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Tax-Exempt Organizations — Common Legal Issues and Traps for the Unwary

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Tax-exempt organizations are often so involved in the fulfillment of their mission that common legal issues may go unnoticed or unaddressed. This article discusses certain issues that crop up again and again for these organizations, and particularly for organizations recognized as exempt under §501(c)(3), and offers practical ways to identify and address those issues.

"PARTNERSHIPS" WITH OTHER NONPROFIT ORGANIZATIONS AND FOR-PROFIT ORGANIZATIONS

Issue

Tax-exempt organizations often enter into common ventures or relationships with other organizations that are collaborative in nature rather than merely quid pro quo. These relationships are frequently referred to as "partnerships" by tax-exempt organizations because the connotation is one of teamwork and working toward a common goal. However, under state law, entering into a "partnership" can result in a host of liabilities that none of the "partnering" organizations intended. In addition, if one of the partners is a for-profit entity, the partnership could jeopardize the federal tax-exempt status of the tax-exempt organization.

If two or more parties join together for a common business purpose, they may create a general partnership under the laws of the state in which they are conducting that business. "Joint ventures," which are generally limited in scope to a specific project, may be considered general partnerships under this theory, as well. By calling the relationship between two organizations a "partnership," the participating organizations could be establishing a presumption, at least to the general public, that they are operating as a general partnership. The problem therein is that, in a general partnership, any general partner can bind the partnership and each general partner is jointly and severally liable for the debts and obligations of the partnership. Thus, in an effort to be collaborative, a tax-exempt organization could inadvertently subject itself to the unsupervised activities of its partner. It would be possible to rebut the existence of a partnership based on the argument that the organizations were not "conducting business." However, the inference created by referring to the relationship as a partnership and the potential cost of having to litigate that position make the problem easier to avoid than to fight.

In addition to the liability concerns of creating a general partnership under state law, if the partner is a for-profit entity, then the problems can compound at the federal income tax level. Any partnership with a for-profit organization can be dangerous and the agreement should be carefully reviewed for compliance with tax-exemption requirements. The activities of a partnership are imputed to its partners for federal income tax purposes. Thus, there need to be adequate procedures in place to ensure that the activities of the partnership further the exempt purposes of a tax-exempt organization partner. Furthermore, the partnership agreement needs to be drafted to ensure that the tax-exempt partner has sufficient control over the partnership to ensure that the partnership's activities continue to further the exempt purposes of the tax-exempt partner and do not allow for any impermissible private benefit or private inurement.[1]

[1] *See* Rev. Rul. 2004-51, 2004-22 I.R.B. 974; Rev. Rul. 98-15, 1998-1 C.B. 718.

ISSN 0886-3547

Ways to Address Issue

Assess the Goals of the Relationship

Although two (or more) organizations may view a short or long-term collaborative project as a partnership, a tax-exempt organization should evaluate exactly what it is seeking to give and receive with respect to the project and determine whether there is a more efficient legal structure for the relationship. For example, if the tax-exempt organization is providing funding for a project and another organization will be performing services relating to the project, then a services agreement with specific project deliverables and set compensation at fair market value may be a better option than a partnership or joint venture agreement. If the tax-exempt organization is assisting another nonprofit organization in obtaining a bid for a project in exchange for the right to participate in the project, then a strategic alliance agreement may be a good option, where the mutual benefits and obligations of the contracting parties are set forth, but there is no ''business'' being operated by two partners in a partnership. As a final example, if a tax-exempt organization wishes to manage some or all of the activities of another not-for-profit organization without acquiring the other nonprofit organization, the tax-exempt organization could enter into a management agreement with respect to such activities, where the services could range from administrative service support to full management services, with fair compensation for such services set forth in the management agreement.

Be Careful with Terminology

If the relationship between the parties is not a partnership, whether it is legally structured as another type of relationship as described above or is an informal collaborative arrangement, tax-exempt organizations should avoid ''partnership'' or ''joint venture'' language if there is no partnership or joint venture, as legally defined. There are other terms that connote a cooperative relationship that do not carry the legal baggage of holding oneself out to the public as a partnership, e.g., collaborative agreement, strategic alliance agreement, cooperative agreement, and affiliation agreement.

