

TAXATION OF CONVERSION TRANSACTIONS

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Changing Between Nonprofit and For-Profit Form**

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CONVERSIONS OF STATUS OF HOSPITALS AND
HEALTH CARE ORGANIZATIONS^{1/}

¶ 1.01 Introduction

Conversions of status of hospitals and other forms of health care organizations, particularly health maintenance organizations (HMOs) and large medical groups, when not motivated by greed or self-interest,^{1/} have typically been motivated principally by capital access needs.^{2/}

Until the 1970s, hospitals usually converted from for-profit to nonprofit status in order to gain access to capital. During the 1920s and through the 1950s, many for-profit hospitals converted from for-profit to nonprofit status and applied for tax exemption.^{3/} Tax-exempt status for hospitals during these years

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^{1/} Several commentators have suggested that some conversions from nonprofit to for-profit status have resulted in windfalls to the management or boards of directors. See, e.g., McMahon, "Fair Value? The Conversion of Nonprofit HMOs," 30 U.S.F.L. Rev. 355 (Winter 1996); Meyer, "Selling...Or Selling Out," 49:8 Trustee 12 (Sept. 1996).

^{2/} While capital access is usually the principal reason given to support a conversion from nonprofit to for-profit status, other frequently cited reasons include (1) to be able to issue stock to public and private investors, rather than rely on debt, to avoid statutory and practical limitations on debt financings; (2) to enhance the corporation's ability to diversify into otherwise taxable lines of business; (3) to provide a means whereby the corporation can offer stock options, restricted stock, and other long-term incentives to management; (4) to enable the corporation to adopt an employee stock ownership plan (ESOP); and (5) to avoid the limiting effects of tax rules, such as Section 501(m)'s limitation on and taxation of commercial-type insurance. Also, some conversions have been motivated by fear of future regulatory or reimbursement charges, or because a conversion was essential to survival.

^{3/} See, e.g., IT 2421, VII-2 CB 150 (1928). Frequently, these conversions were motivated by reasons other than obtaining federal tax exemption, such as claiming the availability of charitable immunity from tort liability or property tax

allowed them to become recipients of charitable contributions, bequests, and other forms of philanthropic support. This capital enabled these hospitals to build facilities and expand services. In fact, the availability of nonprofit, tax-exempt status allowed many hospitals during this period to expand from being little more than extensions of their former physician owners' medical practices.^{4/} Many of the institutions that converted from for-

exemption. *Hamilton v. Corvallis General Hospital Ass'n*, 30 P2d 9 (Ore. 1934) (availability of charitable immunity; hospital converted from for-profit to nonprofit status in sale of asset transaction in 1926); *Board of Supervisors, Warren County v. Vicksburg Hospital, Inc.*, 163 So. 382 (Miss. 1935) (property tax exemption; hospital converted from for-profit to nonprofit status in what appears to be a conversion in place transaction in 1933); *Board of Supervisors of Hinds County v. Jackson Hospital Benevolent Ass'n*, 177 So. 27 (Miss. 1937) (property tax exemption; hospital converted in sale of assets transaction in 1933); *Order of Sisters of St. Joseph v. Town of Plover*, 1 NW2d 173 (Wis. 1941) (property tax exemption); *Fleming Hospital, Inc. v. Williams*, 169 SW2d 241 (Tex. Civ. Apps. 1943) (unemployment taxes); *Village of Hibbing v. Comm'r of Tax'n*, 14 NW2d 923 (Minn. 1944) (company hospital converted to nonprofit status in sale of assets transaction).

^{4/} See, e.g., *Board of Supervisors, Warren County v. Vicksburg Hospital, Inc.*, 163 So. 382 (Miss. 1935) (hospital purchased from founding doctors); *Rogers Mem'l Sanitarium v. Town of Summit*, 279 NW 623 (Wis. 1938) (founding doctor contributed hospital to new nonprofit corporation); *The Fairmont Hospital, Inc. v. State Board of Tax Appeals*, 4 A2d 67 (N.J. 1939) ("Now in the course of time taxes must have become burdensome and in 1935 the doctors cast about for some way of getting rid of them, so they pursued the course" of converting in a sale of assets transaction.); *Rush Hospital Benevolent Ass'n v. Board of Supervisors of Lauderdale County*, 192 So. 829 (Miss. 1940); *State v. Willmar Hospital, Inc.*, 2 NW2d 564 (Minn. 1942) (hospital assets purchased from founding doctors); *Prairie du Chien Sanitarium Co., Inc. v. City of Prairie du Chien*, 7 NW2d 832 (Wis. 1943) ("There can be little doubt that the hospital is maintained primarily for the greater convenience and profit of the managing doctors in the practice of their profession."); *Riverview Hospital v. City of Tomahawk*, 11 NW 2d 188 (Wis. 1943) (hospital a gift of physician); *Raymondville Mem'l Hospital v. State*, 253 SW2d 1012 (Tex. Civ. Apps. 1952); *Malone-Hogan Hospital Clinic Fdn., Inc. v. City of Big Spring*, 288 SW2d 550 (Tex. Civ. Apps. 1956).

profit to nonprofit status during those years have developed into major nonprofit institutions today.^{5/}

Following the end of World War II, the growth in the number and, more importantly, the size of nonprofit hospitals was fueled by access to funds for capital expenditures under the Hill-Burton program.^{6/} In general, only tax-exempt nonprofit or public hospitals were qualified borrowers under the Hill-Burton program.

During the 1960s, and especially following the enactment of the Medicare and Medicaid programs in 1965, nonprofit tax-exempt status created improved access to capital by reason of the fact that prior to 1986, tax-exempt hospitals described in Section 501(c)(3) could generally enjoy unrestricted access to the tax-exempt debt market, whether that debt was private tax-exempt debt in the early years, or public tax-exempt debt in later years.^{7/} While most capital-intensive health care organizations, such as nursing homes, could use industrial development bonds during those years for for-profit projects, the limitations on industrial revenue bonds first enacted in 1968 restricted their attractiveness to small for-profit projects, and larger projects, typically associated with hospitals, called for access to considerably greater amounts of capital than permitted by statute after 1968.^{8/}

^{5/} E.g., Virginia Mason Hospital Ass'n v. Larson, 114 P2d 976 (Wash. 1941) (conversion from for-profit to nonprofit status effected in 1934 in a sale of assets transaction); Fairmont Community Hospital Ass'n, Inc. v. State, 21 NW2d 243 (Minn. 1945).

^{6/} Hospital Survey and Construction Act (also known as the Hill-Burton Act), Pub. L. No. 79-725, § 621 (substantial funds were appropriated for the construction of public and nonprofit hospitals and other health care facilities).

^{7/} For a discussion of the pre-1987 and post-1986 tax-exempt financing laws as they relate specifically to hospitals, see Mancino, "Nonexempt Uses of Tax-Exempt Hospital Bonds," 4:10 The Exempt Organization Tax Review 1324-1340 (Dec. 1991). For an excellent early history of tax-exempt financing, see Lent, "The Origin and Survival of Tax-Exempt Securities," XII National T.J. 301.

^{8/} The first public hospital debt issue was sold in 1968. For a detailed discussion of industrial development bonds from 1968 until 1979, see Roberts, "Industrial Development Bond Financing: Section 103(b) Examined," 32 U. Fla. L. Rev. 1 (1979).

As an interesting sidelight, many of the ancestors of today's publicly traded for-profit hospital management companies were formed during the late 1960s and early 1970s, particularly after the enactment of the Medicare program in 1965 provided a cost-based reimbursement system for capital and a return on equity for proprietary hospitals, which provided a stable source of revenue that would support a public company valuation.^{2/} In their early years, most of these companies were little more than consolidations of existing small for-profit hospitals that were doctor- or entrepreneur-owned,^{10/} and with rare exceptions, no major tertiary care hospitals became part of those for-profit companies until the mid-1980s.^{11/}

The growth of HMOs has had a somewhat different history. Early HMOs were almost exclusively organized as nonprofit organizations,^{12/} and generally qualified for exemption under

^{2/} See, e.g., Wasyluka, "New Blood for Tired Hospitals," Harv. Bus. Rev. 65 (Sept.-Oct. 1970). For example, both American Medical International, Inc. and National Medical Enterprises, Inc., which are merged and now operate as Tenet HealthCare Corporation, were formed in the late 1960s as basically consolidators of small, proprietary hospitals that often were doctor-owned. Am. Hosp. Ass'n, Study of For-Profit Hospital Claims (mimeo. May 22, 1970). The first for-profit chain was formed in 1960.

^{10/} See Alexander & Amburgey, "The Dynamics of Change in the American Hospital Industry, Transformation or Selection?" 44 Med. Care Rev. 279, 292-93 (1987).

^{11/} Among the first tertiary hospitals to be acquired by for-profit companies were Wesley Medical Center, Wichita, Kansas, and Presbyterian-St. Luke's Hospital, Denver, Colorado, and these sales did not occur until the mid-1980s. Much of the impetus to sell resulted from the uncertainties created by the enactment of the prospective payment system for Medicare enacted by Congress in 1983. See Mancino, "Income Tax Exemption of the Contemporary Nonprofit Hospital," 32:4 St. Louis U.L. Rev. 1015, 1031 (1988); "The SamCor Decision: Sale or Lease to an Investor-Owned System," (Samaritan Medical Fdn. 1985).

^{12/} In many states, state laws required that HMOs could only be formed as nonprofit corporations. Many of these laws were not changed until the early 1970s. For a general discussion of the history of prepaid plans, see, e.g., Schwartz, "Early History of Prepaid Medical Care Plans," 39:5 Bull. of the Hist. of Med. 450 (Sept./Oct. 1965).

Section 501(c)(3)^{13/} or under Section 501(c)(4) in most cases.^{14/} To the extent that those HMOs needed capital, that capital came in the form of capital subscriptions from enrollees, along with regular membership fees, and those HMOs with capital assets, such as their own hospitals, typically used traditional asset-based financing, such as conventional mortgage financing. In the Health Maintenance Organization Act of 1973,^{15/} Congress stimulated the growth of nonprofit tax-exempt HMOs by making available loans and grants for feasibility studies and for early-stage development. By the late 1970s, however, that source of financing was eliminated, and the Department of Health and Human Services was actively encouraging HMOs to convert from nonprofit to for-profit status.^{16/} Some of the country's most well-known HMOs, including U.S. Healthcare, Inc., FHP International, Inc. (originally known as Family Health Plan), and MaxiCare Health Plans, Inc., were formed during those early years with support of government grants or loans that were made available only to Section 501(c)(3) or Section 501(c)(4) tax-exempt organizations. In the late 1970s and early to mid-1980s, these organizations converted from nonprofit to for-profit status in large part to gain access to capital through the public equity markets.

In the 1990s, many of the trends that are seen in health care today are again driven by access to capital needs, but those organizations are seeking different types of capital. Since the tax-exempt financing reforms in 1986, hospitals and health care systems are discovering that tax-exempt financing is now burdened with additional constraints in this dynamic marketplace. No longer is debt capacity alone the principal limitation on using tax-exempt financing. It is now also the use restrictions to which tax-exempt bond proceeds can be put that severely constrain the use of tax-exempt debt by hospitals and health systems today.

^{13/} For example, Harvard Community Health Plan was recognized as a Section 501(c)(3) organization when it was formed in the early 1970s.

^{14/} For example, Group Health Cooperative of Puget Sound, Inc., and Kaiser Foundation Health Plans, Inc., both were originally recognized as Section 501(c)(4) organizations, and it was not until the early 1980s that the Service recognized their Section 501(c)(3) status.

^{15/} Health Maintenance Organization Act of 1973, §§ 1303(a), 1304(a)(1). Only loan guarantees were available to proprietary organizations.

^{16/} By 1982, the Department of Health and Human Services was actively supporting conversions. See, e.g., "The Investor's Guide to Health Maintenance Organizations," Office of HMOs, Dept. Health and Human Services (1982 and 1983).

Prior to the 1986 reforms to the tax-exempt financing laws, the lower interest costs of tax-exempt debt, notwithstanding the typically higher costs of issuing tax-exempt debt, frequently made tax-exempt debt the optimal source of capital for nonprofit hospitals and health systems. Since the nonexempt use limitation was 25 percent of bond proceeds, capital-intensive organizations, such as hospitals, could raise large amounts of capital for hospital purposes and would have the ability to use up to 25 percent of the bond proceeds for nonhospital uses such as medical office buildings. Today, the private use limitation is 5 percent of the bond proceeds, and hospital bond issues are subject to a \$150 Million limitation on nonhospital uses.^{17/} These and other limitations enacted in 1986, including the arbitrage rebate requirements and limits on a hospital's ability to replenish working capital used to make capital acquisitions with bond proceeds, create a significant "opportunity" cost as well as a financial cost. Furthermore, the relatively low cost of conventional debt available to proprietary companies, especially today with major lenders seeking substantial borrowers, means that the spread between the financial cost of taxable and tax-exempt debt has narrowed, and this advantage of tax-exempt status has been diminished.

For HMOs, traditional sources of capital available to tax-exempt HMOs are proving inadequate. A few of the larger tax-exempt HMOs (specifically, Group Health Cooperative of Puget Sound, Inc., and Kaiser Foundation Health Plans, Inc.) have used tax-exempt debt to finance their facilities and equipment. However, this source of debt is not readily available for new product development, geographic expansion, or acquisitions; thus internally generated funds and taxable debt financings are the only sources of capital available for those uses.^{18/} These HMOs are increasingly finding themselves at a competitive disadvantage with respect to publicly traded HMOs and other types of taxable managed care companies that are able to use public and private sales of stock, as well as internally generated funds and public and private debt, to finance their product development, geographic expansion, and acquisitions. In fact, beginning in

^{17/} The \$150 million limitation usually becomes significant when previously unrelated healthcare systems want to merge.

