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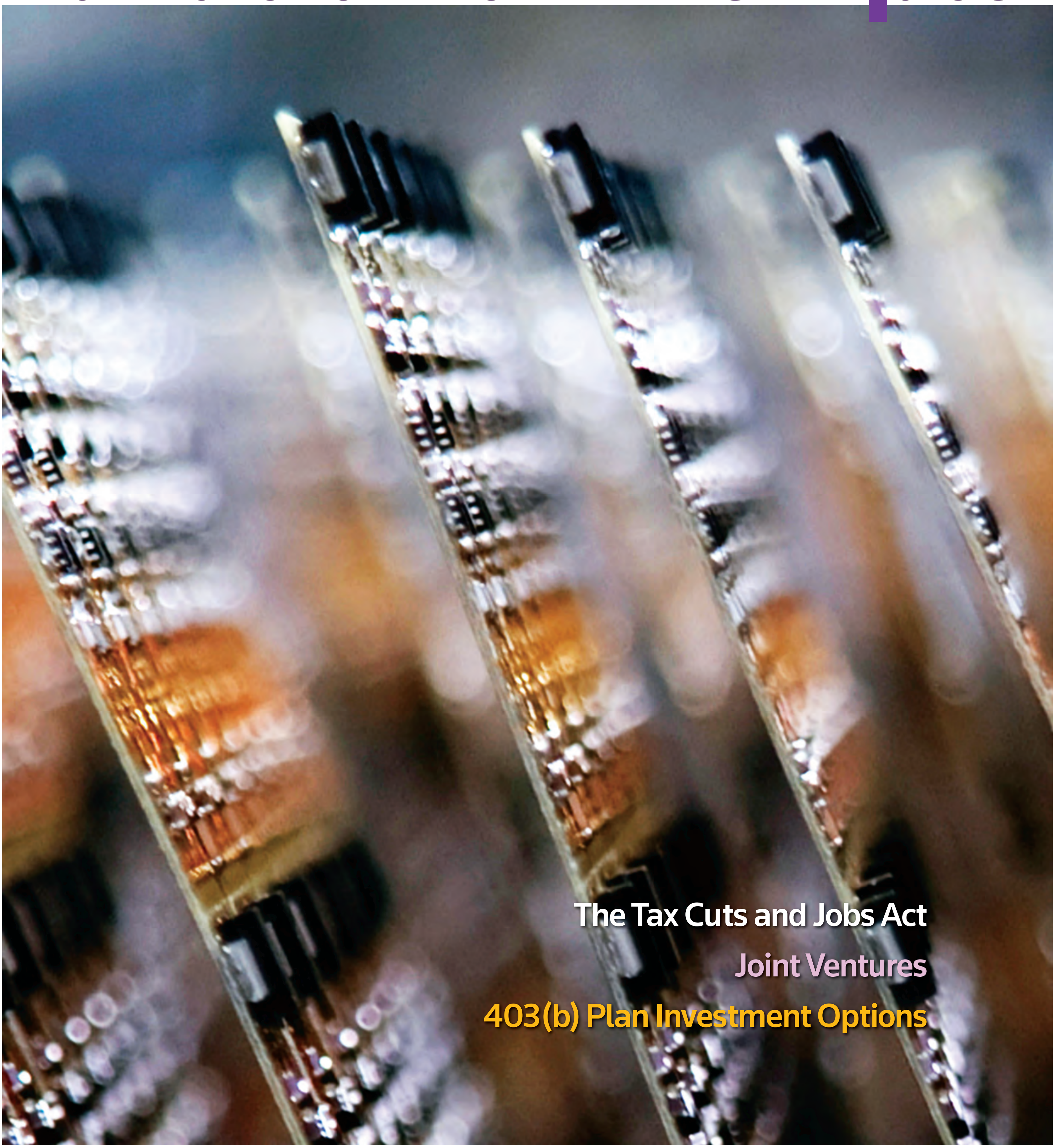

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THE SALE OF CHARITABLE ASSETS TO A FOR-PROFIT TO FURTHER EXEMPT PURPOSES: THE LEGAL CONSIDERATIONS

ERIN BRADRICK

Historically, the majority of sales of substantial charitable assets to taxable entities have occurred in the context of conversions of nonprofit hospitals and schools to for-profit entities,[1] but that trend seems to have been changing recently. Increasingly, there has been a blurring of the line between the nonprofit and for-profit sectors, with rising numbers of social enterprise ventures run by nonprofits, joint ventures between nonprofits and for-profits, and for-profit entities establishing affiliated nonprofits. For-profit entities are more frequently seeking to differentiate themselves and generate goodwill by self-identifying as sustainable businesses or social enterprises, and social entrepreneurs are expressing sector agnosticism as they seek the most effective and efficient way to accomplish their goals. With these changes, it is unsurprising that there is also an increase in the frequency of nonprofit entities considering a sale of significant charitable assets, or all of the assets related to a certain program or set of programs, to a for-profit entity.