WORKER CLASSIFICATION

Issue

Tax-exempt organizations face the same worker classification issues that for-profit organizations face. When an individual is performing services for a tax-exempt organization on his or her own (i.e., not through another organization) and is being compensated for such services, that individual is acting either as an employee or as an independent contractor with respect to the tax-exempt organization. Proper classification of a service provider as an employee or an independent contractor is very important for a variety of purposes, including federal income tax and state workers' compensation laws. The tests for determining the proper status are often similar, but not identical, at the federal and state levels, and, therefore, care should be taken when there is a question as to proper classification, to comply with both federal and state laws. Note that the proper classification of an individual is generally questioned by the IRS or state agencies when the individual is classified as an independent contractor; thus, if an organization is on the fence as to proper classification, the prudent action from a tax perspective is generally to classify the worker as an employee.

The IRS previously delineated 20 common law factors that it would use to determine the proper classification of a service provider as either an employee or an independent contractor. These 20 factors have been repackaged into three more general categories that comprise the test used by the IRS to classify workers: (1) behavioral control; (2) financial control; and (3) relationship of the parties. These three categories subsume the 20 common law factors and emphasize how important the tax-exempt organization's control over the service provider is in determining whether he or she is an independent contractor or employee.

Ways to Address Issue

Structure the Relationship Clearly Up Front. . . in Writing

A tax-exempt organization that seeks to hire independent contractors should have a written independent contractor agreement with such individuals (assuming it is commercially practical). The tax-exempt organization should be familiar with the three categories described above (and the 20 factors contained therein), as well as any state law worker classification guidelines, and should craft the relationship to reflect that the individual will have as many indicia of an independent contractor as possible. The terms of that relationship should be clearly articulated in writing in an independent contractor agreement and the individual should have a clear understanding of the tax ramifications of independent contractor status.

Take Advantage of Current IRS Voluntary Classification Settlement Program

If a tax-exempt organization determines that it has been improperly classifying its employees as independent contractors, the organization may be able to take advantage of a new settlement program intended to give employers a fresh start in classifying their work-

ISSN 0886-3547

ers. On September 21, 2011, the IRS announced a new Voluntary Classification Settlement Program (VCSP) through which qualifying tax-exempt organizations (as well as other employers) can obtain partial relief from federal employment taxes if they properly classify those workers on a going-forward basis. If a tax-exempt organization qualifies for the VCSP, the organization will have limited liability for prior federal employment taxes, not be subject to interest and penalties, and not be subject to an employment tax audit with respect to those workers. The details of the VCSP are contained in Announcement 2011-64.[2]

INTELLECTUAL PROPERTY

Issue

One area that tax-exempt organizations often overlook is their ownership and use of intellectual property, particularly their trademarks and copyrightable materials. The use of intellectual property should be a concern for a tax-exempt organization in terms of both (a) protecting its intellectual property and (b) ensuring that the organization is not infringing upon someone else's intellectual property rights. Protection of the tax-exempt organization's intellectual property requires identifying the intellectual property and preferably registering to secure rights in the intellectual property. Protecting the organization against claims that it is infringing upon another person's intellectual property involves identifying the activities that could raise concerns among other intellectual property rights holders and identifying potential claimants of prior existing rights to such intellectual property.

Ways to Address Issue

Create a Brand That Is Protectable

Trademarks that are generic or too descriptive of the services provided will not be eligible for trademark protection, and, therefore, are fair game for use by another organization. For example, Feed the Homeless is probably generic or too descriptive a name for a single tax-exempt organization to successfully obtain exclusive rights in that phrase. As such, any efforts to create a brand under that name could be undermined by another organization using the same name, or one that is very similar. On the other hand, a distinct name that has no independent meaning will generally result in broad exclusive rights and efforts made under that brand could be protected.

