement, private benefit, and excess benefit transactions.

Although many focus on for-profit entities when thinking of corporate restructuring, tax-exempt nonprofit organizations also use mergers, acquisitions, and conversions in a variety of ways. Organizations exempt from tax under section 501 (c) of the Internal Revenue Code (hereinafter, nonprofits) may want to merge, consolidate, or acquire the assets of another nonprofit or a for-profit organization.[1] Sometimes a nonprofit wants to relinquish its tax-exempt status and convert to a taxable organization, and existing for-profit entities occasionally want to convert to a nonprofit. These scenarios all present federal tax law considerations beyond those encountered when only for-profit entities are involved. Along with the advantages of tax-exempt status come restrictions, some of which determine who can benefit from an organization's assets. Accordingly, in planning transactions, nonprofits should be aware of the risks of violating these restrictions.

These considerations are especially important now because, in many cases, the Internal Revenue Service (IRS) will not determine, except in an examination, whether a restructured nonprofit continues to qualify for exemption. IRS guidance released in February 2018 provides that already-exempt nonprofits no longer must submit a new application for recognition of tax-exempt status when engaging in certain corporate restructurings, such as mergers.[2] Therefore, nonprofits considering these types of changes should be

careful to avoid such common problems as inurement, private benefit, and excess benefit transactions. This is particularly true if the nonprofit is a section 501(c)(3) organization. Should these issues arise in an examination, they could result in the revocation of the organization's tax-exempt status (including retroactive revocation), the imposition of excise taxes, or both.

INUREMENT

Nonprofits, such as those exempt under sections 501(c)(3) and 501(c)(4), are prohibited from having their net earnings inure to the benefit of any individual.[3] If the net earnings inure to the benefit of an individual, then the organization is not operated exclusively for exempt purposes and is not tax-exempt.[4] Inurement occurs when an organization enters into a transaction that benefits its insiders and not the nonprofit, even if the nonprofit does not suffer a financial loss.[5] Thus, inurement results from a transaction between the exempt organization and an individual who is an insider of the corporation, i.e., someone who has the ability to influence or control the organization's net earnings, such as a director or officer.[6] As a result, the nonprofit must consider whether the individuals in control of the organization protected the nonprofit's interests, ensured that transactions with related parties were conducted at arm's length, and that assets were properly valued.[7]

PRIVATE BENEFIT

Nonprofits under section 501(c)(3) are also required to be operated for exempt purposes.[8] The private benefit standard is derived from this operational test.[9] An organization is not considered "operated exclusively" for exempt purposes if more than an insubstantial part of its activities do not further an exempt purpose.[10] Furthermore, an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest.[11] As such, the organization must establish that it is not organized or operated for the benefit of private interests.[12] As a result of this requirement, a section 501(c)(3) nonprofit must ensure that any assets it acquires have been properly valued and that the organization acquired them for a reasonable price.[13] Failure to do so can result in a determination that the organization has provided an impermissible private benefit and thus is not entitled to tax-exempt status.[14]

EXCESS BENEFIT TRANSACTIONS

Nonprofits exempt under sections 501(c)(3) and 501(c)(4) are also subject to an excise tax under section 4958. This tax is imposed on excess benefit transactions between a "disqualified person" and the organization.[15] An excess benefit is any economic benefit a disqualified person receives directly or indirectly from an applicable exempt organization if the value of the economic benefit provided exceeds the value of consideration received.[16] Disqualified persons include not just officers or directors of the organization, but also those in certain relationships with officers and directors, such as immediate family members.[17] Only the excess is subject to the excise tax.[18] The IRS has attempted to assert these penalties in

the context of nonprofit mergers and conversions, particularly when it believes that the valuation is not reasonable.[19]

RELINQUISHING TAX-EXEMPT STATUS

Restrictions that come with tax-exempt status continue to apply to the assets of a nonprofit, even if the organization relinquishes its tax-exempt status. Thus, when a tax-exempt organization converts from a tax-exempt entity to a for-profit, it must still ensure that it is carefully following the rules. An organization exempt under section 501(c)(3) is required to dedicate its assets to an exempt purpose.[20] The organization must also ensure that the conversion does not result in private benefit or inurement.[21] These IRS concerns are in addition to any reviews required by the appropriate state charity regulator in the nonprofit's state of incorporation.