These transactions are occasionally motivated primarily by financial considerations, such as when a nonprofit is seeking to convert to a for-profit entity or when a nonprofit has developed an asset or program that is inherently attractive to a for-profit purchaser. Sales are also sometimes motivated by a nonprofit's desire to wind down its affairs where it holds assets that may not be particularly attractive to other nonprofits..

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However, nonprofit sales of assets to for-profit entities that are motivated primarily by mission alignment and accomplishment of the nonprofit's exempt purposes are becoming more frequent. For example, some nonprofits have come to the conclusion that the operation of their programs within a for-profit entity would be likely to lead to increased and scaled charitable impact in a way the nonprofit seems unlikely to be able to accomplish on its own. Nonprofits that have arrived at this conclusion have then gone on to independently identify for-profit entities that are mission-aligned and have sought competitive bids from interested parties. Other nonprofits have entered into contractual transactions with for-profit entities operating in the same space, and, over time, such partnerships have organically led to discussions of a potential sale of the nonprofit's assets to the for-profit entity.

The sale of charitable assets held by an organization recognized as exempt under Section 501(c)(3) to a for-profit entity raises legal issues at both the federal and state levels, and is potentially subject to oversight by the IRS and the relevant state charity regulator. This article lays out some of those potential legal considerations, and assesses how they may apply to such transactions, particularly where motivated primarily by the nonprofit's desire to further its exempt purposes.

State nonprofit law considerations

Directors' fiduciary duties. In the context of the sale of a nonprofit's assets to a for-profit entity, the fiduciary duties the directors owe the nonprofit, including the duties of care[2] and loyalty,[3] do not necessarily dictate a particular outcome or specific terms of such transaction. They do, however, mandate that each director act in a manner that he or she reasonably believes to be in the best interests of the nonprofit, and puts the interests of the nonprofit above those of any other entity or individual.

When negotiating the terms of a sale, directors should generally seek to get the greatest value in return for the assets being sold, consistent with their applicable fiduciary duties. However, this has the potential to cause tension when a director believes that the sale of the assets to a for-profit, and possibly a particular for-profit, is the most effective and efficient way to further the nonprofit's mission. For example, would it be inconsistent with the duty of loyalty for a director to support the sale of charitable assets to the lower of two for-profit bidders where he or she believes that such purchaser is more likely to use the assets in furtherance of the nonprofit's charitable purpose?

Charitable trust law. Nonprofits hold charitable assets in trust to be used in furtherance of the charitable purposes for which they were raised, and generally may not divert such assets for use in furtherance of another purpose. For example, the Model Nonprofit Corporation Act, Third Edition, states: "Property held in trust by an entity or otherwise dedicated to a charitable purpose may not be diverted from its purpose by any transaction under this [chapter] unless the entity obtains an appropriate order of [*court*] [*the attorney general*] specifying the disposition of the property to the extent required by and pursuant to the law of this state on cy pres or otherwise dealing with the nondiversion of charitable assets."[4]

To be organized for the purposes specified in Section 501(c)(3) and satisfy the organizational test, a nonprofit's articles of incorporation or other appropriate organizing document must also permanently dedicate its assets to be used in furtherance of the organization's Section 501(c)(3)-consistent exempt purposes. In the context of a sale of charitable assets to a for-profit entity, this dedication requirement and the state doctrine of charitable trust typically require that the nonprofit receive at least fair market value (FMV) in exchange for any assets sold, and that the proceeds from the sale be used in furtherance of the charitable purposes for which the sold assets were held.

However, where mission alignment and probable use of the assets by the for-profit purchaser to further exempt purposes are part of the motivation for the sale, it is not as clear whether accepting less than the highest offer would be considered to be a violation of charitable trust. It is likely that most state charity regulators would view the transaction in light of all of the facts and circumstances.

For example, consider a situation in which one potential purchaser offers a set purchase price and is likely to use the purchased assets in furtherance of its charitable purposes. Another offers slightly more money and is likely to use the purchased assets for an unrelated purpose. A third offers slightly more money than the second, but will likely use the purchased assets to defeat the charitable purposes for which they were raised. Would a state charity regulator view all of the facts and circumstances and determine that accepting the first offer is consistent with the charitable trust applicable to the assets being sold, even if the selling organization could have received more for such assets?

Charity regulator review. Although the applicable requirements vary from state to state, the sale of charitable assets, including by an entity subject to the oversight of the respective state charity regulator, generally does not require prior review or approval by such office. However, certain states have enacted legislation requiring prior notice to be provided to the Attorney General or another state regulatory body before a nonprofit sells or otherwise transfers assets representing all or substantially all of the organization's current assets.