Actually Register Your Trademarks and Copyrighted Material

A federal trademark registration is not that expensive, and it is well worth the expense to protect a valued asset of a tax-exempt organization. If the organization does not register its trademark, its rights only cover the particular regions in which it provides services. This means that another organization could freely use a similar name in another region (e.g., in another state), thereby making future expansion difficult and potentially confusing donors. Trademark registration extends the tax-exempt organization's rights to include the entire nation. Moreover, copyright registration is very inexpensive and not only protects the assets, but can give the organization that has filed the copyright registration the right to statutory damages ranging from $750 to $30,000 per act of infringement (potentially up to $150,000 if the act is willful) plus attorney's fees.[3] This is significant because proving actual damages of a copyright infringement is often difficult and because the attorneys fees in a copyright infringement action are often greater than the financial damages that might be available. Thus, having the right to recover fees can make an otherwise impractical infringement action feasible. Registration is also required prior to filing suit for copyright infringement. As a result, an organization that registers its copyrights will often be able to act more quickly should an issue arise.

Address Intellectual Property Issues in Contracts with Your Workers and Third Parties

The tax-exempt organization should make sure that all of its contracts that involve the production or use of intellectual property, e.g., written materials, software (including websites), the organization's name, project names, etc., contain provisions that indicate that any intellectual property produced for the organization belongs to the organization (so-called ''work for hire'') and that the other parties to these agreements will protect and not disclose or use the intellectual property without the organization's express written consent. It is important to understand that, even if the organization pays a contractor such as a website developer to create intellectual property, the organization may not own the work product if there is not a clear written agreement in place. The tax-exempt organization should also be sure that all of its workers and contractors sign agreements that protect the organization's confidential information, such as donor rolls, development plans, and the like.

Keep Good Records

Often, resolving intellectual property disputes is a matter of proving which organization was the first to begin using the intellectual property. It is, therefore, a good idea for tax-exempt organizations to keep good records, including copies of brochures, flyers, and

[2] 2011-41 I.R.B. 503.

[3] 17 USC §504.

ISSN 0886-3547

websites, even after they are no longer in use, together with the business records, such as printing receipts. Such records can be strong evidence in the event a dispute arises. Operations manuals and employee manuals can also help prove how the organization operated in the past, which could be helpful in the event that a patent or trade secret dispute were to arise.

Collect, Define, Assign

If a tax-exempt organization has intellectual property that the organization has not previously taken steps to protect, it should (1) collect the different types of intellectual property and identify who produced each one, (2) define the intellectual property clearly, and (3) have all appropriate individuals assign the intellectual property to the organization to ensure ownership by the organization and agree to protect its confidential information.

Invest in an Ounce of Prevention

If a tax-exempt organization is thinking about using a tradename or embarking on a significant project using that tradename, the organization should check to see if the name (or something similar) is being used by another organization before investing in the name and developing associated goodwill. Assessing the potential risk upfront is almost always less expensive and less frustrating than getting involved in an intellectual property dispute, which can be extremely expensive and time-consuming.

DIRECTOR & OFFICER INDEMNIFICATION AGREEMENTS

Issue

Tax-exempt organizations often have director and officer insurance, without having undertaken — at least in recent memory — an analysis of the organization's obligations to indemnify its directors and officers in the event of a claim. The organization's obligations may exceed the insurance coverage or may be broader or more limited than the current directors and officers believe the obligations to be. For example, many tax-exempt organizations (and for-profit organizations, as well) are surprised to discover that, not only does the organization have an obligation to indemnify a director or officer of the organization, but the organization may also have an obligation to advance the costs of defending the claim unless and until the director or officer is determined to be unworthy of the indemnification.

Ways to Address Issue

Check the Organization's Governing Documents, State Statutes, and Specific Agreements to Determine the Organization's Default Obligations

Often, a tax-exempt organization's articles of incorporation and/or bylaws will contain expansive indemnification obligations. Also, the state statutes governing the tax-exempt organization in the state of organization may have default indemnification provisions or opt-in provisions. In addition to these general indemnifications, an organization may have individual indemnification agreements with specific individuals.