^{18/} It appears that even these types of organizations are encountering problems of complying with private use restrictions in a competitive environment. See, e.g., Priv. Ltr. Rul. 9639053 (June 19, 1996) (a Section 501(c)(3) dedicated group model HMO, strikingly similar to Kaiser, obtains approval of a change in use of tax-exempt bond financed facilities because it expects to expand the types of services and products it will offer because of changes in the health care industry).

the late 1980s, publicly traded managed care companies have accessed the relatively low-cost public debt market, as well as private credit facilities and other financing arrangements, to finance their geographic and product growth strategies.^{19/}

Unlike hospitals and HMOs, the other principal component of the health care industry, medical groups, has, with some exceptions such as The Mayo Clinic and The Cleveland Clinic Foundation, largely been organized in a for-profit form. In recent years, however, many physicians and medical groups are selling their tangible and intangible assets and their operations to nonprofit hospitals and health care systems.^{20/} Typically, these transactions are part of a strategy to develop integrated delivery systems, and where state law does not prevent it, the purchasing entity often remains or becomes a Section 501(c)(3) organization. Physicians and medical groups are frequently attracted to this type of transaction as a means of accessing capital for expansion and other purposes.

In short, access to capital has been and continues to be one of the principal forces motivating conversions of status. Increasingly, however, hospitals, HMOs and other health care organizations are converting from nonprofit to for-profit status, rather than from for-profit to nonprofit status, and medical groups are converting to nonprofit status.

¶ 1.02 Conversions of Tax-Exempt and Taxable Nonprofits to For-Profit Status

[1] Conversion Structures

Conversions of status usually entail changing both an organization's legal form under state law and its federal tax status. Conversions of nonprofit corporations to for-profit corporations typically take one of four different forms.

1. Conversion in Place. This form of conversion usually involves an amendment to the corporation's articles of incorporation to delete the nonprofit aspects and add for-profit

^{19/} Prior to that time, the credit markets were reluctant to lend to HMOs that did not have substantial fixed assets to secure the repayment of the debt.

^{20/} Until the late 1980s, when the first publicly traded physician practice management companies (PPMs) were formed (PhyCor, the first publicly traded PPM, was formed in 1987, and MedPartners/Mullikin, Inc., the largest today, was formed in 1993), paid in capital, retained earnings, and secured debt were the only realistically available sources of capital for medical groups.

powers. In this type of transaction, the legal entity ceases to have the nonprofit characteristics, such as the prohibition against issuing stock or other forms of true equity and the prohibition against the payment of dividends. In place of these limitations, the corporation can issue stock, conduct all lawful business, and pay dividends. Several states, including Arizona, California, Pennsylvania, Utah, and Virginia, permit conversions in place. Several well-known public companies have undergone conversions of status in this manner, including Health Net (now a wholly owned subsidiary of Foundation Health Systems Inc.), FHP International, Inc. (which was acquired by PacifiCare Health Systems, Inc. in 1997), MaxiCare Health Plans, Inc., U.S. Healthcare, Inc. (which has now become part of Aetna, Inc.), and Blue Cross of California (which subsequently merged in an upstream merger with Wellpoint Health Networks, Inc.).

Conversions in place are typically favored by HMOs, PPOs, and other types of managed care organizations that are not significantly dependent upon fixed assets, such as real property. Since the legal entity remains in existence, a conversion in place usually does not disturb such existing contractual relationships as hospital and physician provider agreements. This arrangement contrasts with other forms of conversions, like asset sales, which often require the converting entity to assign contracts and other rights. In other words, the entity after conversion is treated as the same entity before conversion for corporate law purposes.

2. Asset sales. In this structure, a nonprofit seller agrees to sell some or all of its assets to the purchaser, and the purchaser agrees to assume all, some, or none of the liabilities of the seller. Unlike a conversion in place, an asset sale requires the for-profit purchaser to obtain appropriate state and local licenses, and the for-profit purchaser will not automatically succeed to contracts by operation of law. Assignments would need to be made separately, and some contracts may have restrictions on or require consents to their assignability. Transferee liability is determined under applicable state and local law, and, in some jurisdictions, a transferee that is the mere continuation of the transferor may be held liable for the transferor's liabilities.

Asset purchases and sales are the typical transaction structure for acquisitions of nonprofit hospitals by for-profit companies. In most of these transactions, the for-profit acquiror agrees to purchase selected assets that comprise the operating assets of the hospital, and the selling organization retains responsibility for paying the claims of creditors, dealing with Medicare payment adjustments and recoveries, funding pension plan, severance, and other employee costs, and similar matters. In addition, the selling organization retains liability for pre-sale malpractice, workers' compensation, and other

claims. In general, for-profit purchasers today seldom structure a transaction to acquire a hospital other than as an asset purchase, unless there are significant business advantages of doing so.

3. Mergers. This type of conversion structure can occur between nonprofit corporations and for-profit corporations where permitted by state law (e.g., in Arizona, California, and Virginia), subject to regulatory approval as provided by the applicable statute. In these instances, the nonprofit corporation merges with and into a for-profit corporation, and the for-profit corporation is the survivor. The disappearing nonprofit corporation's members, if eligible, receive stock of the surviving corporation, or cash or other merger consideration, depending upon the structure of the transaction.^{21/} All of the assets and liabilities of the nonprofit corporation are transferred by operation of law to the for-profit corporation, although contractual requirements may necessitate obtaining consents to assignments, even to those that otherwise would occur by operation of law.

4. Drop-down conversion. This type of conversion involves the transfer of some or all of the operating assets and liabilities of the hospital or HMO to a wholly or partially owned subsidiary in exchange for stock and/or notes. A drop-down conversion is typically used when an organization, such as an HMO, wants to convert some or all of its assets into a for-profit mode in order to obtain access to capital. In 1993, Blue Cross of California, a nonprofit public benefit corporation, transferred a substantial amount of its operating assets to Wellpoint Health Networks, Inc., a wholly owned for-profit subsidiary. Shortly after that transaction occurred, Wellpoint accessed the public equity market by selling approximately 20 percent of its stock in an initial public offering. In a similar fashion, in 1995 Tristate Foundation for Health, a Section 501(c)(4) managed care company, transferred substantially all of its operating assets to a newly formed subsidiary, ChoiceCare Corporation. Following the completion of that transaction, ChoiceCare Corporation offered stock for sale to its providers and employees. In both of these cases, the original owner of the operating assets retained a substantial percentage of the equity in the continuing operations of the newly formed corporation, and also retained its tax-exempt status, if already exempt. Many HMOs regard this type of conversion as a preliminary step to some other form of transaction, such as an acquisition of another health plan, the acquisition by another health plan, the infusion

^{21/} Priv. Ltr. Rul. 8446047 (Aug. 17, 1984) (conversion of a membership interest into a stock interest in connection with a conversion of status from nonprofit to for-profit will not result in taxable gain or loss).

of cash from a strategic investor, or a public debt or equity offering.

The four types of conversions are the forms that have typically been used by tax-exempt hospitals, HMOs, and other forms of health care organizations to convert from nonprofit to for-profit status. Very often, however, peculiar requirements under a state's licensing or corporate law, business considerations, regulatory requirements, or other factors will influence the choice of conversion structure. In addition, special considerations will affect conversions, however structured, of nonprofit organizations that are currently taxable, such as Blue Cross and Blue Shield health plans.

In addition to the four typical conversion forms, *partial conversion* structures have been increasingly used. These partial conversions are generally structured using some form of joint venture. For example, a joint venture may be formed by two unrelated entities, such as an investor-owned hospital management company and a free-standing nonprofit hospital or hospital system. Some of these joint ventures are designed to combine the resources of the two venturers to create a new entity, like a specialty hospital, or they are used to combine all of the hospital operations and related activities of both venturers in a particular market. In the typical case, each party receives an interest in the joint venture entity (e.g., as a general partnership or a limited liability company (LLC)). In a few other cases, however, it has been proposed that the nonprofit hospital or system receive equity of the investor-owned company along with an interest in the joint venture entity.^{22/}

[2] Conversion Consideration

When early hospitals first converted from for-profit to nonprofit status, the transactions were frequently structured as fairly primitive leveraged buyouts. A new corporation would be formed and the original owners of the hospital would agree to sell the assets of the hospital to the new corporation. As consideration for the purchase of the hospital assets, the new nonprofit corporation would borrow money from a bank or other lender, securing the loan with the assets that were acquired, and use the loan proceeds to pay for the assets. As an alternative, the new corporation might instead issue secured promissory notes or debentures to the selling individual or organization. The cases involving converted hospitals suggest that their owners frequently contributed a portion of the assets that were

^{22/} For a discussion of whole hospital joint ventures, see Mills, "Whole Hospital Joint Ventures Raise Questions About Exemption," 7:5 J. Tax. Exempt Orgs. 204 (Mar./Apr. 1996).

necessary for hospital operations and in a few cases the owner contributed the entire hospital to the new corporation.

Similarly, the early conversions from nonprofit to for-profit status of HMOs used equally primitive financing structures. Since many of the HMOs that converted in the late 1970s and early 1980s had little free cash, and frequently had loans that had to be repaid as a condition to getting approval for the conversion, purchasers often paid nominal amounts of cash and delivered promissory notes for the balance of the purchase price.

Beginning in the mid-1980s, conversion consideration has become more sophisticated in terms of its structure as have the structures of the transactions themselves. Conversion consideration must, of course, be structured carefully to reflect the true fair market value of the assets or operations that are being acquired. While some conversions, particularly sales of hospital assets, are usually effected with the use of cash consideration since outstanding debt usually must be defeased, HMO conversions with greater frequency are using more complex financing structures and, as discussed below, the recipient of the conversion consideration, whether it is the original owner or new entity, will frequently receive equity in the purchaser as part or all of the conversion consideration. Thus, while cash is, of course, valued at face value, noncash conversion consideration such as common or preferred stock, convertible debentures, or straight debt are subject to rigorous review to determine the true fair market value of such noncash consideration. Moreover, the structure of noncash conversion consideration is affected by such factors as the converted organization's public charity or private foundation status as well as its status as a Section 501(c)(3) or Section 501(c)(4) organization.

As discussed above, most hospital sales, particularly those made to public companies such as Columbia/HCA HealthCare Corp. or Tenet HealthCare Corp., are structured as cash purchases. Usually, the bulk of the cash consideration is payable at closing, although buyers typically hold back a certain percentage of the purchase price to be reconciled after post-closing adjustments have been made and to protect the buyer against the seller's indemnities as well as breaches of representations and warranties.

By contrast, HMO conversions have evolved into much more complex financing arrangements. For example, when Maxicare converted from nonprofit to for-profit status, it simply issued a promissory note for the unpaid portion of the purchase price that had a principal amortization schedule and bore interest. When FHP converted from nonprofit to for-profit status, however, a portion of the conversion consideration was payable in cash, and

a substantial portion of the conversion consideration was payable in the form of a convertible note. The structure of the note was straight debt that was amortizable and bore interest. However, at the option of the FHP Foundation, the recipient of the conversion consideration, that debt could be converted into stock of FHP. By the time that Health Net converted from nonprofit to for-profit status, the California Department of Corporations required that the tax-exempt recipient of the conversion consideration, The California Wellness Foundation, received secured promissory notes evidencing the full fair market value of the HMO's assets at the time of conversion, and 80 percent of the equity of the converted entity. The equity of Health Net's parent, HN Management Holdings, Inc. (now known as Foundation Health Systems, Inc.), was divided into two classes of common stock: (1) Class A voting common stock that reflected 20 percent of the equity of the company, which was acquired by the management group, and (2) Class B nonvoting, convertible common stock, which was acquired by The California Wellness Foundation. The characteristics of both classes of common stock were identical, except that the Class A common stock was voting stock, and the Class B common stock was nonvoting stock that would be convertible to voting stock in the hands of a third-party purchaser.

Because of the large amounts of consideration being paid in connection with conversions, and the inherent imprecision of valuations, the retention of some form of equity in the converted entity by the converting organization or its successor can serve as an important hedge against the possibility that the valuation is incorrect or incapable of being determined with complete precision as of the date of conversion. From a fiduciary point of view, however, an evaluation must be made as to the risks associated with retaining a substantial amount of the conversion consideration in the form of equity in the converted organization, since it cannot always be assumed that the value will always increase or increase at a rate higher than that of a more diversified investment portfolio. Furthermore, even if equity is provided, careful consideration must be given to the development of a plan for monetization of the equity over time.

[3] Charitable Trust Law Considerations

Regardless of the form of the conversion, a nonprofit corporation's articles of incorporation or state law will require that its assets be irrevocably dedicated to charitable or other nonprofit purposes. Because of this so-called nondistribution constraint, state charitable trust law typically requires that the fair market value of the nonprofit corporation's assets be

used for charitable purposes or for other purposes consistent with the converting organization's historic nonprofit purposes.^{23/}

Many states require that the state attorney general be notified of a proposed transfer of all or substantially all of a nonprofit corporation's assets, and certain types of transactions, such as mergers, may actually require the approval of the attorney general or another state regulator. In addition, many states, including California, have enacted or are in the process of enacting legislation that would place with the attorney general in a greater role with regard to evaluating and approving conversion transactions.^{24/} Nonetheless, the legal power and inclination of state authorities to oversee and approve conversions from nonprofit to for-profit status will vary from jurisdiction to jurisdiction.^{25/}

[4] General Federal Tax Considerations

[a] Tax-Exemption Considerations

Perhaps the most significant tax issue affecting conversions from nonprofit, tax-exempt status to for-profit, taxable status is the general requirement that the transferring or selling organization must receive the full fair market value of the transferred assets, regardless of the form that the conversion takes.^{26/} As a general rule for federal tax purposes,

^{23/} If there will be a material change of the organization's purpose after the conversion, a cy pres or similar legal proceeding may be required in order to obtain equitable relief from any charitable obligations. See, generally, Atkinson, "Reforming Cy Pres Reform," 44 Hastings L.J. 1112 (July 1993).

^{24/} See, e.g., A.B. 3101, amending various statutes to impose additional requirements on health care facilities prior to their entering into various transactions, including all types of conversion transactions, in California.

^{25/} See, e.g., Meldin & Perkins, "HMO Conversions: How to Distribute the Charitable Assets?," Clearinghouse Rev. 467 (Oct. 1987).