For example, the law applicable to California nonprofit public benefit corporations requires such entities to provide notice to the Attorney General 20 days before they sell, lease, convey, exchange, transfer, or otherwise dispose of all or substantially all of their assets "unless the transaction is in the usual and regular course of its activities or unless the Attorney General has given the corporation a written waiver of [the applicable] section as to the proposed transaction."[5]

While California law does not define what constitutes "substantially all" in this context, the California Attorney General has asserted that it has the full authority to review any transaction in which charitable assets subject to its oversight are being sold, to obtain all relevant information related to such transaction, and to take appropriate actions to remedy any breach of trust that occurs.[6] In making this assertion, the Attorney General points to its broad statutory authority to bring an action to enjoin, correct, obtain damages

Nonprofits hold charitable assets in trust to be used in furtherance of the charitable purposes for which they were raised, and generally may not divert such assets for use in furtherance of another purpose.

1 Specifically, private foundations may be subject to the following excise taxes and operating restrictions: A 2% tax on net investment income (Section 4940), prohibitions on self-dealing (Section 4941), minimum income distribution requirements (Section 4942), prohibition on excess business holdings (Section 4943), limitations on high-risk investment of foundation assets (Section 4944), and limitations on expenditures of foundation funds (Section 4945). Additionally, while public charities can undertake certain insubstantial lobbying activities, private foundations cannot lobby at all. Section 501(h).

2 Section 507.

3 Section 170(b)(1)(A).

4 Section 6104(b).

5 "For purposes of this title, the term 'private foundation' means a domestic or foreign organization described in section 501(c)(3) other than" the organizations listed in subparagraphs (1) through (4) of Section 509(a).

6 Section 509(b).

for, or otherwise remedy a breach of charitable trust,[7] and its general authority to examine any California nonprofit public benefit corporation at any time to "ascertain the condition of its affairs and to what extent, if at all, it fails to comply with trusts which it has assumed or has departed from the purposes for which it is formed."[8]

If a California nonprofit corporation is required to provide advance notice of a proposed sale to the state Attorney General, it must submit to the Attorney General a letter signed by an attorney for or director of the corporation describing the details of the proposed transaction; a copy of the resolution adopted by the board of directors approving the transaction; current financial statements; and its articles of incorporation and the formation documents for any other party to the transaction.[9] The Attorney General may also request evidence of an independent appraisal or otherwise demonstrating that the sale price and terms are fair to the nonprofit.

Certain states have enacted legislation requiring prior notice to be provided to the Attorney General or another state regulatory body before a nonprofit sells or otherwise transfers all or substantially all of the organization's current assets.

In its Review Protocol with respect to such transactions, the California Attorney General lists extensive documents that should be obtained and reviewed, including any collateral or ancillary agreements; financial documents on which future earnings and FMV analysis may be based; relevant contracts that may affect value; employee contracts; information relating to ownership interests in the purchaser; and all documentation relating to the process by which the board approved the proposed transaction.[10] The Protocol makes clear that the Attorney General primarily will be reviewing the transaction to ensure no self-dealing or private inurement will occur, and that the nonprofit is receiving at least FMV in exchange for the assets it is selling.[11]

In a similar document, the Michigan Department of Attorney General states that its broad common law and statutory authority to protect charitable assets in the state extends to the sale of charitable assets.[12] Although the Michigan Nonprofit Corporation Act does not explicitly require notice to be provided to the Attorney General in advance of the sale of a Michigan nonprofit's assets, even if substantially all of the assets are being sold, the Attorney General indicates on its website that the "sale or conversion of nonprofit entities to for-profit ones creates a risk that charitable assets will be diverted for private benefit," and because of "the risk to charitable assets, the Charitable Trust Section reviews these transactions."[13]

The Review Process document issued by the Michigan Attorney General states that any party requesting review by the Attorney General should submit a lengthy list of documentation relating to the proposed transaction, including a narrative describing the purposes and programs of the nonprofit, the circumstances that led to the proposed sale, and the process used to reach the terms of the proposed transaction; copies of all bona fide purchase offers received by the nonprofit in the prior three years; copies of all nonprofit board and committee meeting minutes discussing the proposed sale or the specific transaction; copies of the due diligence materials used by the board or committee; information related to any related-party transactions; copies of any ancillary agreements that may involve directors, officers, or key employees of the nonprofit; and information regarding how the proceeds of the sale will be used.[14]

However, while both of these Attorney General guides emphasize the importance of ensuring that the nonprofit receives FMV in exchange for any assets it sells, neither addresses how mission furtherance may affect the terms of the transaction, or how the Attorney General would consider the nonprofit's acceptance of a lower offer by a potential purchaser that was more mission-aligned. Rather, the California Review Protocol explicitly states "[s]imply put, the charitable beneficiaries are entitled to receive maximum value for their assets."[15]