Instead of Blanket Indemnification, Provide That Indemnification May Be Granted by the Organization on an Individual Basis

Requiring indemnification to be individually negotiated and agreed upon encourages a tax-exempt organization and its directors and officers to evaluate the particular risks the organization is likely to face and make informed and thoughtful decisions regarding the extent of indemnification, the costs of insurance, whether funds will be advanced, and how well the organization's insurance dovetails with the organization's indemnification obligations.

CORPORATE GOVERNANCE

Issue

Tax-exempt organizations are generally more aware of their corporate governance policies and procedures now than they have been in the past in large part thanks to the revamping of the IRS Form 990. Many organizations have had a knee-jerk reaction to the questions on the Form 990 regarding which policies a tax-exempt organization has in place by simply adopting them all, quickly, without giving much thought as to whether they are necessary or appropriate.

Ways to Address Issue

Assess the Organization's Policies and Amend (or Even Repeal) Them as Appropriate

Tax-exempt organizations should take a thoughtful look at what policies the organizations have in place and whether those policies are appropriate for the size, activities, and financial status of the organizations. Some policies are not required or do not even make sense for an organization. Those policies that are necessary or appropriate should be tailored to fit the particular needs of the tax-exempt organization.

Assess the Organization's Governing Documents Against Current Practice and Adjust One or the Other If Needed

In addition to its policies, an organization's leadership should take a thoughtful look at its governing documents, e.g., articles of incorporation, bylaws, policies, rules and procedures, and key position job descriptions, to ensure that these documents comport

ISSN 0886-3547

with the organization's current actual practice. If not, the organization should assess which approach (or some other approach altogether) makes sense for the organization's mission and exempt purposes and amend either its practice or documents, or both.

Educate the Organization's Directors Regarding Their Fiduciary Duties

At least once a year, a tax-exempt organization's directors should be educated on the scope of their state law fiduciary duties, as well as the federal income tax laws regarding excess benefit transactions (or private foundation excise taxes, as the case may be).

SHARING OF EXPENSES

Issue

The economic climate of the last few years has caused tax-exempt organizations to become more creative and efficient in the way they deliver their services and manage their expenses. One way to keep costs down is to share employees, office space, or administrative resources with another organization, be it another nonprofit organization or a for-profit organization. Obviously, if the other organization is a for-profit organization, the issue of private benefit arises (and possibly the issue of private inurement if the for-profit organization is in any way related to the tax-exempt organization). In any event, the tax-exempt organization should document the arrangement clearly so that (a) each party understands what its rights and benefits are in the arrangement, (b) there is a clear contractual relationship established to rebut a claim of a partnership between the parties and to avoid liability of the tax-exempt organization for the actions of the other party, (c) there is a clear allocation of risk between the parties with respect to potential liability issues, and (d) the arm's-length relationship between the parties is established from the outset of the arrangement.

Ways to Address Issue

If the Organization Is Not Sharing Resources, Assess Whether Such an Arrangement Might Make Sense

Times change. There may be opportunities for a tax-exempt organization to share personnel or space that may not have been useful for the tax-exempt organization in the past, or a potential sharing party who may not have been willing previously to share resources may now be more favorably disposed to such an arrangement with the tax-exempt organization.

If the Organization Is Sharing Resources, Properly Document the Arrangement in Writing

Any sharing of resources should be clearly documented in detail in writing so as to avoid confusion by the parties and establish the terms of the arrangement in the event they are ever questioned by a third party.

Take Care to Structure the Arrangement at Arm's-Length and Avoid Any Private Benefit or Private Inurement

The terms of the sharing arrangement should be arm's-length, negotiated between disinterested parties, with any potential conflicts of interest fully disclosed. In the event the directors of the tax-exempt organization approve a sharing arrangement where there is a conflict of interest, the decision process and conflict disclosure should be fully documented in the minutes of the organization, and any applicable federal income tax ramifications, e.g., excess benefit transaction or self-dealing restrictions, should be considered prior to approving any such arrangement.

