



NO PROTEST RECEIVED
Released to Manager, EO Determinations - Cincinnati

DATE: [REDACTED]

SUBJECT: [REDACTED]

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Date: [REDACTED]

[REDACTED]
[REDACTED] c.
[REDACTED]

Contact Person: [REDACTED]
ID Number: [REDACTED]
Telephone Number: [REDACTED]

Employer Identification Number: [REDACTED]

Dear Applicant

We have considered your application for recognition of exemption from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). Based on the information submitted, we have concluded that you do not qualify for exemption under that section. This letter replaces our previous proposed denial dated [REDACTED]. The basis for our conclusion is set forth below.

School Charter and Character

You were incorporated pursuant to the [REDACTED]. You were formed as an open-enrollment charter school [REDACTED]. You entered into a Contract for Charter with the [REDACTED], pursuant to which you was authorized to establish and operate an open-enrollment charter public school, and to receive state aid from the [REDACTED]. The Contract for Charter with the Board of Education is in effect from August 1, 1988 through [REDACTED]. The Contract for Charter states that you shall take and refrain from all acts necessary to be and remain in good standing as an organization exempt from taxation under section 501(c)(3) of the Code. You are financially accountable to the [REDACTED] for all state school aid you receive and have also applied to the [REDACTED] for an open-enrollment charter.

You established the school for the [REDACTED] year. The school is a general educational school for grade levels kindergarten through sixth grade located in a [REDACTED]. The Bylaws and the charter application provide that you will expand [REDACTED]. The charter application also provides for expanding into [REDACTED].

[REDACTED]

You are an entrepreneurial and business charter school. You are committed to the philosophy that students in urban areas (minority students in particular) need to learn the principles of economic development through their daily educational process. Integrated in the core subjects (social studies, math, language arts, and science) are business ownership and management. You also offer foreign languages, sports, music, art and extra curricular programs. The school involves local business owners in the curriculum, and helps students create, own, and/or operate small businesses as part of their graduation requirements. Moreover, you prepare students to create good jobs in the community.

Three Organizations with Overlapping Directors

You originally operated as part of a group of three organizations. You were a membership corporation with the sole member corporation [REDACTED]. The Member was formerly [REDACTED]. You contracted to have your school managed by [REDACTED]. [REDACTED] were key members of your board and the boards of the Member, and [REDACTED] officers in these organizations.

[REDACTED]

You were incorporated in [REDACTED] but, according to your Bylaws located your principal office in [REDACTED]. Your Articles of Incorporation stated that your initial Board consisted of [REDACTED]. The exemption application and charter school application also listed [REDACTED]. In the charter school application to the [REDACTED] was described as a parent but there is no evidence that she was a parent of a student at your school in [REDACTED]. Your Bylaws stated that the initial directors would be the two incorporators and a third person selected by the incorporators. It is assumed that [REDACTED] was selected by [REDACTED] your third director. The application also listed [REDACTED] as Secretary/Treasurer. In a [REDACTED] you stated that the [REDACTED] did not receive any compensation from you. Your application listed the address of all three board members as [REDACTED].

Until you ceased to be a membership organization, the Member, according to your Bylaws, had the responsibility of appointing and removing (with or without cause) members of your board of directors. Your Bylaws stated that if you no longer have a member, vacancies on your board would be filled by the affirmative vote of a majority of the remaining directors. If there is no member, a director may be removed, with or without cause, by a two-thirds vote of the remaining directors.

Your Bylaws and the [REDACTED] stated that your board of directors would appoint an advisory board, which would include one or more parents or guardians of students at the school, one or more professional educators, and one or more representative of the business community and community at large. Your Bylaws and charter application also stated that the Advisory Board should also be reflective of the school's ethnic composition. The charter application also stated that the Advisory Board would consist of five to nine

[redacted]
representatives, have member terms of three years, and meet at least bi-monthly. Your Bylaws and charter application also provided that your board appoints and may remove (at its sole discretion) members of the advisory board.