Federal tax law considerations

Private benefit. Although Section 501(c)(3) does not directly mention private benefit, it does require an organization to be organized and operated exclusively for one or more purposes set forth in that Section. The associated Regulations provide that an organization is not organized and operated exclusively for exempt purposes within the meaning of Section 501(c)(3) if it serves a private rather than public interest.[16] Although a 501(c)(3) exempt organization may provide benefits to private entities or individuals, such benefits must be incidental, both quantitatively and qualitatively, to furthering the organization's public purposes.[17]

In this context, qualitatively incidental means that "the private benefit is a mere byproduct of the public benefit."[18] Quantitatively incidental means that the private benefit must be insubstantial in amount when compared to the public benefit of the specific activity in question.[19]

When there is a sale of a 501(c)(3)'s assets to a for-profit entity, the 501(c)(3) will typically need to ensure that it receives at least FMV in return for any assets that it sells to avoid providing a prohibited private benefit to the purchaser. However, a finding of private benefit does not necessarily require that a 501(c)(3) receive less than FMV for goods or services that it sells, or make payments for goods or services that it purchases that are more than FMV. Rather, the question is generally whether the 501(c)(3) is providing a substantial benefit to a private individual or entity. Any scrutiny of such a transaction would look to whether it was engaged in and structured for the benefit of the 501(c)(3) and to further its exempt purposes, or primarily for the benefit of the for-profit purchaser.

Private inurement. Section 501(c)(3) describes an organization organized and operated exclusively for one or more of the purposes set forth in that Section, "no part of the net earnings of which inures to the benefit of any private shareholder or individual."[20] The corresponding Regulations provide that an organization is not operated exclusively for one or more exempt purposes within the meaning of Section 501(c)(3) if it permits its net earnings to inure to the benefit of private shareholders or individuals.[21] In this context, a private shareholder or individual is someone who has a personal and private interest in the activities of the organization, referred to as an "insider" of the organization.[22] While there is no strict definition of "inure" in this context, it is generally understood as providing unjust enrichment from the organization's net earnings or assets to an insider of the organization.[23]

In a substantial sale of a 501(c)(3)'s assets to a for-profit entity, the greatest risk of inurement exists when directors, officers, or other key employees of the selling organization have a financial interest in the purchaser or otherwise in the proposed transaction. As the IRS has noted,

> …[t]here is no absolute prohibition against an exempt section 501(c)(3) organization dealing with its founders, members, or officers in conducting its economic affairs. However, any transaction between a section 501(c)(3) organization and one or more individuals who control the organization, in which the individuals appear to receive a disproportionate share of the benefits of the exchange relative to the exempt purposes served, presents a possible case of prohibited inurement.[24]

The risk of inurement may arise where a for-profit entity owned or controlled by an insider of the nonprofit or his or her family members initiates discussions of a sale with the 501(c)(3). It may also arise by virtue of the proposed terms of the transaction. For example, it may be customary in a for-profit acquisition of another for-profit entity for the acquiring entity to offer lucrative compensation packages, stock options, bonuses, or other benefits to the leaders of the to-be-acquired entity to incentivize the deal. However, in the context of the purchase of a 501(c)(3)'s assets, such offers may be viewed as allowing amounts that should have been paid to the 501(c)(3) to instead improperly inure to the benefit of its insiders.

Excess benefit transactions. Even when a transaction in which insiders of the 501(c)(3) public charity have an interest does not rise to the level of private inurement, the excess benefit transaction rules may apply. Under Section 4958, an excess benefit transaction is "any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit." A disqualified person generally includes any person who, at any time during the five years prior to the date of the transaction involving the excess benefit, was in a position to exercise substantial influence over the affairs of the organization, a family member of such an individual, or an entity of which such a person controls 35% or more.[25]

A disqualified person who receives an excess benefit is subject to an initial excise tax equal to 25% of the excess benefit.[26] If the disqualified person fails to correct the excess benefit transaction within the taxable period (the period between when the transaction occurs and the earlier of the date of mailing of a deficiency notice by the IRS with respect to the 25% tax or the date on which the 25% tax is assessed), he or she will also generally be subject to an additional excise tax equal to 200% of the excess benefit.[27] Whenever the initial tax is imposed on a disqualified person pur-

A 501(c)(3) organization will typically need to ensure that it receives at least FMV in return for any assets that it sells to avoid providing a prohibited private benefit to the purchaser.