^{26/} For a discussion of valuation issues, see Young, "Ownership Conversions in Health Care Organizations: Who Should Benefit?" 10:4 J. Health Politics, Policy and Law 765 (1986); Dunn, Shields and Stern, "The Dynamics of Leveraged Buy-Outs, Conversions, and Corporate Reorganizations of Not-for-Profit Health Care Institutions," 12:3 Topics in Health Care Fin. 19, 25-26 (Spring 1986); Lutz, "How Much?" Modern Healthcare 85 (Feb. 12, 1996).

an organization's tax-exempt status would not be adversely affected simply because it changes the means by which it carries out its charitable purposes. For example, a tax-exempt hospital that was formed and has historically operated for the purpose of promoting health and that has operated hospitals as a means of carrying out that charitable purpose would not lose its exemption simply because it sells its assets to a for-profit purchaser or engages in another form of conversion transaction. Rather, continued exemption would be predicated on that organization's continuing to conduct programs or activities that further an exempt purpose or function. Thus, for example, an organization that sells a hospital or HMO and completely ceases to conduct health care operations may nonetheless continue to be recognized as a charitable organization if its purpose or function is making grants to other charitable organizations in a manner that furthers an exempt purpose or function. In fact, in a recent private letter ruling issued to a Section 501(c)(4) HMO that went through a drop-down conversion, the Internal Revenue Service (the Service) concluded that the Section 501(c)(4) transferring organization's exempt status would not be in jeopardy, because it would continue to carry out its social welfare purposes by making grants to other organizations in furtherance of such purposes.^{27/} Similar conclusions have been reached with respect to hospitals that have sold their assets to for-profit organizations.^{28/}

The principal exposure to tax exemption arises because of the prohibition against inurement of net earnings that has always applied to Section 501(c)(3) organizations and that has recently been made applicable to Section 501(c)(4) organizations. Prior to the enactment of Section 4958 in 1996, which now imposes penalty excise taxes on persons who receive excessive benefits directly or indirectly from a Section 501(c)(4) or a Section 501(c)(3) organization,^{29/} the Service and the courts generally took the position that the prohibition against inurement of net earnings was absolute in that virtually any amount of inurement, however slight, would result in loss of tax-exempt status. One way that an organization's net earnings could inure to the benefit of a private shareholder or individual or other insider was if the organization sold or transferred assets to that individual, or to an organization owned or controlled by that individual, for less than the assets' fair market value. This situation is the focus of a pending Tax Court case, Anclote

^{27/} Priv. Ltr. Rul. 9635037 (June 3, 1996).

^{28/} See, e.g., Priv. Ltr. Ruls. 8418127 (Feb. 2, 1984), 8645075 (Aug. 14, 1996), 8717063 (Jan. 29, 1987).

^{29/} See, infra ¶ 1.04 for a discussion of Section 4958 as it applies to conversions.

Psychiatric Center, Inc. v. Commissioner,^{30/} in which it has been alleged that a tax-exempt psychiatric hospital's net earnings inured to the benefit of private shareholders or individuals as a result of the sale of its assets to a corporation formed by members of its board of directors for an amount that allegedly was less than its fair market value. In that case, the tax-exempt organization sold the hospital assets to its directors for \$6,318,000, including assumed liabilities of \$1,818,000. Two years later, the corporation owned by the board of directors sold the assets to an unrelated third party for \$29,587,000.^{31/}

The structure of the conversion will dictate whether the existing entity will continue to hold the proceeds from the conversion transaction, whether such proceeds are in cash, notes, or securities of the converted entity. In the case of conversions in place and forward mergers, the tax-exempt entity either ceases to be a nonprofit corporation or disappears completely. Consequently, the proceeds from the conversion transaction must be distributed to a new or existing charitable recipient. For example, when Health Net, a California-based Section 501(c)(4) HMO, converted from nonprofit to for-profit status in a conversion in place, a new organization was formed to serve as the recipient of the proceeds of the conversion. That organization, The California Wellness Foundation, was organized as a Section 501(c)(3) private foundation. A similar approach was used when FHP International, Inc., was converted in a conversion in place. The recipient of the charitable funds in that case was The FHP Foundation. When Safeguard Health Plans, Inc.,^{32/} a Section 501(c)(4) dental HMO, converted from nonprofit to for-profit status, the conversion proceeds were distributed to two existing tax-exempt dental schools.

When the conversion is structured as a sale of assets, the selling organization remains in existence and thus can continue

^{30/} Anclote Psychiatric Center, Inc. v. Comm'r, 70 TCM 1577 (1995).

^{31/} Priv. Ltr. Rul. 8234084 (May 27, 1982) (the private letter ruling that approved the transaction based in part on representations that fair market value was paid); Priv. Ltr. Rul. 9130002 (the technical advice memorandum that revoked Priv. Ltr. Rul. 8234084, and revoked the hospital's tax-exempt status for the below-market sale to directors); Anclote Psychiatric Center, Inc. v. Comm'r, 70 TCM 1577 (1995); see also Hancock Academy of Savannah, Inc. v. Comm'r, 69 TC 488 (1977).

^{32/} This organization is now a wholly owned subsidiary of Safeguard Health Enterprises, Inc., a publicly traded company.

to use the proceeds from the conversion transaction in furtherance of charitable purposes. Thus, for example, when Good Samaritan Health System sold substantially all of its operating assets to Columbia/HCA Healthcare Corporation in January 1996, the sale proceeds were retained by the organization, which now operates under the name Good Samaritan Charitable Trust; this organization will continue to operate certain programs that it retained and will make grants in furtherance of charitable purposes. As an alternative, a new organization can be created, as was the case when Irvine Medical Center, Inc., sold substantially all of its assets to American Medical International, Inc. In that case, following the sale, the net sale proceeds were transferred to a newly formed private foundation, Irvine Health Foundation, which makes grants to support health-related projects in the community.

Continuing exemption problems potentially arise from and after the conversion transaction, depending on the relationship between the converted organization and the new, proprietary operator of the hospitals or HMOs. In the mid-1980s, the Service approved several transactions where the selling organization intended to continue to support certain indigent care and similar types of activities carried on by the purchasing organization. More recently, however, the Service has questioned the propriety of a selling organization's support of the purchasing organization's indigent care activities, especially where the support is provided on a preferential basis.

In addition, the Service remains concerned with transactions that result in the purchasing proprietary organization having substantial control over the selling organization's board of directors. While technically an overlap is permitted for federal tax law purposes, most converting organizations have in fact completely separated the governance of the buying and selling organizations, except for some continuing involvement in governing the proprietary organization from and after the conversion transaction.

Finally, pre-conversion and post-conversion compensation arrangements with executives and board members will be scrutinized by the Service, as well as state regulators, to determine their reasonableness. Special review by the Service, as well as state regulators, will be given to change of control and similar agreements, as well as inducements provided by purchasers, such as stock options.

[b] Public Charity Status Issues

When a Section 501(c)(3) organization converts from nonprofit to for-profit status in a transaction, such as an asset sale, that allows the organization to continue in existence, the organization must be concerned with the question

of whether or when it will become a private foundation, if at all.^{33/} In the case of hospitals, they qualify as public charities because of the nature of the activities they conduct (i.e., they operate hospitals and are thus public charities described in Sections 509(a)(1) and 170(b)(1)(A)(iii) of the Code). In the case of HMOs described in Section 501(c)(3), they typically are classified as public charities because they derive most of their support from the conduct of related trades or businesses and are thus public charities described in Section 509(a)(2). It should be noted that a Section 501(c)(3) HMO may be classified as a hospital described in Sections 509(a)(1) and 170(b)(1)(A)(iii), because it owns and operates hospital facilities that are associated with the conduct of its HMO business.^{34/}

In most instances, a hospital or HMO that sells its assets will have several options with regard to its future public charity status. In fact, unless the organization transfers its assets, including conversion consideration, to a newly formed organization, the organization will in most instances be able to continue to qualify as a public charity for at least some period of time following the sale of assets and the discontinuation of the hospital or HMO operations.

First, the organization may continue to be classified as a hospital described in Sections 509(a)(1) and 170(b)(1)(A)(iii) because it continues to carry on other functions, such as operating outpatient clinics, that are of the type that would allow it to be classified as a Section 170(b)(1)(A)(iii) hospital. For example, in Private Letter Ruling 8418127,^{35/} the Service ruled that an organization that sold an acute care hospital could continue to qualify for public charity status as a Section 170(b)(1)(A)(iii) hospital because it would continue to be a provider of health care through certain alternative delivery systems, in particular birthing and family centers, minor emergency centers, and freestanding diagnostic centers. After reviewing the specific aspects of the expected operations of these programs, the Service concluded that these activities constituted the provision of medical care on an outpatient basis, and thus the facilities may be considered to be hospitals within the meaning of Section 170(b)(1)(A)(iii). The Service therefore concluded that upon the consummation of the proposed sale of the

^{33/} Public charity status is of no concern to Section 501(c)(4) organizations, unless the ultimate recipient of the conversion consideration is a tax-exempt organization described in Section 501(c)(3).

^{34/} See, e.g., Priv. Ltr. Rul. 7707083 (Nov. 21, 1977).

^{35/} Priv. Ltr. Rul. 8418127 (Feb. 2, 1984).

hospital assets and the institution of the alternative delivery activities, the organization would continue to be treated as an organization described in Sections 509(a)(1) and 170(b)(1)(A)(iii) and would not be considered to be a private foundation.

If, on the other hand, the organization will cease conducting activities that will allow it to be classified as a Section 170(b)(1)(A)(iii) hospital, the organization will have three other options available for continuing to qualify as a public charity. First, if the organization continues or puts in place a fundraising program that can reasonably be expected to be successful, the organization may be able to be classified as a publicly supported organization described in Sections 509(a)(1) and 170(b)(1)(A)(vi). Since the Service has ruled that Section 170(b)(1)(A)(iii) hospitals are also eligible to be classified as Section 170(b)(1)(A)(vi) organizations if they have sufficient public support,^{36/} the organization may simply be able to continue as a Section 170(b)(1)(A)(vi) organization, as long as it continues to meet the mechanical or facts and circumstances test for public charity status.

Second, if the organization does not have sufficient public support to enable it to be entitled to the additional Section 170(b)(1)(A)(vi) classification, it nonetheless will be entitled to the additional classification as a Section 509(a)(2) organization. Although the Service has not published a revenue ruling specifically dealing with this issue, it has issued private letter rulings in which it concluded that a hospital was entitled to the additional classification as a Section 509(a)(2) organization on the basis of its sources of support from governmental programs, particularly Medicare and Medicaid. Thus, even after the organization sells its hospital assets, it will be able to continue to be classified as a Section 509(a)(2) organization until it fails to satisfy either the one third of support test or its investment income and net after-tax unrelated business income exceeds the one third of support limitation.^{37/}

If a converting organization ceases to conduct hospital-type activities and does not appear to be able to continue to meet the support tests that would allow it to continue as a Section 170(b)(1)(A)(vi) or Section 509(a)(2) public charity, it may nonetheless remain a public charity if it restructures its organization and governance in a manner that allows it to qualify as a Section 509(a)(3) support organization of another Section

^{36/} See Rev. Rul. 76-416, 1976-2 CB 57.

^{37/} See, e.g., Priv. Ltr. Ruls. 8234084 (May 27, 1982), revoked on other grounds; 9130002 (March 19, 1991); 9538026 (June 26, 1995); 9635029 (May 30, 1996); 9643036 (July 31, 1996).

509(a)(1) or Section 509(a)(2) organization. As an alternative, the converting organization may distribute the conversion consideration to another, pre-existing charitable organization, such as a newly formed organization, or to an existing public charity, such as a community foundation.

[c] Private Foundation Issues

Section 501(c)(3) organizations that undergo a conversion will generally fall into one of two categories: (1) those that continue in existence as Section 501(c)(3) organizations and thus can continue to qualify as public charities, for a time, and (2) those that disappear at the time of conversion so that the conversion consideration is distributed to another existing Section 501(c)(3) organization or to a new Section 501(c)(3) organization formed expressly for the purpose of receiving that conversion consideration. In some cases, therefore, the private foundation issues do not have to be faced until some time after the conversion is completed, while in other cases the private foundation issues must be confronted both before and at the time of the conversion. Frequently, the private foundation considerations have an effect on how the organization relates to the converted organization on a long-term basis.

The provisions of Chapter 42 of the Code relating to private foundations present a number of complex issues that must be addressed before, at the time of, and after a conversion transaction if the recipient of the conversion consideration is or at some time in the future will likely become a private foundation.^{38/} Some of the more significant issues are identified below.

[i] Disqualified person status. A threshold issue that must be addressed is whether the successor to the converted assets is a disqualified person with respect to the converting organization or its successor. In a transaction where the assets of the converting organization are sold for their fair market value and the converting organization remains in existence, the successor to the converted assets is not likely to be treated as a disqualified person with respect to the converting organization unless it has some other kind of relationship, such as a management agreement. However, a question arises as to whether an organization that converts in place and distributes the conversion consideration to an existing or a new private foundation is a substantial contributor with respect to that foundation. As previously discussed, a conversion in place should be treated as a deemed sale of assets

^{38/} Chapter 16 contains a complete discussion of the tax rules applicable to private foundations.

by the converting organization, followed by a distribution of the conversion consideration to the existing or new foundation. However, the converted entity continues in existence for corporate law purposes, it could be argued that the second step in that transaction (i.e., the distribution of the conversion consideration to the existing or new private foundation) is a gift. Also, in those situations, the converting organization must use care not to become a substantial contributor with respect to the private foundation prior to the time of the conversion.

The status of the converted organization as a disqualified person with respect to the private foundation creates potential post-conversion problems under Section 4941, which imposes an excise tax on acts of self-dealing between a disqualified person and a private foundation. For example, post-conversion sales and exchanges of property between a private foundation and its qualified person will be acts of self-dealing unless they fall within very limited exceptions. Similarly, loans or other extensions of credit between a private foundation and a disqualified person will be treated as acts of self-dealing. Thus, for example, the use of debt in connection with a conversion could inadvertently result in an act of self-dealing. Similarly, certain transactions with respect to that debt, such as its restructuring or prepayment, could also constitute acts of self-dealing.

Several narrowly drafted exceptions provide limited relief from the harsh application of the self-dealing rules in the case of certain transactions. Again, however, if the converted entity is a disqualified person, care must be used in structuring transactions that fall within one or more of those exceptions. For example, if a transaction between a disqualified person and a private foundation occurs pursuant to a liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization, the transaction is not treated as an act of self-dealing if certain conditions are satisfied. What happens, for example, if the private foundation receives substantial equity in the converted organization as part of its conversion consideration? What happens if the private foundation is the only holder of securities of a particular class (e.g., nonvoting common stock or preferred stock) and the converted organization wishes to redeem some portion of all of those securities, or it is obligated to do so pursuant to an agreement entered into at the time of conversion between the foundation and the converted organization? Properly structured, many of these transactions can fall within an exception; however, failure to strictly adhere to the provisions of Section 4941 could result in an inadvertent act of self-dealing.