Further considerations may also apply if the organization is a private foundation. Private foundations wishing to terminate or merge with another tax-exempt entity must adhere to the rules for terminating a private foundation under section 507.[22] Failure to comply with those rules or to time the transaction appropriately can result in a substantial termination tax.[23]

CONVERSIONS OF FOR-PROFITS TO NONPROFITS

When a for-profit converts to a nonprofit, the organizations should be careful to ensure that they are engaging in tax-exempt activities, have properly valued their assets, have paid any

necessary taxes under section 337(d) on the appreciation of its assets, and have not been formed to serve private interests. Failure to do so could result in a denial of their request for recognition of tax-exempt status or revocation of their status in an examination.[24]

CONCLUSION

In the context of tax-exempt organizations, it is important to ensure that any merger, acquisition, or conversion takes into account the organization's tax-exempt status and ensures that the rules applicable to those organizations are not violated.

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[1] All section references are to the Internal Revenue Code of 1986, as amended (the Code), and all regulatory references are to the Treasury Regulations currently in effect under the Code.

[2] Rev. Proc. 2018-15, 2018-9 I.R.B. 376.

[3] I.R.C. § 501(c)(3); I.R.C. § 501(c)(4)(B); Treas. Reg. § 1.501(c)(3)-1(c)(2).

[4] I.R.C. § 501(c)(3); I.R.C. § 501(c)(4)(B); Treas. Reg. § 1.501(c)(3)-1(c)(2).

[5] Anclote Psychiatric Ctr., Inc. v. Comm'r, 76 T.C.M. (CCH) 175 (1998).

[6] *See* Rev. Rul. 69-283, 1969-1 CB 156 (the IRS has viewed the prohibition as relating only to insider-controlled benefits).

[7] *Id.*

[8] I.R.C. § 501(c)(3); Treas. Reg. § 1.501(c)(3)-1(c)(1).

[9] I.R.C. § 501(c)(3); Treas. Reg. § 1.501(c)(3)-1(c)(1).

[10] Treas. Reg. § 1.501(c)(3)-1(c)(1).

[11] Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).

[12] *Id.*

[13] *See*, *e.g.*, Hancock Acad. of Savannah v. Comm'r, 69 T.C. 488 (1977).

[14] *Id.*

[15] I.R.C. § 4958; Treas. Reg. § 53.4958-3 (a disqualified person is any person in a position to exercise substantial influence over the affairs of the organization and those certain relationships with the disqualified person).

[16] Treas. Reg. § 53.4958-1(b).

[17] Treas. Reg. § 53.4958-3.

[18] Treas. Reg. § 53.4958-1(a).

[19] *See*, *e.g.*, Caracci v. Comm'r, 118 T.C. 379 (2002), *rev'd,* 456 F. 3d 444 (5th Cir. 2006).

[20] Treas. Reg. § 1.501(c)(3)-1(b)(4).

[21] Anclote Psychiatric Center, Inc. v. Comm'r, 76 T.C.M. (CCH) 175 (1998).

[22] I.R.C. § 507.

[23] I.R.C. § 507(c); I.R.C. § 507(d)(1)(C); Treas. Reg. §

1.507-3.

[24] *See, e.g.*, Rev. Rul. 69-266, 1969-1 C.B. 151.

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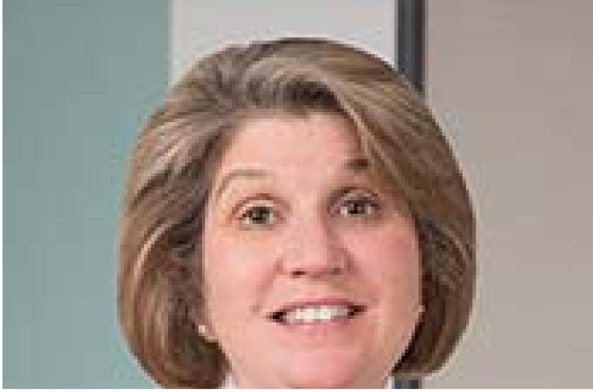

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