7 Section 509(a)(1).
8 Section 509(a)(2).
9 Section 509(a)(3).
10 Section 509(a)(4).
11 That is so because Sections 509(a)(3) and Section 509(a)(4) are available only to a relatively narrow category of exempt entities.
12 Section 509(d); Reg. 1.170A-9(f)(7).
13 Exempt function income is income earned by the organization in furtherance of its exempt purposes, such as admission fees, sales of merchandise, performance of services, and furnishing of facilities. Reg. 1.513-1(d)(4)(i).
14 Reg. 1.170A-9(f)(6).
15 Reg. 1.170A-9(f)(3).
16 Included in the definition of disqualified persons are "substantial contributors"—those who make contributions in excess of $5,000—if their contributions are greater than 2% of the organization's overall support. Sections 4946(a)(1)(A), Section 507(d)(2).
17 Sections 4946(a)(2); Section 507(d)(2).
18 Sections 509(d)(1)-(6).
19 Regs. 1.170A-9(f)(4)(v); Reg. 1.509(a)-3(d)(2).
20 Reg. 1.170A-9(f)(4)(v)
21 Regs. 1.170A-9(f)(4)(v)(B); Reg. 1.509(a)-3(d)(2).
22 Reg. 1.170A-9(f)(4)(vii).
23 That is the case even though the current regulations attempt to mitigate the effects of uncommon variations in the organization's revenue stream by determining the qualification for public charity status based on a five-year snapshot.
24 Reg. 1.170A-9(f)(6)(ii).
25 Reg. 1.509(a)-3(c)(3).
26 Reg. 1.170A-9(f)(6)(ii). A similar analysis applies for analyzing whether exempt entities that are initially classified as public charities under Section 509(a)(2) continue to qualify as public charities after their fifth year. Regs. 1.509(a)-3(c)(3)(i)-(iii).
27 Regs. 1.170A-9(f)(6)(iii); Reg. 1.509(a)-3(c)(4).

suant to Section 4958(a)(1), organizational managers of a 501(c)(3) (including any officer, director, or individuals having similar powers or responsibilities) are also subject to an excise tax of 10% of the excess benefit, up to a total of $20,000, if the managers willfully and without reasonable cause approved the transaction knowing it was an excess benefit transaction.[28]

When a 501(c)(3) public charity engages in a sale of its assets to a for-profit entity in which a disqualified person has a direct or indirect financial interest, it will trigger consideration of the excess benefit transaction rules. To avoid providing an excess benefit, it will likely be all the more important for the nonprofit to ensure that it receives as least FMV for any assets that it sells to a disqualified person or an entity owned or controlled by a disqualified person.

Specific transaction considerations

Determining purchase price and terms of sale. As mentioned above, to avoid providing a prohibited private benefit, engaging in an excess benefit transaction, or breaching the doctrine of charitable trust, the consideration to be provided in exchange for the assets of a 501(c)(3) must generally reflect at least the FMV of such assets. Both the IRS and state Attorneys General have emphasized the importance of obtaining an independent valuation of the assets to be sold as a mechanism for ensuring FMV is obtained.[29] Using external experts and processes to value the assets is particularly crucial where insiders of the nonprofit stand to gain from the sale in some manner.

Both the IRS and state Attorneys General have emphasized the importance of obtaining an independent valuation of the assets to be sold as a mechanism for ensuring FMV is obtained.

The IRS has noted that, where the sale is to an independent third party in an arm's-length transaction,

> a presumption exists that the purchase price (arrived at through negotiations) represents fair market value. However, where the purchaser is controlled by the seller (or there is a close relationship between the two) at the time of the sale, this presumption cannot be made because the elements of an arm's length transaction are not present. In situations where there is common control of or a close relationship between the buyer and seller and both tangible and intangible assets are being purchased, the value of the tangible assets must first be established by independent appraisal.[30] Although stated in the context of a nonprofit's purchase of the assets of a for-profit hospital, the principles also likely apply in the reverse situation.

The California Attorney General points to the definition of FMV set forth in the Code of Civil Procedure as instructive in the context of the sale of nonprofit assets to for-profits.[31] That definition states that the

> fair market value of the property taken is the highest price on the date of valuation that would be agreed to by a seller, being willing to sell but under no particular or urgent necessity for so doing, nor obliged to sell, and a buyer, being ready, willing, and able to buy but under no particular necessity for so doing, each dealing with the other with full knowledge of all the uses and purposes for which the property is reasonably adaptable and available.[32]

However, the definition also acknowledges that certain property may not have a widespread market by which FMV can readily be judged. This is often the case where discussions of nonprofit sales of assets to for-profits have grown organically out of prior mission-furthering transactions and relationships between the two entities involved. In such instances, the nonprofit's primary assets of value are typically intangible assets, including developed technology, other intellectual property, and customer relationships. The definition pointed to by the California Attorney General goes on to state that the "fair market value of property taken for which there is no relevant, comparable market is its value on the date of valuation as determined by any method of valuation that is just and equitable."[33]

A representative from a state charity regulator's office recently unofficially stated her understanding that certain assets will not have a readily available market and their sale may not be the result of competing bids from multiple potential purchasers. The representative noted that obtaining an independent valuation from outside experts may not always be in the best interests of the selling nonprofit (for example, where the valuation of difficult-to-value assets may be very costly and the value of such assets is likely rather low). In either instance, the representative indicated that the office would expect a detailed explanation of all of the relevant factors leading to the proposed terms of the transaction and would consider all such facts and circumstances in its review.