RAFFLES AND OTHER GAMES OF CHANCE

Issue

Fundraising is a core component of most tax-exempt organizations' revenue generation efforts. Raffles and similar games of chance are often employed by tax-exempt organizations as a fundraising tool. However, if a tax-exempt organization is going to conduct games of chance — including raffles — in any state, the organization needs to consult the laws of that state to ensure that the organization is not violating the gaming laws in the state. Many tax-exempt organizations are not aware that failure to comply with the sometimes very rigorous requirements may be a crime under state law. For example, in Florida, if a tax-exempt organization holds a raffle, the organization must comply with an extensive list of disclosure and operational requirements, one of which is that no purchase is necessary to enter the raffle, or the organization will be committing a second degree misdemeanor crime.[4] Because each state has different gaming laws, if the organization is engaged in a multistate game of chance, the best practice is to structure the game so that it complies with the laws in the most strict jurisdiction.

Ways to Address Issue

Determine if the Fundraiser Is Subject to the Gaming Laws

Certain types of games, e.g., games of skill rather than chance, may not be subject to the gaming laws of the relevant jurisdiction.

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[4] Fla. Stat. §849.0935 (2011).

ISSN 0886-3547

If the Fundraiser Is Subject to the Gaming Laws, Organize the Activities to Comply with the Law, Opt for a Different Fundraiser, or Move the Fundraiser to a More Liberal Jurisdiction

Games can be structured to comply with the gaming laws, but the practical implications — financial or otherwise — may not be palatable to the tax-exempt organization. The organization may simply elect to have a different fundraiser that does not implicate the gaming laws or may opt to have the fundraiser in a different state or at a location within the state where such activities are permissible, e.g., a reservation managed by a Native American tribe under the U.S. Department of the Interior's Bureau of Indian Affairs, which is exempt from state gaming laws, or a private venue where gaming is permitted because it is licensed and regulated by the state.

CHARITABLE SOLICITATION REGISTRATION REQUIREMENTS

Issue

Many states require any nonprofit organization that plans to solicit donations for a charitable purpose within the state to register with the state (and pay a filing fee) for consumer protection purposes prior to soliciting donations. A ''charitable'' purpose is generally defined much more broadly for these purposes than it is for federal income tax purposes. Although registration and filing fees can become onerous and expensive for organizations that solicit donations in multiple jurisdictions, it is required and organizations should check the laws of any state in which the organizations have even minimal contacts. Some states are more rigorous in their enforcement of the registration requirements and in their interpretation of how much contact is necessary for the state to have jurisdiction to require registration. The registration requirement generally includes both the filing of a registration statement and certain financial disclosures.

Organizations can file solicitation registration statements in most states using the Uniform Registration Statement, which was developed by the National Association of State Charities Officials and the National Association of Attorneys General, as part of an ongoing effort to encourage compliance with the states' solicitation registration requirements. The most recent version of the Uniform Registration Statement was released in May 2010 and it supports 37 jurisdictions (36 states and the District of Columbia), and requires (and includes) supplemental forms for 13 jurisdictions.[5]

Ways to Address Issue

Determine Where the Organization Is Soliciting Funds

If a tax-exempt organization is soliciting funds in a state through any means, including in person, by print, by phone, by television advertising, or by mail, the organization will likely be subject to the registration requirements of that state. The internet causes complexity with respect to determining nexus for requiring registration, but if the organization sends any solicitation materials into the state as a follow-up to internet solicitation, the state may assert jurisdiction for requiring registration.

Assess the Organization's Activities in Each Jurisdiction

The organization should assess whether its fundraising activities in a particular state are significant enough to justify continuing to solicit funds in that state and registering to solicit funds in the state. The organization can also adjust its internet solicitation follow-up activities so as to avoid establishing nexus with a state solely as a result of a mailed thank-you letter with a subsequent appeal.

MERGERS AND ACQUISITIONS

Issue

For better or for worse, the economy has caused an increase in the consolidation of tax-exempt organizations as less robust organizations have sought refuge for their programs in larger, more recession-proof organizations and as organizations of similar size or financial status have joined together to weather the economic storm. Whatever the reason, tax-exempt organizations are increasingly finding themselves in the relatively uncommon territory of mergers and acquisitions. While these types of transactions can be comfortable ground for many for-profit entities, many tax-exempt organizations find the mergers and acquisitions process unfamiliar and daunting.