[ii] Minimum payout requirements. Another issue that converted entities operating as private foundations must

address is the minimum payout requirements under Section 4942. The regulations under Section 4942 allow for a phase-in of the minimum payout requirements for new private foundations, and presumably this phase in of the payout requirements will apply to public charities that cease to be classified as such sometime after the time the conversion takes place. Also, since private foundations are required to make minimum distributions of at least 5 percent of the excess of the aggregate fair market value of all assets of the foundation other than those used or held for use directly in carrying out the foundation's exempt purposes, reduced by the acquisition indebtedness with respect to those assets, noncash conversion consideration that is not easily monetized must be used judiciously in order to ensure that the private foundation has sufficient cash with which to meet its payout requirements.

[iii] Excess business holdings rules. The excess business holdings requirements of Section 4943 also present some issues for private foundations that acquire equity in the converting entity as part of the conversion consideration. For example, private foundations are permitted to own up to 20 percent of the voting stock of a corporation, and up to 35 percent in special situations. If disqualified persons also own 35 percent of the voting stock in the same corporation, the permitted holdings of the foundation are reduced by the amount of voting stock held by the disqualified persons. A threshold question is, of course, whether the equity interests held by the private foundation are in fact voting stock. The regulations provide that the determination of whether stock is voting or not is made with reference to the voting rights of the stockholder contained in the organizational documents creating the stock. In fact, the Service has ruled that consensual alterations of voting rights, such as an agreement not to exercise the voting rights of a particular class of stock, will generally not alter the treatment of the stock as voting stock for purposes of Section 4943.^{39/}

If the converted entity itself is a disqualified person with respect to the private foundation, then the converted corporation's officers and directors will be treated as disqualified persons if they own 35 percent or more of the voting stock of the converted entity. Consequently, holdings of those persons may be aggregated with those of the foundation for purposes of determining whether the foundation itself has excess business holdings.

On the other hand, private foundations are permitted to own any amount of one or more classes of nonvoting stock of a corporation if all disqualified persons actually or

^{39/} See GCM 39855 (July 19, 1991).

constructively own no more than 20 percent of the voting stock in the corporation. Any equity interests that do not have voting powers attributable to them are nonvoting.^{40/} Under the regulations, stock that carries voting rights that will vest only when indeterminate conditions have been met (e.g., preferred stock that gains voting rights if no dividends are paid thereon) will be treated as nonvoting stock until the conditions that cause the rights to vest have occurred. Similarly, nonvoting stock that is convertible to voting stock, such as convertible preferred stock, will be treated as nonvoting stock until the conversion feature is exercised.^{41/} Finally, debt obligations, including debts that are convertible into voting or nonvoting stock as well as warrants, options and other rights to acquire stock are not considered equity interests for purposes of Section 4943.^{42/} Thus, properly structured debt with equity conversion features may be appropriate. As can be seen, however, the arcane rules of Section 4943 need to be reviewed with extreme care when a conversion transaction occurs and substantial equity is going to be provided to a private foundation, directly or indirectly, and where the converted entity or persons with respect to it may be regarded as disqualified persons with regard to the private foundation.

[iv] Jeopardy investment rules. The jeopardy investment rules also raise structuring questions. Ordinarily, a jeopardy investment is an investment where there has been a failure to exercise ordinary business care and prudence, under the facts and circumstances at the time of investment, and to provide for the long- and short-term financial needs of the foundation to carry out its exempt purposes. Importantly, however, investments obtained by gift are exempt from the jeopardy investment rules. It is also important to recognize, however, that compliance with Section 4944 will not relieve the foundation or its managers from their responsibility to comply with other federal or state laws. Thus, private foundations or their managers must use care to comply with federal and state securities registration, insider trading, short sale, disclosure, and fraud statutes, as well as state laws that prescribe permitted or impermissible forms of investments. Conversely, compliance with state laws does not exempt or relieve private foundations or their managers from the obligations under Section 4944.

[v] Taxable expenditures rules. Finally, private foundations must comply with the rules of Section 4945 that deal

^{40/} Reg. § 53.4943-3(b)(2)(i).

^{41/} Reg. § 53.4943-3(b)(2)(ii).

^{42/} Reg. § 53.4943-3(b)(2)(i) (last sentence).

with taxable expenditures. Thus, for example, a private foundation must use extreme care if it wishes to make grants to the converted entity to fund specific projects or programs. It is appropriate for private foundations to make grants to non-Section 501(c)(3) organizations if they wish to do so, provided that the grant itself is intended to further a charitable, educational, or other exempt purpose, and that the private foundation exercises expenditure responsibility with respect to the grant. Nonetheless, even though permitted, a private foundation would be well advised to be cautious in dealing with the converted entity, especially if it wishes to do so on a selective or discriminatory basis. In fact, the Service generally discourages dealings between the converted and converting organization absent compelling circumstances, and state regulators may object to such transactions as well.

[vi] Summary. The foregoing discussion illustrates the need for great care in operating a converted organization as a private foundation, particularly if the conversion consideration received by the foundation include debt or equity securities of the converted organization, and especially where the converted entity and/or its managers are disqualified persons with respect to the private foundation.

[d] Unrelated Business Income Tax Treatment of Conversion Transactions

[i] General rules. Notwithstanding the fact that a converting organization is exempt from federal income taxation under Section 501(c)(3) or Section 501(c)(4), some portion or all of the sale proceeds from a conversion transaction may be subject to taxation as unrelated business income.

Before turning to the specific tax treatment of conversions, it is important to recognize that every type of conversion transaction will involve a realization event for federal income tax purposes. When an organization undergoes a conversion in place, the amendment and restatement of the organization's articles of incorporation will normally be treated as a realization event. In effect, the conversion will be treated as a deemed sale. Thus, if cash is distributed as a result of the conversion in place, the transaction should be treated as a sale of assets for federal tax purposes. On the other hand, if stock and/or securities are distributed to charitable recipients, the transaction may be treated as a tax-free recapitalization under Section 368(a)(1)(E) of the Code, or it may be disregarded completely. The principal tax issue that arises is whether the continuing organization will be entitled to receive a step-up in basis for the assets acquired, since the sale itself would not be so entitled. If the transaction is treated as a deemed sale of assets and is followed by distribution of the assets, the tax

treatment should be the same as an outright purchase of the assets by a proprietary organization, which is discussed below.^{43/}

When a nonprofit hospital or HMO sells all or substantially all of its operating assets to a third party, the sale of assets used to conduct exempt purposes or functions is generally considered to be a transaction that furthers an exempt purpose and therefore should not generate unrelated business income. The Service has in fact so ruled in several instances.^{44/} More recently, however, it has not been willing to rule that a sale of assets is a transaction that furthers an exempt purpose or function and, therefore, is a related trade or business. Rather, the Service has only been willing to rule that such sale proceeds are excludable from taxation under Section 512(b)(5), or that the transaction is not a regularly carried on.^{45/} Section 512(b)(5) provides that there shall be excluded from unrelated business taxable income all gain from the sale, exchange, or other disposition of property, other than property that would be properly includable in inventory, on hand at the close of the taxable year or property held primarily for sale to customers in the ordinary course of the trade or business. A transaction is not regularly carried on if it is a one-time transaction.

In general, the rulings position of the Service will be an acceptable legal approach for many organizations and will result in the nontaxability of sales of most assets. However, sales of certain assets in connection with a conversion, such as inventories of pharmaceuticals, durable medical equipment, and similar items, will neither be eligible for exclusion under Section 512(b)(5) nor nontaxable because the sales are not regularly carried on (unless the Service is willing to treat a bulk sale of such items as distinguishable from routine sales). It is preferable instead to take the position that the sale transaction is a means to the accomplishment of a charitable end, and that therefore the proceeds from the sale are exempt from taxation as unrelated business income because they are derived from the conduct of a related trade or business.

[iii] Debt-financed income issues. Special care must be used in structuring sales of debt-financed assets. In general, if indebtedness is incurred to acquire an income-

^{43/} Treatment of a conversion transaction as a deemed sale is especially important if a step-up in basis for intangible assets is desired, subject of course to applicable anti-churning rules contained in Section 197.

^{44/} See, e.g., Priv. Ltr. Rul. 8645075 (Aug. 14, 1986).

^{45/} See, e.g., Priv. Ltr. Ruls. 8418127 (Feb. 2, 1984); 8717063 (Jan. 29, 1987); 9635037 (June 3, 1996).

producing asset, directly or indirectly, Sections 512.(b) (4) and 514(a) (1) may require the treatment of the debt-financed portion of the income, as well as its taxation, as unrelated business taxable income. The calculation of debt-financed taxable income is made on a property by property basis, regardless of whether the property is tangible or intangible. Thus, in a sale of assets or in another conversion transaction, such as a conversion in place or forward merger that is deemed to be a sale of assets, the special rules for the sale of a debt-financed asset may apply.

In these instances, the average adjusted basis of the property is the average adjusted basis as of the first day during the year in which the property is held by the organization, and on the day the property is sold or disposed of. The percentage of gain taxed is the highest percentage of acquisition indebtedness equal to the average adjusted basis on sale or other disposition of debt-financed property with respect to the property during the twelve-month period ending with the date of the sale or other disposition.^{46/} The regulations permit adjustments to basis that include decreases in basis for depreciation since the acquisition of the property, and increases in basis for capitalized improvements or additions. Although a complete discussion of the debt-financed income rules is beyond the scope of this paper, certain problem areas in connection with conversions need to be examined.

First, Section 514(b) (1) (A) contains exceptions from the definition of debt-financed property for debt-financed property used in connection with related trades or businesses. Thus, the hospital facilities that are sold or deemed sold in the conversion transaction will qualify as related use assets and therefore will not be classified as debt-financed property. Similarly, if a hospital incurs debt to construct or acquire a medical office building leased to and occupied by members of its medical staff, the leasing activity is generally treated as a related trade or business pursuant to Revenue Ruling 69-464,^{47/} and none of the rental income derived from the related uses is subject to taxation. Thus, any gain on sale of a medical office building that is subject to an acquisition indebtedness should fall under the related use exception and not be treated as debt-financed property for purposes of Section 514.

On the other hand, sales of income-producing assets that are debt-financed, such as commercial office buildings or office buildings that have substantial (more than 15 percent) commercial use, may be partially or completely treated as debt-financed

^{46/} Reg. § 1.514(a)-1(a) (1) (v) (a).

^{47/} Rev. Rul. 69-464, 1969-2 CB 132.

property. Their sale may therefore be taxable notwithstanding Section 515(b)(5).

If debt-financed property is used in an unrelated trade or business by the exempt organization, the property is not treated as debt-financed property as long as it continues to be used in that manner.^{48/} However, this exception does not apply to gain recognized on the sale or other disposition of the property that otherwise would be excluded from taxation under Section 512(b)(5). In effect, then, the gain from the sale of debt-financed property used to conduct unrelated trades or businesses remains subject to tax under Section 514.

Hospitals, medical research organizations, and similar organizations are permitted to engage in certain types of research activities that, though not treated as scientific research and therefore related, are nonetheless nontaxable under Section 512(b)(7), Section 512(b)(8), or Section 512(b)(9). If the organization uses debt-financed property to carry out its unrelated but nontaxable research activities, the debt-financed property used in connection with the activities is not treated as debt-financed property, even if it is later sold.^{49/}

Certain types of otherwise unrelated trades or businesses carried on by charitable hospitals and health care organizations are nontaxable because they are excluded from the definition of "trade or business" under Section 513(a)(1), Section 513(a)(2), or Section 513(a)(3). The significance of this exception is that it not only applies to revenues from these unrelated activities carried on through the use of debt-financed property, but also to any gain on the sale of debt-financed property, if later sold, as unrelated debt-financed income under Section 512(b)(5).

Finally, hospitals frequently acquire land for expansion and future uses. If that land is sold along with the other assets of the hospital, care must be used to ensure that such land falls under the neighborhood land rule and that the property is therefore eligible for treatment as other than debt-financed property.

[e] Special Problems of Nonprofit Taxable Organizations

Many hospitals over the years have formed nonprofit corporations to conduct certain of their activities and operations. However, in many instances these organizations are not eligible for tax-exempt status under either Section 501(c)(3)

^{48/} IRC § 514(b)(1)(B); Priv. Ltr. Rul. 8842002 (July 13, 1988).

^{49/} IRC § 514(b)(1)(C).

or Section 501(c)(4). In addition, many Blue Cross and Blue Shield health plans throughout the United States have been formed as nonprofit corporations. Prior to January 1, 1987, most of those organizations were eligible for tax exemption as Section 501(c)(4) organizations. However, because of the application of Section 501(m) those organizations have become taxable. Thus, in both instances when a conversion transaction takes place, concerns arise as to whether the transaction will be taxable or not.

In a significant development, Private Letter Ruling 9545014,^{50/} the Service ruled that a nonprofit public benefit corporation that is subject to tax could convert from nonprofit to for-profit status in a conversion in place, and distribute its shares to a newly formed 501(c)(4) organization, and have that conversion transaction constitute a tax-free recapitalization within the meaning of Section 368(a)(1)(E).^{51/}

^{50/} Priv. Ltr. Rul. 9545014 (Aug. 18, 1995) (Blue Cross of California); cf. Priv. Ltr. Rul. 8902015 (Oct. 14, 1988) (conversion in place of nonprofit mutual benefit corporation into a cooperative treated as Section 368(a)(1)(E) recapitalization); Priv. Ltr. Rul. 7827031 (Apr. 6, 1978) (recapitalization of tax-exempt cemetery association).