In reviewing any sale of assets to a for-profit, the IRS or relevant state charity regulator is likely to scrutinize all of the terms and conditions of the sale that might affect its fairness and favorableness to the nonprofit, including any contingencies that might influence the total purchase price, indemnification provisions, deferred payments, and noncompete provisions. Whereas installment payments, with post-closing installments tied to future earnings, may be common in for-profit to for-profit acquisitions, they are likely to be viewed skeptically in the context of a for-profit's purchase of a nonprofit's assets, particularly if special protections are not in place to prevent the purchaser from depressing post-closing short-term earnings or unfavorably allocating costs or expenditures.[34]

Where the sale is not an all-cash acquisition and stock represents a significant portion of the purchase price, additional issues affecting the stock value, including liquidity, restrictions on sale, control issues, potential future dilution, and voting rights, are also likely to be carefully scrutinized. Any such issues relative to stock received in exchange for the sale may limit the ability of the selling nonprofit to use the proceeds from the sale in furtherance of its charitable purposes.

In an instructive private letter ruling issued in 2013, which is discussed in further detail below, the IRS examined the sale of all of the subject 501(c)(3)'s assets to a related for-profit in exchange for a specified number of shares of common stock in the for-profit entity.[35] The IRS placed particular emphasis on the lack of an independent appraisal of FMV and the arbitrary determination of the purchase price, noting that the transactions at issue "were not arms length, where the value of assets were arbitrarily determined by the board of directors with no appraisal and those transactions resulted in inurement."[36]

However, there has not yet been any clear guidance about how mission alignment might affect the terms of such a transaction. If FMV is in part determined based on the highest price that would be agreed to by a seller, does a nonprofit have the authority to accept an offer that is not the highest received from a potential purchaser who is more likely to use the sold assets in furtherance of the nonprofit's mission, or to shop the assets only to such aligned entities in the first place?

While not dispositive in other instances, in a recent sale of substantially all of the assets of a California nonprofit to a for-profit entity, the California Attorney General did not object to the proposed transaction, which included an all-cash purchase price within the range of a valuation of the intangible assets to be sold by an independent, third party valuation firm. This was despite the fact that the selling nonprofit had determined that the sale would be more likely to maximize the long-term scalability and potential impact of such assets and proceeded to self-identify potential purchasers. It evaluated them based on each potential purchaser's financial stability, ability to scale the nonprofit's current activities, present investments targeted to achieve impact, and likelihood of success, and then solicited bids from three such identified entities.

Conflicts of interest. Where the terms of the transaction may lead to financial benefits or arrangements with the selling nonprofit's directors, officers, or employees, or their family members, particular attention will be paid to such potential conflicts of interest, especially if they may affect the overall benefit of the transaction to the nonprofit entity and/or the individual's objectivity in approving the transaction. For 501(c)(3)s, such conflicts increase the risks of private inurement and excess benefit transactions.

In the 2013 private letter ruling referenced above, the IRS made a final determination that the subject organization did not qualify for exempt status under Section 501(a) as an organization described in Section 501(c)(3).[37] The organization at issue was formed for the purpose of developing and delivering educational courses and programs to enhance the competitiveness of the automotive service workforce, and to develop standards in education and training for the automotive service industry. It applied for and received recognition of exemption under Section 501(c)(3). It subsequently formed a separate corporation with similar purposes, which it merged into, and continued operating the surviving entity with the disappearing entity's employer identification number and tax-exempt status.

After several failed ventures involving contracts with for-profit entities, the organization was facing financial decline and decided to pivot its business model to online training for automotive service technicians. However, on realizing that this would require significant capital infusion, might be unattractive to grant-making entities, and was possibly unrelated to its exempt purposes, it formed a separate for-profit corporation to engage in such activities. The for-profit and the nonprofit entered into a management services agreement, pursuant to which the for-profit made payments to the nonprofit in the form of cash and stock in the for-profit.

Subsequently, the two entities entered into an asset purchase agreement pursuant to which the nonprofit sold all of its assets, including contracts and accounts receivable, in exchange for a specified number of shares of common stock in the for-profit entity. A majority of the for-profit's stockholders were the officers and directors of the nonprofit and received a certain percentage of the shares of stock of the for-profit. The parties then entered into a stock redemption agreement by which the for-profit agreed to purchase all of its shares held by the nonprofit, with a specified number of shares to be purchased each

When a 501(c)(3) public charity engages in a sale of its assets to a for-profit entity in which a disqualified person has a direct or indirect financial interest, it will trigger consideration of the excess benefit transaction rules.