Some aspects of a potential merger or acquisition are the same for for-profit and tax-exempt organizations, while some aspects are drastically different. The process for a potential merger or acquisition for for-

[5] http://www.multistatefiling.org. In addition to these 37 jurisdictions, Colorado, Florida, and Oklahoma have solicitation registration requirements, but do not currently accept the Uniform Registration Statement.

ISSN 0886-3547

profit and tax-exempt organizations is much the same: (1) there are preliminary talks where the parties feel each other out in terms of overall goals and facets of activities involved; (2) the parties enter into a nondisclosure/confidentiality agreement in which they agree not to disclose any confidential information obtained while evaluating the potential transaction; (3) the parties enter into a letter of intent where they set forth the basic terms of the proposed transaction that they intend to consummate, assuming the due diligence process does not uncover unexpected information (many potential transactions are abandoned before the letter of intent is entered into); (4) the parties exchange information regarding the respective organizations and conduct due diligence with respect to the other to ascertain exactly what each is getting in the transaction; (5) the parties negotiate and execute a definitive agreement that sets forth the terms of the transaction, including representations and warranties with respect to the assets of the acquired organization or the merging organizations; and (6) the transaction is consummated.

The major distinguishing factors of a merger or acquisition involving a tax-exempt organization as the acquired entity are (a) there are no owners receiving any compensation for the acquisition and, as a consequence, (b) there are no individuals willing to stand behind the representations and warranties made in the definitive agreement. In the acquisition of a for-profit organization, the individual or entity owner of the acquired company would be required to indemnify the acquiring organization in the event any of the representations and warranties relating to the assets of the acquired organization were not accurate and the acquiring organization suffered damages as a result. The scope of the representations and warranties and indemnification provisions is generally a heavily negotiated aspect of for-profit acquisitions. However, because there are no ''owners'' of a nonprofit organization, there is not generally any individual or entity that is willing to make such an indemnification to induce the acquiring company to acquire the tax-exempt organization. This lack of direct financial interest is why most merger and acquisition transactions involving tax-exempt organizations are largely based on necessity and/or trust . . . and often a leap of faith.

Ways to Address Issue

Determine What Type of Strategic Option Is Best to Combine the Activities of the Tax-Exempt Organizations

There are a variety of legal structures that a tax-exempt organization can employ to combine its activities with another tax-exempt organization. The basic components of these strategic options and some of their relative pros and cons follow.

Affiliation Agreement — This is an informal structure based on contract between the two organizations, in which the parties agree to assign control of different aspects of their assets or programs to each of the two parties.

The pros of such an agreement are that: (1) there is no need to move assets; (2) there is no change in leadership for either tax-exempt organization; (3) it is relatively easy to sever the relationship; (4) the parties could achieve certain cost reductions and other synergies through a combination of administrative and other functions; and (5) the parties are given ways to work together and achieve cost-savings and other efficiencies and, if successful, possibly to move toward greater integration.

The cons of an affiliation agreement are that: (1) it is relatively easy to sever the relationship because it is purely contractual; (2) the contracts need to clearly articulate functions over which parties exercise separate control; (3) there are potential antitrust issues; and (4) there is a need to check contracts for any restrictions on such type of transaction.

Joint Operating Agreement — This is an informal structure based on contract between the two organizations, in which the parties agree to control all or certain assets jointly and make decisions together or to combine certain discrete functions such as back office operations, purchasing, and certain administrative functions.

The pros of such an agreement are essentially the same as the pros of an affiliation agreement except that there are greater opportunities for joint management, which will help the parties determine whether they desire greater integration if the joint operating agreement is successful.

Similarly, the cons of a joint operating agreement are essentially the same as the cons of an affiliation agreement.