^{51/} The actual structure of Blue Cross of California recapitalization is as follows. On May 20, 1996, Blue Cross of California (the Company) concluded a series of transactions to recapitalize its publicly traded majority-owned subsidiary, WellPoint Health Networks, Inc., a Delaware corporation (Old WellPoint), pursuant to the Amended and Restated Recapitalization Agreement dated as of March 31, 1995 (the Amended Recapitalization Agreement), by and among the Company, Old WellPoint and two newly formed California nonprofit foundations, Western Health Partnerships (the Health Foundation) and Western Foundation for Health Improvement (the Western Foundation). Pursuant to the Amended Recapitalization Agreement, (1) Old WellPoint distributed an aggregate of \$995.0 million by means of a special dividend of \$10 per share to the holders of its common stock, and the Company, as a California nonprofit public benefit corporation, thereupon immediately donated its portion thereof (\$800 million) to the Western Foundation; (2) the Company then donated its assets, other than the Company's Old WellPoint Class B Common Stock and the Company's commercial operations (the Commercial Operations), to the Health Foundation; (3) the Company then changed its status to a California for-profit business corporation by means of filing Amended and Restated Articles of Incorporation with the California Secretary of State and issues to the Health Foundation 53,360,000 shares of Common

¶ 1.03 Conversions of For-Profit Corporations to Nonprofit Status

Conversions from for-profit to nonprofit status have occurred from time to time in the health care industry.^{52/} Indeed, the basic structural approaches for converting an organization from for-profit to nonprofit status essentially mirror those available for converting from nonprofit to for-profit status. The methods include conversions in place, mergers, sale of assets, drop-down conversions, and combinations of these approaches.^{53/}

Stock; and (4) Old WellPoint then merged with and into the Company (the Merger), and the Company changed its name to WellPoint Health Networks, Inc. (collectively, the Recapitalization). In the Merger, (1) each outstanding share of Old WellPoint Class A Common Stock was converted into .667 shares of the Company's Common Stock, and (2) the outstanding shares of the Company's Common Stock held by the Health Foundation prior to the merger were converted into 53,360,000 shares of the post-Merger Company's Common Stock and a cash payment of \$235 million to reflect the value of the Commercial Operations. The Company's Common Stock is entitled to one vote per share, and as a result of the Recapitalization, the 10 to 1 voting rights of Old WellPoint's Class B Common Stock have been eliminated. In connection with the Recapitalization, the Blue Cross/Blue Shield Association has entered into a new license agreement with the Company, which makes the Company the exclusive licensee of the right to use the Blue Cross name and related service marks in California.

^{52/} For examples of medical groups converting from for-profit to nonprofit tax-exempt status, see Priv. Ltr. Rul. 8301017 (Sept. 29, 1982) (addressing depreciation recapture at time of conversion); Priv. Ltr. Rul. 8305052 (Oct. 25, 1982) (same); Priv. Ltr. Rul. 8305143 (Nov. 8, 1982) (addressing unrelated business income taxation of accounts receivable collected after time of conversion); Priv. Ltr. Rul. 8633038 (May 21, 1986) (no unrelated business income tax imposed on receivables collected after conversion).

^{53/} Prior to General Utilities repeal in 1986, stock purchases followed by complete liquidations of the targets were often used, because double-tax treatment could be avoided and the buyer could still get a step-up in cost basis for Medicare cost reimbursement purposes.

[1] Subchapter C Tax Considerations

All of the forms of conversions, other than a direct sale of assets from the for-profit corporation to a nonprofit corporation, raise issues under Subchapter C of the Code regarding the scope of the repeal of the General Utilities doctrine (i.e., the current law requirement that a C corporation must generally recognize gain on a distribution of appreciated property). The basic question is whether the for-profit corporation must recognize gain on the conversion from for-profit to nonprofit status.^{54/}

When Congress repealed the General Utilities doctrine in the Tax Reform Act of 1986, it also amended Section 337(b)(2) to provide that a for-profit corporation making a liquidating distribution to an 80 percent shareholder that is a tax-exempt organization must recognize gain on the distribution unless the exempt organization uses the property distributed in the conduct of a unrelated trade or business.^{55/} Accordingly, any acquisition of a for-profit corporation's stock by an exempt organization, either by purchase or contribution, followed by liquidation, will typically result in recognition of any gain by the liquidating corporation except in unusual circumstances.

Gain recognition may also be required if, instead of liquidating, the for-profit corporation is merged into its nonprofit parent, because such a transaction is treated as liquidation rather than a merger under Section 368(a)(1)(A).^{56/} However, the regulation does not recharacterize a merger of a for-profit corporation into a sibling nonprofit corporation, nor does it recharacterize reorganizations described under Section 368(a)(1)(D), Section 368(a)(1)(E) or Section 368(a)(1)(F) that do not involve a liquidation. On the other hand, the Service has ruled in at least one case that the merger of a for-profit

^{54/} On one occasion, the Service considered the question of whether the sale of a membership interest in a nonprofit corporation would trigger gain realization at the corporation level, and the Service concluded that no gain would be recognized under either Section 311(a) or Section 336(a). See Priv. Ltr. Rul. 8851009 (Sept. 20, 1988) (the ruling did not discuss the effects of any later liquidation or application for exemption).

^{55/} Rulings have been issued where the taxpayer has represented that the distributed property will be used in an unrelated trade or business. See, e.g., Priv. Ltr. Rul. 8950021 (Sept. 18, 1989); Priv. Ltr. Rul. 9104023 (Oct. 29, 1990).

^{56/} Reg. § 1.332-3(d); Priv. Ltr. Rul. 8813042 (Dec. 31, 1987), revoked in part by Priv. Ltr. Rul. 9245026 (Aug. 7, 1992).

corporation into a nonprofit corporation should be completely disregarded, and that the nonprofit corporation should be treated as the same entity for Subchapter C tax purposes as the for-profit corporation.^{57/}

The federal tax effect of other structures resulting in a conversion from for-profit to nonprofit status has been unclear since 1986, and until 1997. Section 337(d)(1), as amended in 1986, authorized the Secretary of the Treasury to prescribe regulations to prevent the avoidance of the repeal of the General Utilities doctrine. The Technical and Miscellaneous Act of 1988 amended the statutory authorization specifically to include avoidance "through the use of a regulated investment company, a real estate investment trust, or tax-exempt entity."^{58/}

Prior to the publication of proposed regulations in 1997 regarding the use of exempt organizations under Section 337(d)(1), there had been speculation that the Service would treat any conversion of a for-profit corporation to a nonprofit corporation that seeks tax exemption as a deemed liquidation under Section 337(b)(2).^{59/} This would require recharacterizing a conversion transaction, such as an amendment to articles of incorporation or a merger, as a transfer by the for-profit corporation's shareholders of their stock to a tax-exempt corporation followed by complete liquidation of the for-profit corporation.^{60/} To recharacterize the transaction would result in gain recognition by the for-profit corporation under Section 337(b)(2). The nonprofit corporation would recognize no gain or loss on the fictional liquidation by virtue of Section 332.

^{57/} Priv. Ltr. Rul. 8813042 (Dec. 31, 1987) (this ruling was issued prior to the enactment of Section 337(d)(1)).

^{58/} Technical and Miscellaneous Act of 1988, § 1006(a)(5)(A)(i)-(ii).

^{59/} See, e.g., Priv. Ltr. Rul. 9044074 (Aug. 8, 1990) (the Service conditioned the ruling on the ground that the business corporation converting into a nonprofit mutual benefit corporation would not apply for exemption following its conversion of status). On the other hand, the Service did not feel compelled to exact that kind of representation in a prior ruling wherein it concluded that the sale of memberships would, in effect, not constitute a constructive liquidation of the nonprofit target. See Priv. Ltr. Rul. 8851009 (Sept. 20, 1988).

^{60/} See, e.g., Priv. Ltr. Rul. 8713070 (Dec. 31, 1986).

In Notice 88-19,^{61/} promulgated before the Technical and Miscellaneous Act of 1988, the Service stated that it intends to tax built-in gain on the conversion of a C corporation to a regulated investment company or a real estate investment trust, but that it also intended to provide relief in the form of a special election under rules similar to the Section 1374 S corporation built-in gain rules.^{62/}

After the General Utilities repeal and prior to the 1988 amendments, the Service issued three private letter rulings in which for-profit corporations converted to nonprofit status and applied for tax exemption, ruling in each case that the conversion qualified as a tax-free F reorganization. Since the 1988 Act, all three private letter rulings have been revoked.^{63/} All revocations cited Section 337(d). Also, the Service had informally indicated that it would no longer rule that a for-profit to a nonprofit conversion will qualify as a tax-free reorganization.^{64/}

In January 1997, confusion as to the effect of Section 337(d) on conversions was largely eliminated when the Treasury Department published proposed regulations pursuant to the authorization contained in Section 337(d)(1).^{65/} Under these proposed regulations, if a taxable corporation transfers all or substantially all of its assets to one or more tax-exempt entities, the taxable corporation must recognize gain or loss immediately before the transfer as if the assets transferred were sold at their fair market values.^{66/} In effect, this general rule will apply to de facto liquidations of corporations where the corporation itself remains in existence following such transfers;

^{61/} Notice 88-19, 1988-8 IRB 14.

^{62/} See, e.g., Priv. Ltr. Rul. 9043040 (July 31, 1990) (applies rules similar to Section 1374 to regulated investment company).

^{63/} Priv. Ltr. Rul. 8751028 (1987), revoked by Priv. Ltr. Rul. 9245027 (Aug. 7, 1992); Priv. Ltr. Rul. 8851039 (1988), revoked by Priv. Ltr. Rul. 9449004 (1992) and Priv. Ltr. Rul. 8813042 (Dec. 31, 1988), revoked in part by Priv. Ltr. Rul. 9245026 (Aug. 7, 1992).

^{64/} See "Conversion From For-Profit to Nonprofit Corporate Status May No Longer Qualify as a Tax-Free Organization," 33:7 Tax Management Memorandum 106 (April 6, 1992); Rev. Proc. 94-76, 1974-2 CB 825 (no rulings policy).

^{65/} Prop. Reg. § 1.337(d)-4.

^{66/} Prop. Reg. § 1.337(d)-4(a).

actual liquidating distributions will be governed by Section 337(b)(2). What is unclear is whether this rule will apply to purported charitable contributions of appreciated assets. If such "contributions" are bona fide, the contributing corporation would not only be entitled to a charitable deduction under Section 170(a)(1) of the Code, but also it would not generally be taxed on any built-in gain, irrespective of whether the contributed property as sold would have resulted in ordinary income or capital gain to the corporation. On the other hand, if the purported contribution is recharacterized as a dividend, it would nonetheless be subject to tax under Section 311(a).

Of great importance to nonprofit taxable corporations is the proposed regulation that would treat a taxable corporation's change in status to a tax-exempt entity as equivalent to a transfer of all of its assets to a tax-exempt entity immediately before the change in status becomes effective.^{67/} By characterizing the change in status from taxable to tax-exempt as equivalent to a transfer of all of the taxable corporation's assets to a tax-exempt entity, the taxable corporation will be required to recognize gain or loss immediately before the transfer, as if the assets transferred were sold at their fair market values. Importantly, the proposed regulations also provide that if a state, a political subdivision thereof, or an entity any portion of whose income is excluded from gross income under Section 115, acquires the stock of a taxable corporation and thereafter any of the taxable corporation's income is excluded from gross income under Section 115, the taxable corporation will be treated as if it transferred all of its assets to a tax-exempt entity immediately before the stock acquisition.

The proposed regulations create a number of exceptions for certain types of changes of status from taxable to tax-exempt. First, if a corporation previously exempt under Section 501(a) regains its tax-exempt status under Section 501(a) within three years from the later of a final adverse adjudication on the corporation's tax-exempt status, or the filing by the corporation, or by the Secretary or his delegate under Section 6020(b), of a federal income tax return of the type filed by a taxable corporation, the change in status from taxable to tax-exempt will not be treated as a taxable sale of assets.^{68/} Similarly, a newly-formed corporation that is tax-exempt under Section 501(a) within three taxable years from the end of the

^{67/} Prop. Reg. § 1.337(d)-4(a)(2).

^{68/} Prop. Reg. § 1.337(d)-4(a)(3)(i)(A).

taxable year in which it was formed will not be subject to tax at the time it receives exemption.^{69/}

An important exception is provided for corporations previously exempt under Section 501(a) or that applied for, but did not receive, recognition under Section 501(a) before January 15, 1997. If those corporations are exempt under Section 501(a) within three years from the date of publication of the regulations in the Federal Register as final regulations, they will not be subject to recognition of gain or loss.^{70/} This is an important exception that applies to many nonprofit taxable Blue Cross and Blue Shield organizations. Those organizations generally become taxable on January 1, 1987 by reason of Section 501(m)(1). Thus, if they distribute their operating assets that consist of commercial-type insurance to another organization, presumably in a non-recognition transaction, they should be able to reapply for tax-exempt status, and not have such reapplication be treated as a sale of all of its assets.

The proposed regulations also include a so-called "anti-stuffing" rule that prevents the organization from acquiring all or substantially all of the assets of another taxable corporation, and then changing its status to that of a tax-exempt entity.^{71/} In effect, this prevents loss corporations from acquiring corporations with assets having built-in gain, and corporations having built-in gain from acquiring loss corporations.

[2] Tax-Exemption Considerations

Much of the conversion activity in the early half of this century involved conversions of taxable, for-profit hospitals to nonprofit status. Indeed, it was these early conversions that have resulted in the bulk of the legal precedent in this area. In more recent years, however, health care assets of a different type have been converted from for-profit to nonprofit status. During the past ten years, a growing number of tax-exempt hospitals and health systems (and, to a limited extent, tax-exempt HMOs) have been acquiring medical practices and other types of businesses from for-profit owners. These transactions, much as the same as early hospital conversions, present similar issues.

A basic requirement for exemption is that an organization must be operated exclusively for one or more exempt purposes.

^{69/} Prop. Reg. § 1.337(d)-4(a)(3)(i)(B).

^{70/} Prop. Reg. § 1.337(d)-4(a)(3)(i)(C).

^{71/} Prop. Reg. § 1.337(d)-4(d).

Even if an organization meets the organizational test, it will still be denied exemption if it fails to satisfy the operational test.^{22/}

In order for an organization to qualify for Section 501(c)(3) exemption, it must be operated exclusively for "religious, charitable, scientific" or other exempt purposes specified in Section 501(c)(3). Section 501(c)(3) thus focuses on the purpose of the organization and not on the specific activities.^{23/} The term "charitable" as used in Section 501(c)(3) is generally the broadest exempt purpose, and it is the one that is most relevant to health care organizations because it includes the promotion of health.