28 Specifically, a relationship described in Sections 4946(a)(1)(C)-(G).

29 Reg. 1.509(a)-3(c)(4)(i). These factors are listed in the regulations underlying the requirements for qualifying as a Section 509(a)(2) public charity. However, they are expressly incorporated into the analysis for testing a Section 509(a)(1) charity. Reg. 1.170A-9(f)(6)(iii).

30 *Id.*

31 Reg. 1.509(a)-3(c)(4)(ii).

32 *Id.*

33 Reg. 1.509(a)-3(c)(4)(iii).

34 Reg. 1.509(a)-3(c)(4)(iv).

35 Reg. 1.509(a)-3(c)(4)(v).

36 Reg. 1.509(a)-3(c)(4)(vi).

37 Reg. 1.509(a)-3(c)(4)(vii).

month at a set price. However, when the for-profit was later unable to meet its stock purchasing obligations, the agreement was amended to cease payments to the nonprofit until such time as the for-profit had sufficient cash flow to continue. When it did resume the purchases two years later, it was at a significantly lower purchase rate per month. For five years after the sale of its assets, the nonprofit essentially had no activities other than to hold the cash and stock received from the for-profit.

Where the terms of the transaction may lead to financial benefits or arrangements with the selling nonprofit's directors, officers, or their family members, particular attention will be paid to the potential conflicts of interest.

In the private letter ruling, the IRS determined that the relevant organization was not described in Section 501(c)(3) because, by selling all of its assets to a for-profit entity in a transaction that resulted in private inurement, it was not operated primarily for 501(c)(3) exempt purposes. In assessing the private benefit and private inurement, the IRS found that the benefits received by the for-profit were more than incidental and the 501(c)(3) was operated as the instrument to subsidize the for-profit.

When applicable, state self-dealing statutes that apply to transactions in which the nonprofit's directors or officers have a financial interest may also be implicated where the sale of a nonprofit's assets to a for-profit involves a potential conflict of interest. For example, in California, the self-dealing statute applicable to California nonprofit public benefit corporations in part requires a transaction in which a director of the nonprofit has a material financial interest to be approved in advance by a good faith and informed vote of a majority of the directors then in office without counting the vote of any interested director, and that the board considered and determined in advance that the nonprofit could not have obtained a more advantageous arrangement with reasonable effort under the circumstances.[38] This "most advantageous arrangement possible" requirement may make it challenging for a subject California nonprofit to accept an offer from a purchaser that is not the highest offer received where a director has a material financial interest in the transaction, even if attempting to prioritize charitable impact.

Even if the transaction's benefits are flowing to the nonprofit's junior employees, rather than to its officers, directors, or key employees, it may still raise concerns of prohibited private benefit. For example, if a nonprofit accepts a lower offer from a purchaser who is willing to employ many or all of the nonprofit's employees, and therefore may be more likely to use such assets to continue furthering their charitable purpose, over a higher offer from one who is not, it could raise the question of whether such acceptance provides a prohibited private benefit to such individuals. If the compensation and retention arrangements offered by the potential purchaser are considered by the nonprofit's board of directors in approving the transaction, there may also be a question of whether such terms affected the board's objectivity or the carrying out of the directors' fiduciary duties.

Use of sale proceeds. Regardless of the transaction's final terms, the selling nonprofit will be required to use the proceeds from the sale in furtherance of its 501(c)(3) exempt purposes and, short of a cy pres action permitting otherwise, consistent with the charitable trust restrictions on the assets that were sold. This may be accomplished by pivoting the programmatic activities of the nonprofit to serve the same class of beneficiaries through a different set of programs, or through a shift to grantmaking to support consistent activities conducted by other entities. At the state level, if applicable, the Attorney General or other oversight body reviewing the proposed transaction will expect to see a description of how the nonprofit plans to use the sale proceeds to continue furthering its charitable purposes post-closing.[39]

To continue qualifying as exempt under Section 501(c)(3), the selling nonprofit will also need to keep satisfying the operational test and ensuring proper use of its remaining assets, including any proceeds from the sale. In a particularly egregious situation, the IRS revoked the exempt status of a nonprofit under Section 501(c)(3) after it sold its assets to a for-profit entity and then failed to distribute the proceeds from the sale to another organization recognized as exempt under Section 501(c)(3). Instead, it permitted the proceeds to inure to the benefit of one of the nonprofit's directors.[40]

While the prohibition of such direct inurement of sale proceeds may be rather obvious, the IRS has also not looked favorably on a nonprofit merely sitting on such proceeds. In the 2013 private letter ruling discussed above, the IRS rebuked the nonprofit's assertion that its post-sale activities consisted of making grants to other tax-exempt organizations with similar purposes, noting that, at the end of the five-year period