Joint Venture Agreement — This can be in the form of a simple state law general partnership or a more formalized entity, such as a limited liability company. This would generally involve a transfer of assets to the joint venture. The joint venture agreement would establish a governing board, which would manage the assets owned by the joint venture. Ownership of the joint venture does not need to be 50/50, but can be as otherwise agreed by the parties. (Although note the potential issues described in this article of a tax-exempt organization's involvement with a joint venture. Joint ventures can be useful, but should be structured so as to protect the tax-exempt organization from state law liability and from adverse federal income tax-exemption issues.)

The pros of such an agreement are that: (1) there is no change in leadership of either tax-exempt organi-

ISSN 0886-3547

zation; (2) the new board of directors for the joint venture would oversee the management of the joint venture assets; (3) the parties can structure governance so that one party has control, subject to a veto right by the other party on major decisions; and (4) such an agreement is more advantageous than an affiliation agreement or joint operating agreement from an antitrust standpoint.

The cons of a joint venture agreement are that: (1) there is a need to identify and transfer assets into the joint venture; (2) there are potential issues regarding provider numbers and license transfers; (3) there is a need to check contracts for any restrictions on such type of transaction; (4) depending upon the governance structure, one party could cede control to the other; (5) due diligence is critical as there is no likely party to stand behind representations and warranties; and (6) there is a possible Hart-Scott-Rodino antitrust filing requirement, depending on the structure and the assets transferred into the joint venture.

Merger — One corporation (the acquired corporation) merges into the other corporation (the surviving corporation). The acquired corporation would cease to exist. All assets and liabilities of the acquired corporation would become assets and liabilities of the surviving corporation by operation of law. A merger agreement would set forth how the surviving corporation's governing documents would be amended going forward.

The pros of a merger are that: (1) it can be a cashless transaction between two tax-exempt organizations; and (2) the assets transfer to the surviving company by operation of law.

The cons of a merger are that: (1) the surviving entity emerges with all of the assets and liabilities (known and unknown) of the acquired company; (2) the acquired company loses control of its historical assets unless it gets equal representation on the board of the surviving corporation; (3) there are potential issues regarding provider numbers and license transfers; (4) there is a need to check contracts for any restrictions on such type of transaction; (5) due diligence is critical as there is likely no party to stand behind representations and warranties; and (6) there is a possible Hart-Scott-Rodino antitrust filing requirement.

Asset Purchase — The assets of the acquired corporation are sold to the acquiring corporation for some amount of consideration. The asset purchase agreement would set forth terms of the acquisition and representations and warranties with respect to the assets. The acquired corporation would continue to exist (and, assuming the acquired corporation is a tax-exempt organization, any consideration paid for the assets could be distributed to another tax-exempt organization in compliance with the acquired corporation's governing documents). The acquiring corporation would own the newly acquired assets.

The pros of an asset purchase are that: (1) the acquiring company is able to select only the assets it would like to purchase; (2) the acquiring company is able to select only the liabilities (if any) it would like to assume subject to "successor liability" principles; and (3) the assets could be acquired in a separate corporation to segregate liabilities and limit exposure.

The cons of an asset purchase are that: (1) there is a need to identify and transfer assets into the acquiring corporation; (2) it is potentially a very complicated transaction to accomplish, depending on the types and amounts of assets and contracts of the acquired company; (3) the acquired company loses control of its historical assets unless it obtains equal representation on the board of the acquiring corporation; (4) it could require an actual capital outlay to purchase the assets if the transaction is not essentially a gift; (5) there are potential issues regarding provider numbers and license transfers; (6) there is a need to check contracts for any restrictions on such type of transaction; (7) due diligence is critical as there is likely no party to stand behind representations and warranties; and (8) there is a possible Hart-Scott-Rodino antitrust filing requirement.

Change in Membership to Parent/Subsidiary Structure — The governance documents of one corporation (the subsidiary) are modified to provide that the other corporation (the parent) is the sole member of the subsidiary. The parent would be given broad oversight power and authority with respect to decisions made by the board of directors of the subsidiary. The subsidiary would continue to exist with its existing board, although election and removal of the directors of the subsidiary would be at the discretion of the parent.