One of the earliest administrative pronouncements involving hospitals and tax exemption was the 1928 Income Tax Unit Ruling 2421,^{24/} which involved the denial of tax-exempt status to an organization formed and operated exclusively by a physician. While the Service reviewed in detail factual information concerning the organization, its control, and the use of its resources by physicians, the significance of Income Tax Unit Ruling 2421 is that it reflects a healthy skepticism of the motives of the physicians who formed the hospitals. During the pre-Depression era, a proliferation of small hospitals often formed by physicians, singly or in partnership, took advantage of the new potential for-profit created by the progress in surgical services.^{25/}

It is likely that the primary purpose in forming the hospital described in Income Tax Unit Ruling 2421 as a nonprofit institution was to enable the founding physician to gain access to needed capital in the form of charitable contributions or to obtain legitimacy through the "halo" effect created by the

^{22/} See, e.g., *American Campaign Academy v. Comm'r*, 92 TCM 103, 1062 (1989); *Spanish American Cultural Association of Bergenfield, Inc. v. Comm'r*, 68 TCM 931 (1994).

^{23/} See, e.g., Rev. Rul. 69-572, 1969-2 CB 119 ("The performance of particular activity that is not inherently charitable may nonetheless further a charitable purpose. The overall result in any given case is dependent on why and how that activity is actually being conducted."); Rev. Rul. 76-91, 1976-1 CB 150.

^{24/} IT 2421, VII-2 CB 150 (1928).

^{25/} See, Starr, "The Social Transformation of American Medicine" 165 (1982).

hospital's nonprofit status.^{26/} Subsequent to that ruling, litigation was brought to establish exemption of a variety of other hospitals.^{27/}

The contemporary published guidance available that is applicable to conversions is found in Revenue Rulings 76-91^{28/} and 76-441.^{29/} In Revenue Ruling 76-91, the owners of a for-profit hospital formed a new nonprofit corporation to purchase and operate the hospital. Over one half of the board of directors of the nonprofit corporation consisted of the stockholders of the for-profit corporation. The ruling indicates that the nonprofit hospital intended to operate the hospital in a charitable manner in accordance with Section 501(c)(3) rather than on a proprietary basis, although the operation of the facility and the types of services provided were going to remain essentially unchanged. In order to establish the selling price of the hospital, the owners obtained an independent appraisal of the tangible assets and then computed the value of the intangible assets by the capitalization of excess earnings formula set forth in Revenue Ruling 68-609.^{30/} The ruling notes that the value of the tangible assets established by this method was substantial. The ruling concludes that the new nonprofit corporation qualifies for exemption as an organization described in Section 501(c)(3) and identifies a number of issues that had to be considered in reaching that conclusion.

^{26/} Id. at 152-153; Rosenberg, "The Care of Strangers" (1987).

^{27/} See, e.g., *Comm'r v. Battle Creek, Inc.*, 126 F2d 405 (5th Cir. 1942) (exemption of small sanitarium in Miami Springs, Florida upheld, although its charter also authorized it to "conduct any other lawful business"); *Intercity Hospital Association v. Squire*, 56 FSupp. 472 (W.D. Wash. 1944), (Social Security exemption of two small hospitals located in Grays Harbor County, WA upheld, although previously operated by the same physicians as for-profit hospitals); *Davis Hospital, Inc. v. Comm'r*, 4 TCM 312 (1945) (exemption of small hospital in Statesville, GA upheld, although to incorporation as nonprofit, the same hospital was run as a for-profit venture, and after incorporation, patients who were able to pay were charged); *Goldsby King Memorial Hospital v. Comm'r*, 3 TCM 693 (1944) (exemption of seventy-two-bed hospital in Selma, Alabama, upheld).

^{28/} Rev. Rul. 76-91, 1976-1 CB 150, considered in GCM 36311 (June 16, 1975).

^{29/} Rev. Rul. 76-441, 1976-2 CB 147.

^{30/} Rev. Rul. 68-609, 1968-2 CB 327.

First, the ruling notes that where an organization purchases its assets from an independent third party, a presumption exists that the purchase price (arrived at through negotiations) represents fair market value. However, the ruling adds that where the purchaser is controlled by the seller (or there is a close relationship between the two at the time of sale), this presumption of reasonableness cannot be made because the elements of an arm's-length transaction are not present. The ruling goes on to state that 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. The ruling adds that the purchaser must then establish the components of the intangible assets, indicate how those components will be used to further its exempt purposes, and establish the aggregate value of those intangible assets. The ruling observes that in the case of a hospital, accreditation for an internship or residency program, good labor relations, and active medical staff and favorable location are some factors that might have intangible value and enable a hospital to carry on a public service more efficiently.

The ruling also discusses that when an organization claiming exemption under Section 501(c)(3) purchases intangible assets for a use that is directly and substantially related to its exempt purpose, the capitalization of excess earnings formula is an acceptable method of determining their value. In the situation considered in Revenue Ruling 76-91, the nonprofit corporation had established that the hospital had acquired intangible assets and that the hospital would continue to be operated in a manner to provide essentially the same services it had previously. In these circumstances, concluded the ruling, the intangible assets would contribute directly and substantially to the accomplishment of the nonprofit corporation's exempt purposes, and it was therefore appropriate for the nonprofit corporation to value them by means of the capitalization of excess earnings formula. Thus, the ruling concludes that the purchase of the intangible assets of the for-profit corporation by the nonprofit corporation did not result in inurement of the nonprofit corporation's net earnings, nor did the transaction serve a private rather than a public interest.

In Revenue Ruling 76-441, two slightly different sets of facts were involved. In one situation described in that revenue ruling, the organization was the successor nonprofit organization to a former for-profit school. The organization had purchased all of the for-profit school's personal property and leased the land and buildings from the former owners of the for-profit school. The personal property was purchased at fair market value and the rental of the leased facilities was at fair rental value. The former owners of the for-profit school were employed by the organization to provide supervision and care of the students and

the salaries paid to the former owners were commensurate with their responsibilities and reasonable compensation for their services. None of the organization's officers or directors was related to the former owners, nor was any of them a business associate of the former owners.

In the second situation, a nonprofit corporation received all of the stock in a for-profit school as a school. The organization then liquidated the for-profit school and assumed all of its liabilities, including notes owed to the former owners. The liabilities assumed by the nonprofit organization exceeded the fair market value of its assets, and the board of directors was composed of the former owners of the stock of the for-profit school.

The Service concluded that, in the first situation, the organization established that it was operated to serve a public rather than a private interest and was therefore entitled to Section 501(c)(3) exemption. The ruling observes that the purchase price was at fair market value and that the rentals paid were fair rental value. The ruling also states that the compensation payable to the former owners was reasonable for their services.

By contrast, the ruling concludes that the organization in the second situation was not entitled to exemption, because the former owners benefited from the assumption of liabilities in excess of fair market value. The Service concluded that the nonprofit school was substantially serving the private interests of the directors who were honoring the liabilities in excess of fair market value and who were thus self-dealing and would benefit financially from the transaction. That organization was therefore denied exemption.

The basic principles established in these revenue rulings have been followed by the Service in addressing a wide range of conversion-like transactions involving purchases of medical assets by tax-exempt hospitals and health care systems. The principal focus is, of course, on the payment of fair market value for any assets purchased, and the payment of fair rental value for any assets leased by the tax-exempt organization. Of equal importance is the recognition that it continues to be appropriate for a tax-exempt organization to pay amounts for intangible assets, as long as those intangible assets are related to the operation of the tax-exempt organization on a going-forward basis.

Revenue Ruling 76-91 indicated some flexibility with regard to the ability of the former owners of the for-profit corporation to control the new nonprofit corporation. However, the Service has been less willing to permit sellers of health care assets, particularly medical practices, to be in positions of substantial

control of the purchasing organization, either directly or indirectly.

¶ 1.04 Conversion Transactions and Intermediate Sanctions

Section 4958 of the Code, which was enacted as part of the Taxpayer Bill of Rights 2,^{81/} imposes penalty excise taxes on disqualified persons and organization managers who benefit from or approve excess benefit transactions that occur on or after September 14, 1995. The penalty excise tax is applied to excess benefit transactions with public charities described in Section 501(c)(3), and those with social welfare and other organizations described in Section 501(c)(4).^{82/} In addition, the penalty excise taxes apply to excess benefit transactions with an organization that was a public charity or a social welfare organization at any time during the five-year period ending on the date of the transaction.

Since 1969, policymakers, lawmakers, commentators, and tax practitioners have suggested that some form of sanction short of revocation of exemption (i.e., an "intermediate sanction") should be made applicable to public charities that engage in a transaction with an insider (e.g., an officer or a director) if the transaction might otherwise jeopardize the public charity's continued tax-exempt status because it results in the inurement of the public charity's net earnings or excessive private benefit to the insider.^{83/} However, the first legislation proposing intermediate sanctions was not introduced until 1991. In November of that year, Representative Fortney ("Pete") Stark introduced H.R. 4042, which was directed at health care organizations and specifically focused on a conversion of status of an HMO from its Section 501(c)(4) tax-exempt nonprofit status to that of a business corporation.

As enacted, Section 4958 covers a broad range of transactions beyond just conversions and applies to all public charities as well as to social welfare organizations. Nonetheless, it has great bearing on conversions to and from nonprofit tax-exempt status that involve the boards of directors

^{81/} Pub. L. No. 104-168, § 1311.

^{82/} The Taxpayer Bill of Rights 2 also modified Section 501(c)(4) to add an express inurement prohibition.

^{83/} For a recent example of criticism of nonprofit organization accountability, see Herzlinger, "Can Public Trust in Nonprofits and Governments Be Restored?" Harv. Bus. Rev. 97 (Mar./Apr. 1996).

or management of the organizations and physicians or medical groups that are particularly influential within the organization.

[1] Effect of Excess Benefit Transactions on Tax Exemption

For periods prior to the effective date of Section 4958 (i.e., September 14, 1995), public charities and social welfare organizations may still be subject to loss of tax exemption if they participated in excess benefit transactions during those periods. As previously stated, the principal challenge to a conversion transaction will be that the conversion transaction or related components, such as compensation arrangements, result in the inurement of the net earnings of a Section 501(c)(3) organization to the benefit of one or more private shareholders or individuals with respect to that organization. As an alternative, it may be argued that the transaction or its elements confer excessive private benefit to such individuals. For social welfare organizations, the analysis is somewhat different, since Section 501(c)(4), prior to its amendment by the Taxpayer Bill of Rights 2, did not contain an express inurement prohibition.

Nonetheless, for transactions that occur on or after September 14, 1995, the Section 4958 penalty taxes will generally be the sole sanction when an excess benefit transaction occurs. Thus, in most instances, only the persons who benefit from the transaction directly or indirectly, and the persons who participate in its approval or implementation will be subject to taxation.

The legislative history indicates that revoking the exemption of the organization itself would be appropriate only in cases where the excess benefits "rise to a level where it calls into question whether, on the whole, the organization functions as a charitable or tax-exempt organization."^{84/} The legislative history adds that "in practice, revocation of tax-exempt status, with or without the imposition of excise taxes, would occur only when the organization no longer operates as a charitable organization."^{85/} Presumably, this is merely another way of saying that an excess benefit transaction, however large or small, would always be subject to the penalty excise taxes of Section 4958, while exemption revocation would only occur when the organization's participation in one or more excessive benefit transactions indicates that it has a substantial non-exempt purpose.

^{84/} H. No. 104-506, 104th Cong., 2d Sess. 59, n. 15 (1996) (hereinafter, House Report).

^{85/} Id.

[2] Transactions Subject to the Excise Taxes

The excise taxes of Section 4958 apply to any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of a disqualified person if the value of the economic benefit provided exceeds the value of the consideration received by the organization.

Although "economic benefit" is not defined by Section 4958, it clearly applies to benefits that have a measurable fair market value, such as the purchase or sale of a substantial portion of the operating assets of a hospital, health care plan, or medical practice. While the Treasury has been directed by the legislative history to provide clarification that certain types of transactions (e.g., an organization's provision of nonexclusive benefits) are not subject to the intermediate sanctions rules, virtually any financial transaction associated with a conversion of status, whether it is the purchase or sale of the operating assets themselves, the provision for change of control payments to executives, or the provision of continuing employment following the conversion, will be subject to Section 4958 if it results in the provision of economic benefits in excess of fair market value.

It is important to note that the excise taxes of Section 4958 apply to indirect as well as direct participation in excess benefit transactions. The legislative history makes it clear that a tax-exempt organization cannot avoid the taxes by causing a taxable subsidiary to pay excessive compensation to an individual who is a disqualified person with respect to the organization. If the concept of an indirect excess benefit transaction is developed in a manner similar to the way indirect self-dealing is defined for Section 4941 purposes, it is likely that the tax-exempt organization will need only to have a majority of ownership and control of a business corporation in order for Section 4958 to apply to transactions between a disqualified person and a subsidiary of an applicable tax-exempt organization. Thus, in conversion transactions such as that undertaken by Blue Cross of California, in which a new Section 501(c)(4) organization now owns approximately 80.2 percent of the stock of Wellpoint Health Networks, Inc. (the name under which the converted Blue Cross of California nonprofit public benefit corporation now operates), continuing transactions between Wellpoint Health Networks, Inc., and the Section 501(c)(4) organization and/or those between Wellpoint Health Networks, Inc., and its board of directors, management, and other disqualified persons will be scrutinized for purposes of determining whether any of those transactions result in excess benefits flowing directly or indirectly to such persons.

[3] Special Rule for Personal Services

A special rule is included under Section 4958 for economic benefits provided in exchange for personal services. Section 4958(c)(1)(A) provides that "an economic benefit shall not be treated as consideration for the performance of personal services unless the organization clearly indicated its intent to so treat such benefit." This special rule applies when the organization purchases personal services from a disqualified person and requires the organization, in effect, to declare its intention to treat any benefit as compensation for personal services at the time it decides to provide the benefit. If the organization fails to characterize the benefit as an intention to serve as compensation for personal services at or prior to the time it is paid, or afterwards under some limited circumstances, the organization cannot argue after the fact that it intended to treat the benefit as additional compensation for personal services.

In the context of conversion transactions both to and from tax-exempt status, compensation arrangements are frequently employed. The compensation arrangements may be little more than additional cash compensation that is paid to an executive in a change of control, or it may be substantial long-term incentive compensation in the form of stock options or other forms of equity securities in the converted entity. While it is unlikely that cash compensation will present much difficulty in a conversion transaction, the use of equity-based compensation methods may. Thus, it is important for converting organizations and their boards and management to structure compensation arrangements, equity purchase agreements, and similar transactions so that they reflect their original intention.