38 Reg. 1.509(a)-3(c)(4)(viii).
39 Reg. 1.509(a)-3(c)(4)(ix).
40 Rev. Rul. 76-440, 1976-2 CB 58.
41 Reg. 1.509(a)-3(c)(6), Example 2.
42 Reg. 1.509(a)-3(c)(6), Example 3.
43 Reg. 1.509(a)-3(c)(6), Example 4.
44 Reg. 1.509(a)-3(c)(6), Example 5.
45 Reg. 1.509(a)-3(c)(6), Example 6.
46 Reg. 1.509(a)-3(c)(6), Example 7.
47 1976-2 CB 58.
48 In fact, due to the potential for uncertainty in determining whether a contribution is an unusual grant, the regulations expressly authorize private letter ruling requests for that purpose. Reg. 1.509(a)-3(c)(5).
49 See e.g. Ltr. Rul. 201239011; Reg. 1.509(a)-3(c)(6), Example 6 (note 45, *supra*).

after the sale, a total of only two distributions had been made by the organization.[41]

Post-sale relationships. Ongoing relationships between the 501(c)(3) and the for-profit purchaser of its assets after the closing of the transaction can be particularly problematic. Where such sales have grown organically out of a prior mission-furthering partnership between the entities, it may be assumed that the parties will continue in close collaboration after the transaction. However, as mentioned above, the selling organization's continued 501(c)(3) exempt status will be dependent on its continued operation in a manner that is consistent with the exemption requirements.

The 501(c)(3) cannot act merely as the exempt entity arm of or "simply the instrument to subsidize"[42] the for-profit purchaser. Operating in a manner that indicates a substantial private benefit, including by steering business to a for-profit entity, may cause the organization to fail to be operated primarily in furtherance of exempt purposes within the meaning of Section 501(c)(3). This is true even if any payments from the 501(c)(3) to the for-profit entity are reasonable in light of what the nonprofit is receiving in return.[43] Rather, as the Ninth Circuit Court of Appeals has held, in scrutinizing a contractual relationship between a 501(c)(3) and a related for-profit, the central "inquiry is not whether particular contractual payments to a related for-profit organization are reasonable or excessive, but instead whether the entire enterprise is carried on in such a manner that the for-profit benefits substantially from the operation of the" 501(c)(3).[44]

If the terms of the sale incorporate or assume that, post-closing, the nonprofit will be required to contract with the for-profit purchaser for certain services or use of the sold assets, that will also be viewed suspiciously in any regulatory entity review. For example, the California Attorney General Review Protocol states "[w]here sale proceeds are tied to the provision of services by the acquiring for-profit entity, they should be carefully scrutinized for necessity, valuation, and verifiability. These provisions are always suspect."[45]

The IRS has also noted the potential problems with such post-transaction contractual arrangements, particularly where insiders of the selling entity have a financial interest in the for-profit purchaser or where the nonprofit does not maintain substantial ongoing exempt activities. In the 2013 private letter ruling, the IRS said that, following the sale of the nonprofit's assets to the for-profit, the entities also entered into an administrative services agreement pursuant to which the nonprofit paid the for-profit a monthly fee to provide it with accounting and financial services, grant management services, maintenance and security of historical and official business, and other administrative services.[46] In finding that the nonprofit was not operated in a manner consistent with exemption under Section 501(c)(3), the IRS in part determined that the organization's post-transaction activities consisted primarily of making monthly payments to the purchaser for administrative services, which resulted in a prohibited private benefit to the for-profit purchaser and indirect private inurement to the common directors of the two entities.[47] If disqualified persons of the selling 501(c)(3) public charity are parties to such post-sale transactions, including if the purchasing entity is sufficiently controlled by disqualified persons and is itself a disqualified person, the excess benefit transaction rules discussed above may also apply.

Conclusion

Sales of significant charitable assets by 501(c)(3) public charities to for-profit entities motivated primarily by mission alignment and accomplishment of the 501(c)(3)'s exempt purposes are increasing in frequency. For example, 501(c)(3)s have independently reached the conclusion that certain charitable assets or programs would be more likely to lead to increased and scaled charitable impact if operated by a for-profit entity, rather than by the 501(c)(3). Sale conversations have also grown organically out of a prior contractual relationship between a 501(c)(3) and a for-profit operating in the same space.

As more 501(c)(3) entities engage in social enterprises and seek to achieve impact through the development of technological or other tools, and as more entrepreneurs seeking to have positive social influence elect for-profit business models for doing so, it is likely that there will be continued changes in the nature of, and motivation for, the sale of charitable assets to for-profit entities.

Such sales, regardless of motivation, raise significant legal issues under both state and federal laws and may potentially be subject to oversight or review by the IRS and the relevant state charity regulators. While many of the basic legal principles applicable to the sale of 501(c)(3) charitable assets to for-profit entities are well-established, there remain many open questions as to how and under what conditions such sales may be structured when a substantial or the primary motivation is to further the selling 501(c)(3)'s exempt purposes. ■