The pros of such a change are that: (1) the parent does not actually take on any assets or liabilities; (2) the parent controls the assets indirectly as the sole member; (3) the level of control and autonomy of the subsidiary's board can be negotiated; (4) it is probably the least complicated transaction of the various alternatives with the possible exception of the affiliation or joint operating agreement; (5) it might permit future financing based on "obligated group"; and (6) if both organizations are in good financial condition, the change could provide greater access to capital.

The cons of a change to a parent/subsidiary structure are that: (1) the subsidiary loses some and potentially all control, although the subsidiary would still have day-to-day control; (2) there are potential issues regarding provider numbers and license transfers on "change of control"; (3) the parent's control is indirect, through its vote as a member and its ability to appoint board members; (4) there is a need to check contracts for any restrictions on such type of transac-

ISSN 0886-3547

tion; and (5) there is a possible Hart-Scott-Rodino antitrust filing requirement.

New Holding Company — A new nonprofit corporation (structured to be recognized as tax-exempt under §501(c)(3)) is formed to manage both organizations. The governance documents of both organizations (the subsidiaries) would be modified to provide that the new corporation (the parent) is the sole member of both subsidiaries. The parent would be given broad oversight power and authority with respect to decisions made by the boards of directors of both subsidiaries. The subsidiaries would continue to exist with their existing boards, although election and removal of the directors of the subsidiaries would be at the discretion of the parent.

The pros of a new holding company are that: (1) the new holding company parent does not actually acquire any assets or liabilities (other than membership interests in the two subsidiaries); (2) the new holding company parent indirectly controls assets as the sole member; (3) the level of control and autonomy of each subsidiary's board can be negotiated; (4) it is one of the least complicated transactions of the various alternatives; (5) it might permit future financing based on ''obligated group''; and (6) if both organizations are in good financial condition, a new holding company could provide greater access to capital.

The cons of a new holding company are that: (1) there is a need to acquire recognition of exempt status for the new holding company; (2) the subsidiaries lose some and potentially all control, although each would still have day-to-day control; (3) there are potential issues regarding provider numbers and license transfers on ''change of control''; (4) the parent's control is indirect, through its vote as a member of both subsidiaries and ability to appoint board members; (5) there is a need to check contracts for any restrictions on such type of transaction; and (6) there is a possible Hart-Scott-Rodino antitrust filing requirement.

Address Potential Legal Issues

As the pros and cons outlined above indicate, there are a variety of legal issues that must be evaluated with each scenario, even after the ''best'' strategic option for the tax-exempt organization has been identified. Perhaps the most daunting legal hurdle that a tax-exempt organization faces is the requirement that the proposed transaction not violate any existing contract or obligation of either organization. This means that every lease, grant agreement, bond document, loan agreement, or other contract must be reviewed carefully during the due diligence process to be sure that the proposed transaction will not trigger a breach of an agreement and that consent to the transaction is obtained prior to the transaction, if at all possible.

Address Control Issues Before the Closing of the Transaction

Because there are no owners of a tax-exempt organization and no compensation to be paid out to shareholders, the issue of control of the surviving organization, in whatever form, becomes a significant part of the merger and acquisition negotiation process. The parties need to obtain a level of comfort with how the surviving organization is going to be governed, who will appoint the directors, and any time periods that must be met before those rules can be modified. The parties should put those agreements in writing as part of the transaction's definitive agreement.

Be Wary of Potential Private Inurement

The parties should take special care to ensure that there is no extra compensation or excess benefit being provided to any of the individuals involved in the transaction that would implicate the prohibition on private inurement or the imposition of excise taxes.

CONCLUSION

Although these are a few of the significant legal issues that arise for tax-exempt organizations, the prevailing theme for any tax-exempt organization and its directors is to take action thoughtfully and deliberately and put those actions (and deliberations) in writing. Just as tax-exempt organizations have financial audits performed regularly, tax-exempt organizations should also have legal audits performed to keep on track and keep legal issues in the forefront of decision-making. Such routine self-assessments make for better decisions and healthier organizations and reflect directors that are committed to their fiduciary duties of care and loyalty.

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