In a pre-Section 4958 transaction, for example, an HMO converted from nonprofit to for-profit status using the conversion in place approach. The transaction was structured similarly to a typical management buyout in that senior management and certain board members were given the opportunity to acquire approximately 20 percent of the stock of the converted entity. This transaction was structured as an outright stock purchase even though it could also have been argued that the equity position provided to management was intended as compensation for past and future services. If the transaction were to take place on or after September 14, 1995, the parties would have to use great care in structuring the equity purchase arrangement. If the equity purchase was intended to serve as additional compensation for past or future services, the parties would have to be sure to document the reasonableness of the compensation and that to treat it as such at the time they entered into the transaction. On the other hand, if the transaction is intended simply to permit the executives to purchase equity in the corporation at fair market value, then the

parties should carefully document that fair market value was paid, since it will not be able to argue after the fact that any difference between fair market value and the amount actually paid was really intended to serve as additional compensation.

[4] Other Forms of Private Inurement

Section 4958(c)(2) authorizes the Treasury to issue regulations that would include as excess benefit transactions those transactions in which the amount of any economic benefit provided to or for the use of a disqualified person is determined in whole or in part by the revenues of one or more of the activities of the organization. While this provision is undoubtedly directed at compensation arrangements that are based on gross revenues, net revenues, net income, or some similar measure, it can also apply to contingent purchase price arrangements made in connection with conversion transactions, where the purchase price or other consideration payable by one or more of the parties depends upon the subsequent economic performance of the other from the time of conversion and thereafter.

[5] Rebuttable Presumptions of Reasonableness

Organizations and disqualified persons will be entitled to rely on a rebuttable presumption of reasonableness for compensation arrangements and other types of potential excess benefit transactions if certain specific requirements are satisfied. The effect of the rebuttable presumption is that once the requirements are satisfied, the Service can rebut the presumption only if it develops sufficient contrary evidence to rebut the probative value of the evidence relied upon by the board or committee. This may include challenges to the data used or evidence that the particular services were not actually performed. Nonetheless, this shift of the burden of proof, at least in the audit context, from the taxpayer to the Service should greatly reduce the number of controversies concerning the fairness of compensation arrangements or other transactions. It is not clear, however, whether the rebuttable presumption will have any significance beyond the audit context, such as in litigation.

In order for the rebuttable presumption to be available, three requirements must be satisfied. First, the compensation arrangement or other transaction must be approved by a board of directors or trustees, or a committee thereof, that is composed entirely of individuals unrelated to and not subject to the control of the disqualified persons in the arrangement. This requirement applies with respect to a particular transaction, and, director's or trustee's independence apparently is not compromised if the individual receives compensation or otherwise benefits from transactions with the organization that do not

directly or indirectly involve the particular transaction under consideration. In fact, the statement in the legislative history seems to support this analysis, that is, that reciprocal arrangements whereby an individual approves compensation of the disqualified person and the disqualified person in turn approves the individual's compensation do not satisfy the independence requirement.

In the context of conversion transactions, the rebuttable presumption will have one of two possible effects. If the transaction is of the type that can be approved by the board of directors or trustees, the complete independence requirement will either prevent any trustee or director from participating in the transaction directly or indirectly or it may preclude the organization, its managers, and disqualified persons from relying on the rebuttable presumption at all because the independence requirement cannot be satisfied. If the transaction is of a type that can be approved by a committee of the board, for example, a special committee formed specifically for that purpose, the independence requirement may be satisfied. However, in some states, such as California, a transaction with members of the board or officers would be subject to the interested party rules. Thus, a committee, however independent, comprised of less than a majority of the board of trustees or directors of an organization will not be empowered to approve such a transaction except in the case of an emergency, which is unlikely to be the usual case, and the transaction will therefore not be eligible for protection under the rebuttable presumption.

Even though conversion transactions will very often require attorney general or other governmental approvals, the first requirement of the rebuttable presumption cannot be satisfied other than by action by the organization's own board of directors or trustees or by a committee thereof. Thus, the mere approval of the conversion transaction by a state's attorney general or another governmental agency will not permit the organization, its managers, or disqualified persons to rely on the rebuttable presumption.

The second requirement of the rebuttable presumption is that the independent board or committee must obtain and rely upon appropriate data as to comparability. Survey data, as well as actual market conditions, evidence by written offers, will serve such a purpose. In order to rely on such data, however, the board or committee must have reason to believe that the data are reliable. This requirement of the rebuttable presumption does not necessarily require a board or committee to engage the services of valuation experts or compensation experts, or to conduct an auction. It appears to permit the board or committee to conduct its own investigation and obtain its own information that supports the reasonableness of a particular compensation arrangement or the fairness of a particular transaction.

Nonetheless, because a conversion transaction will typically involve purchases or sales of assets having substantial value, complicated capital and other structures, and other factors, a board or committee would be wise to engage appropriate experts to assist in structuring and valuing the transaction; indeed, the Service may take the position that in this type of transaction, it would be unreasonable for a board or committee not to do so. In practice, a board or committee would be well advised by its legal counsel to engage the services of qualified valuation consultants, investment bankers, or others who have sufficient knowledge or experience with regard to the complexities of conversion transactions.

The legislative history indicates that the approval of a particular compensation arrangement or transaction by a state or local legislative or regulatory body does not determine the reasonableness of the particular transaction. This provision was undoubtedly directed at situations where a particular transaction, such as a conversion from tax-exempt to taxable status, is submitted to a state attorney general or another regulatory body for its approval, and as part of that approval process the attorney general or regulatory body makes an independent determination that the transaction was reasonable or reflected fair market value. The legislative history is, in effect, placing the burden directly upon the board or committee to reach its own independent conclusions of reasonableness, and does not allow them to rely on the opinions of state attorneys general or state governmental agencies.

Finally, the board or committee approving a compensation arrangement or other transaction related to a conversion must adequately document the basis for its determination. In effect, the organization is obligated to keep detailed information concerning its data gathering and deliberative processes, as well as detailed information concerning specific votes on particular arrangements or transactions.

[6] Taxes on Disqualified Persons

Section 4958(a)(1) imposes an initial tax on disqualified persons equal to 25 percent of the excess benefit made available to or for the use by the disqualified persons. An additional tax equal to 200 percent of the excess benefit will be imposed on the disqualified persons if the initial tax has been imposed and the excess benefit is not corrected within the taxable period. Since correction includes undoing the excess benefit to the extent possible and taking any additional measures necessary to place the organization in a financial position not worse than it would be in if the disqualified persons were dealing under the highest fiduciary standards, the disqualified persons will, in effect, be required to disgorge any excess benefit that they may have obtained in order to achieve

correction. In addition, the organization itself may be obligated to bring litigation to seek recoupment if the disqualified persons do not voluntarily return the excess benefits they received to the organization.

The initial and additional taxes must be paid by any disqualified person with respect to an excessive benefit transaction. If two or more disqualified persons are liable for the initial or additional tax, all disqualified persons with respect to the transaction will have joint and several liability for the tax. There is no limit on this liability, and the excise taxes, because they are characterized as penalties, may not be deductible.

The term "disqualified person" is defined to include three classes of persons. First, included are persons who, at the time of the excess benefit transaction, are in a position to exercise substantial influence over the affairs of the organization, as well as persons who were in positions of influence at any time within five years of the excess benefit transaction. Consequently, persons who are senior executive officers or who are members of the board of directors or trustees will undoubtedly have sufficient legal authority over the affairs of the organization to be classified as disqualified persons. In addition, a person or an organization may become a disqualified person because of the control that the individual or organization exercises over the affairs of the organization, such as pursuant to a long-term management contract or consulting agreement. It is significant to note, however, that the definition of "disqualified person" is not limited to persons who hold formal positions; conversely, merely having a title (e.g., "trustee emeritus") does not cause a person to be automatically treated as a disqualified person.

What remains unclear, and undoubtedly will remain so until regulations are issued, is how far the scope of influence must be and the nature of the authority a person must have in order to be treated as a disqualified person. For example, an honorary trustee may be invited to attend board meetings and participate in discussions but may not be counted for quorum purposes or be entitled to vote. In this case, the honorary trustee is in a position to use his or her persuasive powers but will have no legal authority or fiduciary duty with respect to the action being considered. It is unclear whether a person in that position will be treated as a disqualified person. Similarly, a person who is a substantial user of the organization's facilities, such as a major referring physician of a hospital, may have sufficient influence over the affairs of the organization to warrant treatment as a disqualified person. While the legislative history makes it clear that physicians will not automatically be disqualified persons unless it is established that they are in a position to exercise substantial

influence over the affairs of the organization,^{86/} it will be up to the Treasury to provide guidance as to when the actions of an admitting physician reach a point where it becomes appropriate to treat that individual as a disqualified person. This latter aspect is clearly going to have an impact on physician practice acquisitions.

In the context of conversion transactions, the five-year look-back rule will eliminate the ability of a person to resign from an organization's board or senior management position and immediately cease to be a disqualified person with respect to the organization. In the private foundation context, a person who is a disqualified person because he or she is a foundation manager generally ceases to be treated as a disqualified person with respect to transactions that are approved and implemented after he or she resigns from the board of directors or trustee of or otherwise separates from service with the foundation.^{87/} The five-year look-back requirement will ensure that there is a high degree of independence on the board if it later engages in a transaction with a person who ceased to be in a position of exercising substantial authority for more than five years.

In addition, family members of a disqualified person will also be treated as disqualified persons. In general a disqualified person's family will include the person's spouse, children (including adopted children), and parents. Also included are disqualified person's siblings and their spouses.

Finally, the term "disqualified person" applies to corporations, partnerships, trusts, and estates in which disqualified persons actually or constructively own more than 35 percent of the voting power in the case of corporations, 35 percent of the profits interest in the case of partnerships, or 35 percent of the beneficial interests in the case of trusts and estates.

[7] Taxation of Organization Managers

A tax of 10 percent of the amount of the excess benefit, up to \$10,000 for each transaction, will be imposed on any organization manager who participates in an excess benefit transaction if certain conditions are met. The term "organization manager" is defined as any officer, director, or trustee of the organization as well as any individual having powers or responsibilities similar to those individuals. However, a person having the title of officer, director, or

^{86/} House Report at 58, n. 12.

^{87/} Rev. Rul. 76-448, 1976-2 CB 368, considered in GCM 36668 (Mar. 29, 1976).

trustee will not automatically become an organization manager if it can be established that the title does not confer any authority to the individual to participate or bind the organization.

In order for an organization manager to become liable for the tax, the organization manager must participate in the excess benefit transaction. In general, this participation is likely to include affirmative actions, such as voting in favor of a particular transaction, as well as silence or inaction on the part of a director or an officer of an organization who is under a duty to speak or act. On the other hand, a director or officer should not be considered to have participated in an excessive benefit transaction if he or she opposes the act in a manner consistent with the fulfillment of his or her responsibilities to the organization. Also, participation should not include discussions or debates that leads to action or inaction that actually results in the excessive benefit transaction or creates a legally binding obligation.

Conversion transactions involving hospitals or HMOs will generally require the involvement of the organization's board of directors or trustees. Thus, it will be incumbent upon the persons serving on those boards to use extreme care in evaluating conversion transactions.

Smaller transactions, such as purchases of medical practices, may also be subject to the excessive benefit taxes, although they may not be significant enough to require board approval. In those cases, the management of the organization involved in negotiating and approving a medical practice acquisition with a physician or medical group that is classified as a disqualified person must use extreme care to ensure that they are acting reasonably and are not willfully and without reasonable cause engaging in an excessive benefit transaction. At a minimum, these individuals should obtain legal advice as to whether a purchaser or seller of the medical practice is a disqualified person, and they should obtain qualified valuation or other advice as to the fairness or reasonableness of the amount of consideration being paid and the terms of the transaction. While it is likely that regulations implemented for interpreting Section 4958 will incorporate an advice of counsel defense similar to that available under Chapter 42 of the Code, many of the transactions implicating Section 4958 involve factual as well as legal questions. Hopefully, a reliance on the advice of valuation or other experts defense will be developed and incorporated in those regulations.

¶ 1.05 Tax-Exempt Financing Considerations

Tax-exempt hospitals and health care systems typically use the proceeds of tax-exempt bond offerings to finance the construction and renovation of hospitals and health care facilities and to purchase medical and other types of equipment necessary for the conduct of their businesses. One of the significant issues that all tax-exempt hospitals and health care systems must face in connection with a conversion is determining how to deal with outstanding tax-exempt bonds when the hospital or health care system decides to undertake a conversion or intends to engage in conduct that would result in a substantial change in use of the bond financed facilities and equipment.^{88/}

Under the present statutory scheme, which was enacted in 1986, Section 141 of the Code defines a "private activity bond" as a bond that meets security interest and trade or business tests.^{89/} Governmental hospitals may use up to 10 percent of bond proceeds for private or nonexempt uses without jeopardizing the tax-exempt status of the interest payable on the bonds.^{90/} Section 501(c)(3) hospitals and health care organizations are subject to a general rule that a bond will cease to be a qualified 501(c)(3) bond if more than 5 percent of the net bond proceeds is used for nonexempt or private business uses.^{91/} The bond provisions also provide that no more than 2 percent of the proceeds of a qualified 501(c)(3) bond issue may be used to finance issuance-related costs.^{92/}

Section 150(b)(3) deals with changes of use from related to unrelated purposes by the organization when there is not change of ownership. In this case, the property is treated as used in an unrelated trade or business, and the organization will be deemed in receipt of gross unrelated business income equal at least to the fair rental value of the property. Also, the organization may not deduct the interest in calculating its net

^{88/} For a general discussion of this issue see Mills, "Exempt Financing and Exempt Status Can Cloud Hospital Joint Ventures," 7:6 J. Tax Exempt Orgs. 252 (May/June 1996).

^{89/} IRC § 141(b)(1), (2); Reg. § 1.141-2.

^{90/} IRC § 141(b)(1); Reg. § 1.141-3(a).

^{91/} IRC § 145(a)(2)(B). For a detailed discussion of the tax-exempt bond rules, see Mancino, "Nonexempt Uses of Tax-Exempt Hospital Bonds," 4:10 The Exempt Organization Tax Review 1324-1340 (1991).

