Sale of Nonprofit Assets Creates New Benefits and Risks

What are the legal requirements when a nonprofit sells its assets?

BY JOHN R. OWEN, III

Many nonprofit hospitals—often under mounting financial pressure—are being sold to for-profit healthcare organizations. A recent survey suggests that the sale of these nonprofit hospitals has become the largest transfer of charitable assets in history—nearly $9 billion so far.

And hospitals aren't the only nonprofit organizations whose assets are being converted. Trends indicate that other types of nonprofits are becoming increasingly involved in such transfers. All nonprofits, therefore, should be aware of the legal requirements that apply when a nonprofit's assets are sold to another entity.

What Are the Legal Requirements?

Under the common law of trusts and the nonprofit laws of most states, the proceeds from the sale of nonprofit assets must continue to serve the community. If a charitable hospital is sold, for example, the proceeds of the sale may be used to establish a charitable foundation which continues to serve the community. It's the job of the Attorney General to review whether the proceeds serve the public's interest. It's the job of the Internal Revenue Service (IRS) to check that individuals within nonprofit organizations don't misuse the tax-exempt status of a nonprofit organization for personal gain in a sale.

State Attorney Generals and the IRS, therefore, scrutinize the sale of nonprofit assets. Either can derail a sale if it causes a loss to the community or violates tax laws. Because of this heightened scrutiny, boards of directors of charities selling all or part of their assets should be closely involved in the sale process.

Three legal requirements apply under the common law of trusts and the Internal Revenue Code when substantially all the assets of a nonprofit are sold:

1. Full and fair value must be paid for the charitable assets conveyed.
2. The proceeds of such conveyance must be applied to proper charitable purposes.
3. Private individuals must not receive improper private benefit. Golden parachutes, severance payments, and generous salaries with nonprofit foundations are suspect.

How to Satisfy Your Attorney General

Parties to a sale of nonprofit assets should notify the Attorney General well in advance of a sale of substantially all of the nonprofit's assets. The Attorney General will ask several questions:

1. Is the sale price of the charitable assets fair? Parties to a sale of charitable assets should obtain an independent, professional appraisal of the assets and provide a full explanation of the appraisal method. It is best if the charity can find more than one bidder for the asset.
2. How will the proceeds of the sale be used? If the sale proceeds will be used to form a foundation, for example, this foundation should continue to serve the community's charitable needs.

It is best if the charity can find more than one bidder for the asset.

3. Are there any special restrictions on the charitable assets? If a charity, or a fund within a charity, was created by a donor to serve a certain purpose, proceeds from the sale of its assets should be used to fulfill the donor's wishes. If the original purpose of the donor can no longer be fulfilled—the eradication of smallpox, for example—then an approximation of the original intent should be sought and approved by the Attorney General and possibly a court.

How to Satisfy the IRS

In its review of the sale of nonprofit assets, the IRS will want to know:

1. Did the charity receive an appraisal of the assets by independent, nationally-recognized professionals? The IRS publishes valuation standards for all appraisals. In general, the IRS expects the price of a nonprofit asset to be in excess of four to six times the asset's "earnings before interest, taxes, depreciation and amortization."
2. Did the nonprofit organization look for other bidders?
3. Will the for-profit purchaser provide charity care?
4. Have there been arms-length negotiations to ensure that the amount paid for the charity's assets is fair and won't result in private benefit to the buyer or any private shareholder or individual?
5. Will some charity continue to promote care in the community previously served by the nonprofit?
6. Will "insiders" at the nonprofit receive excess compensation or other benefits from a foundation created with proceeds from the sale?

The sale of nonprofit assets can lead to stronger providers that are better able to meet the needs of the community. Parties to such sales need to take care, however, to negotiate at arms length and to satisfy legal requirements. ■

Selected References

Muehrcke, Jill, ed., *Law & Taxation*, *Leadership Series*.

O'Connell, Brian, "Salaries in Nonprofit Organizations," *Nonprofit World*, July-August 1992.

Schmidt, Sarah J., "Avoiding the Snares of Intermediate Sanctions," *Nonprofit World*, November-December 1996.

Tesdahl, D. Benson, "New Penalties Proposed for Nonprofits," *Nonprofit World*, January-February 1996.

These publications are available through the Society for Nonprofit Organizations' Resource Center. See the *Resource Center Catalog*, included in this issue, or contact the Society at 6314 Odana Road, Suite 1, Madison, Wisconsin 53719 (800-424-7367).

John R. Owen, III, is a member of the tax department at Eckert Seamans Cherin & Mellott, LLC, a national law firm (600 Grant Street, 42nd Floor, Pittsburgh, Pennsylvania 15219, 412-566-6000). Mr. Owen's practice focuses on the establishment of many different types of charities and tax-exempt organizations with the IRS. He has advised on complete reorganizations of tax-exempt entities, including taxable and tax-exempt affiliates, and sales and conversions of nonprofit entities to for-profit organizations, and vice versa.

Nonprofit World • Volume 16, Number 4 July/August 1998
Published by the Society for Nonprofit Organizations
6314 Odana Road, Suite 1, Madison, WI 53719 • (800) 424-7367