Your Bylaws provided that your board would appoint and maintain an advisory board so long as the member remains a member of the corporation. Upon conversion to a directorship corporation, your board would decide whether to maintain the advisory board. In a [redacted] letter, you reported that you had an advisory board comprised of members of the [redacted] which included [redacted]

[redacted] meeting indicates that [redacted] were members. No mention was made in these notes (or any other document) concerning the Advisory Board recommending persons to serve on your Board of Directors. It is unclear whether an Advisory Board continues to exist after your conversion to a directorship corporation.

Your Bylaws provided that purpose of an Advisory Board is to provide your board and officers with independent advice related to the administration of the school. The charter application stated that the Advisory Board would review the instructional program and make recommendations regarding the general operation of the school. Your charter application also stated that recommendations from the Advisory Board would be submitted including agenda items, in writing, to your Board of Directors.

Your Bylaws were amended to provide that the board would include at least one parent or guardian of a child attending the school operated by the corporation, at least one professional educator, preferably a person with school administrative experience, and other representatives from the community, business and industry. Your Bylaws stated the the directors would serve for a three-year term. The charter application stated that the Advisory Board would select one liaison representative to the Board of Directors in the first year, and two representatives starting in year two. The liaison representatives would have a one-year term with voting privileges on the Academy Board of Directors.

Your Bylaws stated that your board would hold one annual and at least five regular meetings each year with the date and time established by a resolution of the you board. Your Bylaws stated that your board of directors meetings are open to the public as required by [redacted]. These open meetings require that notice of the meeting time and place be given and a record of the meeting be taken.

[redacted] 30. They also agreed not to serve as an officer or director of you as long as they retain an economic interest in [redacted] serves as your management company. Minutes of a [redacted] you Board meeting indicated that the current directors were [redacted] [redacted] Family Healer (Master) [redacted] [redacted] The [redacted] 30 resolution of the Board of Directors stated that [redacted]

[REDACTED]
president. [REDACTED] was the secretary [REDACTED] was the president. [REDACTED] resigned [REDACTED] and was again appointed as a director in the [REDACTED] board meeting along with [REDACTED]. The only board member resumes provided were of [REDACTED].

[REDACTED] These resumes stated that [REDACTED] is a [REDACTED] resources, [REDACTED] [REDACTED] owns and operates [REDACTED] [REDACTED] in [REDACTED] [REDACTED]. [REDACTED] an acknowledgment that they read and reviewed a memorandum entitled [REDACTED].

[REDACTED] This 1986 Management Agreement would be terminated if your expanded board, as contemplated in your Bylaws and application, did not approve the Management Agreement. The Management Agreement provided that expanded board would include additional representation. You represented that these new board members would not be affiliated with [REDACTED], you stated that ultimately none of the [REDACTED] directors would be your directors. [REDACTED] board resolution, your board resolved that upon expansion of the board of directors, as contemplated in your bylaws and the charter school application, the board could reconsider the Management Agreement with [REDACTED]. The new Management Agreement submitted by you was dated [REDACTED] before the [REDACTED] resigned from the board on [REDACTED]. The minutes of the S [REDACTED] board meeting stated that there was approval and signing of amendment and restated Management Agreement.

Member

[REDACTED] is a [REDACTED], exempt as an organization described in section 501(c)(3). Your directors [REDACTED] were also Directors of [REDACTED]. In addition, two other members of the [REDACTED] were also Member directors. [REDACTED]

[REDACTED] The exemption application stated that [REDACTED] you and that no dues or fees were required or have been paid by you to the [REDACTED]. The Bylaws stated that you would be organized as a membership corporation but could thereafter be converted into a directorship corporation upon resolution of the board and consent of the Member. You later changed from a membership organization to a self-perpetuating Board of Directors. In spite of this change, there was the approval of a loan from [REDACTED] in the minutes of the [REDACTED] you board of directors meeting.

The relationship between you and [REDACTED] can be best described as evolved. At various places in your submitted information you have been referred to as a (1) sole member corporation, (2) trade name of Member, (3) subordinate organization covered under Member's group ruling, (4) doing business as [REDACTED], and finally, (5) a directorship corporation.