^{92/} IRC § 147(g).

unrelated business taxable income.^{23/} Similarly, if the original Section 501(c)(3) owner sells the bond-financed property and the bonds are not defeased, the purchaser is precluded from deducting the interest incurred in connection with assuming the liability for the bonds outstanding with respect to the transferred asset pursuant to Section 150(b)(5). Thus, at least 95 percent of the property financed by an issue of qualified 501(c)(3) bonds must be continued to be owned and used by Section 501(c)(3) organizations using the property in an exempt activity or by a governmental unit as long as the bonds remain outstanding in order for the interest paid to the bondholders to remain excludable from gross income under Section 103(a).

Revenue Procedure 93-17^{24/} provides safe harbor guidelines for determining whether a change in the use of bond financed property will cause the interest on outstanding bonds to become taxable retroactive to the date of their issuance. A change in the use of bond financed property will satisfy the safe harbor guidelines if five factors are met.

1. The issuer and the ultimate borrower must reasonably have expected at the time the bonds were issued that the bonds proceeds would be used for qualified use for the entire term of the bond issue.
2. The bond-financed property must have been used for qualifying use for at least five years after the date the bonds were issued or refinanced or the date that the property was placed in service, whichever is later.
3. The transaction resulting in the change of use must be bona fide and negotiated at arm's length, and the new user must pay fair market value for its use of the facility.
4. The transaction must be not be an attempt to avoid the requirements of the Code relating to the issuance of tax-exempt bonds.
5. The borrower must take one of the permitted remedial actions set forth in the revenue procedure.

The revenue procedure then specifies several types of remedial actions that a borrower must take in order to qualify

^{23/} IRC § 150(b)(3)(B). See, e.g., Priv. Ltr. Rul. 9406028 (Nov. 16, 1993) (the imputation of unrelated business income and nondeductibility of interest and user charges begins on the date a change of use occurs).

^{24/} Rev. Proc. 93-17, 1993-1 CB 507.

for the Revenue Procedure 93-17 safe harbor. The borrower must redeem at the earliest call date an amount of bonds equal to the bonds allocable to the new nonqualifying use^{25/} or spend an amount equal to the amount of bonds allocable to the new nonqualifying use on replacement property that is qualified within one year after the change of use^{26/}; or if the new use would have qualified for tax-exempt financing had certain procedural requirements been satisfied, the bond owner must comply with those requirements within 90 days after the change of use.^{27/} In addition, appropriate remedial action may include a combination of approaches.^{28/}

If a change in use does not satisfy the safe harbor guidelines, the Service will consider the issuance of a private letter ruling confirming the tax-exempt status of the bonds on a facts and circumstances basis. In recent years, the Service has issued several private letter rulings in connection with sales of assets and similar types of conversion transactions.^{29/} In

^{25/} Priv. Ltr. Rul. 9444009 (July 28, 1994) (sale of hospital to for-profit corporation ruled to be approved change of use because, in part, bonds were redeemed prior to proposed date of sale); Priv. Ltr. Rul. 9533016 (May 16, 1995) (for-profit buyer of hospital will purchase all outstanding bonds and, at time assets are sold, tender them for cancellation).

^{26/} See, e.g., Priv. Ltr. Rul. 9510011 (Dec. 7, 1994) (use of sale proceeds to acquire additional capital assets approved as remedial action that will promote a reasonable practical matching between the subsidy provided the tax exemption and qualified use that is required by Sections 141(b) and 145).

^{27/} Priv. Ltr. Rul. 9419022 (Feb. 10, 1994) (lease of county hospital facilities to tax-exempt nonprofit hospital ruled to be a qualified alternative use after the change of use); Priv. Ltr. Ruls. 9545007 (July 26, 1995) (similar conclusion); Priv. Ltr. Rul. 9547014 (Aug. 24, 1995) (similar conclusion); Priv. Ltr. Rul. 9610013 (Dec. 6, 1995) (similar conclusion); Priv. Ltr. Rul. 9613021 (Jan. 2, 1996) (similar conclusion).

^{28/} See, e.g., Priv. Ltr. Rul. 9522050 (Mar. 8, 1995) (multiple remedial actions for several bond issues approved in connection with sale of nursing homes to for-profit operator); Priv. Ltr. Rul. 9609027 (Nov. 30, 1995) (multiple remedial actions approved for bonds issues to tax-exempt scientific research organization that intends to sell its assets to for-profit research company).

^{29/} Priv. Ltr. Rul. 9345031 (Aug. 12, 1993) (transfer of hospital assets from state university to newly formed

addition, some bond counsel are willing to issue opinions that a change in use will not adversely effect the tax-exempt status of outstanding bonds, even if the safe harbor is not met with respect to the five-year requirement. Typically, in these cases, the borrower must still meet the other requirements of Revenue Procedure 93-17.

In most instances, a borrower undergoing a complete conversion from nonprofit to for-profit status must make a good faith tender offer to purchase the outstanding bonds if the bonds are not callable at the time of conversion. Usually the borrower will be required to pay premium over the current market value for the bonds. Whether a tender offer is made in good faith will depend again on the facts and circumstances, and bond counsel will sometimes look at the success of the tender offer; they may also look at the offering price and its relationship to current market values. If less than all of the bonds are purchased pursuant to the tender offer, all remaining bonds must be defeased at the earliest call date.^{100/}

Regulations concerning tax-exempt bonds published in January 1997 revise the treatment of tax-exempt bonds after a change of

nonprofit, tax-exempt hospital approved, as long as the university meets the public approval requirement prior to the time the hospital is transferred and files the appropriate Form 8038 within the prescribed time after the hospital properties are transferred); Priv. Ltr. Rul. 9406028 (Nov. 16, 1993) (lease to joint venture of hospital facilities that did not qualify under safe harbor because five-year rule not met and lease was not negotiated at arms' length approved because the hospital agreed to make a tender offer for bonds allocated to nonexempt use prior to execution of lease); Priv. Ltr. Rul. 9427025 (Apr. 11, 1994) (proposed sale of hospital assets to for-profit company approved because bonds will be redeemed under extraordinary redemption provision); Priv. Ltr. Rul. 9438008 (June 17, 1994 (sale of nursing homes to for-profit operator ruled to be permitted change of use because seller will use sole proceeds to make a tender offer for the bonds and establish an escrow to the first call date to retire bonds that are not tendered); Priv. Ltr. Rul. 9548030 (Sept. 5, 1995) (hospital equipment pool sales and trade-ins).

^{100/} Priv. Ltr. Rul. 9535037 (June 2, 1995) (tender offer at premium, coupled with irrevocable escrow with yield restrictions, found to be reasonable remedial action in connection with sale of hospital facilities); Priv. Ltr. Rul. 9543033 (July 28, 1995) (tender offer at premium, coupled with irrevocable escrow, approved in connection with sale of nonprofit hospital to for-profit operator).

use and are effective on or after May 16, 1997. For qualified 501(c)(3) bonds, Regulation Section 1.141-2(d) requires that the issuer and the Section 501(c)(3) organization reasonably expect, as of the issue date, that the issuer will meet the requirements under Section 141. An issue will cease to be an issue of qualified 501(c)(3) bonds if, after the date of issue, the issuer or the Section 501(c)(3) organization deliberately takes any action to cause the bonds to fail to comply with the applicable requirements. However, the regulation provides that the remedial actions of Regulation Section 1.141-12 may be applied to prevent a deliberate action from causing an issuer to cease to be treated as tax-exempt bonds.

Regulation Section 1.141-12(a) permits remedial action if all of the following requirements are met:

1. The issuer covenants on the issue date that it will not take action that would cause the bonds to be private activity bonds and establishes reasonable procedures to ensure compliance.
2. Transactions resulting in private use are bona fide and at arm's length, and the new user pays consideration equal to the fair market value for the use of the financed property.
3. The issuer certifies as part of the bond documents the issuer's expectations regarding the use of proceeds as of the issue date.
4. No circumstances indicate an attempt to avoid the requirements of Section 141.
5. If the bond-financed facility is transferred exclusively for cash, disposition proceeds must be used to redeem the bonds at the earliest call date after the deliberate action. If the bonds are not redeemed within 90 days of the date of the transfer, disposition proceeds must be used to establish a defeasance escrow for those bonds within 90 days. If the transfer is not exclusively for cash, funds other than tax-exempt bond proceeds must be used to redeem the bonds or establish a defeasance escrow within the same time periods. In addition, the Service must be notified that the defeasance escrow has been established.

However, according to the regulations, the establishment of a defeasance escrow does not satisfy the requirement if the bond terms do not provide for redemption within six months of the date of the action and if, as of the issue date of the bonds, there was more than a remote possibility that the financed property

would be transferred to a nongovernmental person before the date the bonds could first be redeemed. Thus, the possibility of transfer is remote if the facility is one not customarily owned and operated by nongovernmental persons; however, there is no indication of when the possibility would be remote if the facility is one customarily owned by nongovernmental persons. Thus, in effect, the regulations would require all future bond issues for tax-exempt hospital facilities to contain a special call provision allowing the bonds to be called within six months after any change of use, since it is obvious that the absence of hospital operations by nongovernmental persons could not be established.

The regulations also provide remedial actions consisting of alternative qualifying uses of the facility or disposition proceeds. In addition, the Service is permitted to publish additional remedial actions in the Internal Revenue bulletin.

The proposed rules are based on, but are intended to be more flexible than, the safe harbors and Revenue Procedure 93-17. However, the Treasury and the Service are considering a more direct remedial action in lieu of defeasance. Under this procedure, an issuer could request a closing agreement. A condition to the closing agreement would be the issuer's payment to the Service of the interest rate differential between applicable tax-exempt and taxable rates for the remaining maturity of the bonds basically the benefit of the bonds' lower tax-exempt interest rate. The payment would be increased by 20 percent if the establishment of a defeasance escrow would not satisfy the requirements of the proposed regulations discussed above (e.g., if there was more than a remote possibility of transfer as of the date of issue). If this closing agreement procedure is established, defeasance under the regulations would no longer be an option.

¶ 1.06 The Future of Conversions

Predicting what will happen in a marketplace as dynamic as that of health care is at best a risky proposition. As demonstrated in this chapter, many of the changes of form from for-profit to nonprofit or vice versa have been dictated by capital access needs and concerns. In many cases, the marketplace has dictated the capital access needs and business considerations that have prompted health care organizations to convert their status. In other cases, however, conversions have been dictated by either the intended or unintended consequences of government action. For example, many for-profit hospitals converted from for-profit to nonprofit status because of government decisions to create capital funding access, such as the Hill Burton Act, and tax legislation that improved the accessibility of tax-exempt financing. Similarly, early HMO development in the nonprofit form was encouraged by access to

federal loans and grants made available under the HMO Act of 1973, while later conversions of status from nonprofit to for-profit status were actively encouraged as the federal government intentionally attempted to stimulate the growth of private capital investment in HMOs.

Today, some of the conversions of status are being dictated by the unintended consequences of government action. Most specifically, the changes in the tax-exempt financing laws enacted in 1986 are now affecting the behavior of nonprofit hospitals and health care systems because of the opportunity costs the revised rules exact, coupled with the fact that the differences in financial cost of taxable versus tax-exempt have narrowed.

With this background in mind, some elemental projections can be made for the future of conversions of status of hospitals and health care organizations. First, hospitals are still local businesses that have strong operational and emotional ties to the communities in which they operate. While a significant number of nonprofit hospitals and health care systems have sold their assets to investor-owned companies, that trend is likely to slow down as other alternatives become more viable, such as joint venture alternatives in which the nonprofit hospital has an opportunity to participate in the equity upside of the for-profit corporation while at the same time obtaining improved access to capital through the public stock and debt markets. In fact, there may be a few conversions from for-profit to nonprofit status, such as the recent repurchase by a new nonprofit corporation of the Presbyterian-St. Luke's Hospital in Denver.^{101/}

For HMOs, the prospects for nonprofit HMOs appear to be getting less attractive. Nonprofit, tax-exempt HMOs are encountering with greater frequency the practical limitations that resulted from the enactment in 1986 of Section 501(m) of the Code, which has limited their ability to design products in a manner that avoids federal income taxation. Moreover, while tax-exempt debt has been available to Section 501(c)(3) HMOs for use in connection with the acquisition of facilities and equipment, these funds are not available for working capital or the acquisition of intangible assets to any large degree. Therefore, other sources of capital must be used (usually taxable debt and retained earnings) to fund geographic expansion, whether through their own initiative or through acquisitions, and product development. This type of capital may prove to be expensive and not as readily available as equity capital is to for-profit, investor-owned companies. Thus, there may be a much more limited

^{101/} See generally Schlesinger, "Investor Dominated Healthcare Is Not Inevitable," 3:5 HealthSpan 13 (May 1986).

future for regional nonprofit HMOs and in fact even for some of the larger nonprofit HMOs.

Finally, the sales of medical groups and medical practices by for-profit organizations to nonprofit health care systems appears to be slowing. The actual experience of nonprofit hospitals and health care systems that have acquired physician practices has not been one of great success. In fact, a substantial number of the nonprofit systems have indicated that they are losing money on operations from the medical groups that they have acquired for a variety of reasons, including the failure of the medical groups to meet expected productivity levels, the bidding up of purchase prices and compensation levels because of competition in the marketplace, and the inability to manage medical groups effectively in the more bureaucratic-like hospital environment. Similarly, a growing number of public and private physician practice management companies are accessing venture capital, bank debt, and public equity through stock sales to the public, and those organizations are providing an alternative for capital access to nonprofit hospitals and health care systems. In fact, because of the high multiples of earnings at which public company PPM stocks are trading, the prices that publicly traded PPMs may be willing to pay for medical practices may be greater than the price that a nonprofit hospital or health system may be able or willing to pay.

There is no one way of rationalizing the conversion phenomena either today or in the past. Likewise, it is doubtful that there is sufficient capital to effect a wholesale conversion of the nonprofit and governmental hospital system that has developed over the past 100 years to for-profit status. What we are likely to see is more fact-based and less fear-based decision making, the continued maintenance of a stronger but more consolidated nonprofit sector, and the continued development of a stronger, larger for-profit sector. Nonetheless, a complete shift of the U.S. hospital system to for-profit status remains unlikely for the foreseeable future.