In the J [REDACTED] lease agreement for school property, you were listed as the trade name of your [REDACTED]. While the lease for school property listed the [REDACTED] as the property

[REDACTED]

lessor, the [REDACTED] Management Agreement between [REDACTED] and you provided that the building and related capital facilities remain your property and you will maintain insurance on the property. No sub-lease between you and [REDACTED] has been provided.

[REDACTED] a [REDACTED]. Two of your original directors [REDACTED]. Your third director and the liaison representative of the advisory board (which has voting rights on the board of directors) were not [REDACTED] application for exemption provided your address as [REDACTED] was the president and founder of [REDACTED]. The [REDACTED] Agreement between you and [REDACTED] provided that the parties acknowledge that the two members of the board of directors of the Academy have a substantial and financial interest in [REDACTED] and that the agreement has been approved by the sole disinterested member of the you board of directors. While not named, the sole disinterested member must be [REDACTED].

The approval of the Management Agreement was subject to the application of the [REDACTED]. This chapter applies to charter schools by virtue of [REDACTED].

If a local public official has a substantial interest in a business entity or in real property, the official shall file, before a vote or decision on any matter involving the business entity... an affidavit stating the nature and extent of the interest and shall abstain from further participation in the matter if... the action on the matter will have a special economic effect on the business entity that is distinguishable from the effect on the public

It is not clear that only abstaining from a vote on the Management Agreement would be sufficient to "abstain from further participation in the matter" if the primary focus of the school was the contract with the management company. Although [REDACTED] for you, [REDACTED] as the representative of you. Moreover, the Management Agreement was executed by [REDACTED] in the [REDACTED] lease of your school premises by an independent company to your member, the Member's representative was also [REDACTED] as Your representative. Consequently, [REDACTED].

[REDACTED] as key figures in many schools [REDACTED] who were the key figures in you, the [REDACTED] were also key figures in several other schools. The [REDACTED] formerly ran private small low-income, inner-city private schools receiving \$ [REDACTED] tuition per student. After several states enacted charter school legislation, the [REDACTED] began to operate charter schools that received payments closer to \$ [REDACTED] per student.

Management Agreements with _____ reported the following on the relationship of _____ with other schools. While the Management Agreement did not define "principals", these principals most likely were _____. Both Management Agreements reported that the principals of _____ were instrumental in creating other charter schools (i.e., incorporation, recruiting the initial board of directors, preparing the charter schools applications along with the curriculum and other related documents submitted with the application). The _____ reported that the principals of _____ were instrumental in creating you (i.e., incorporation, prepared charter school application, and prepared the curriculum and related application documents). Both Management Agreements stated that the principals of _____ operated a chain of kindergarten and pre-kindergarten schools in _____. Management Agreements stated that the principals of _____ are also the founders and principal administrators of three private schools for students in pre-kindergarten through _____ grade in _____.

While the _____ were controlling the activities of _____, you indicated that _____ managed these schools. You reported that the _____ was embarked upon a plan to charter schools, like you, throughout the country. As of _____ had organized four other corporations in _____, and also organized corporations in _____.

_____ was also listed as the manager of other charter schools. Your _____ reported that _____ manages six charter schools in _____ and a charter school in _____. As of _____, _____). The _____

Your Educational Program Used in Several Schools

_____ intended to implement an innovative educational program at the school. The _____ indicated that the school design, educational program, and management principles that used in the _____ charter schools, _____ and the _____ would also be used by you.

Your Resources

You reported that you owned various equipment, such as student and teacher desks and chairs, office equipment, school supplies, and various related assets necessary for the operation of the school. Management services and some equipment are provided by _____ as described below. The school facility is leased from an independent organization by the _____ as described below.

Management Agreements

[REDACTED]

You entered into an [REDACTED] Management Agreement with [REDACTED] from [REDACTED]. This Management Agreement would be automatically renewed for an additional term of one year, and from year to year thereafter, unless written notice of intent to terminate or renegotiate is given by either party not later than [REDACTED] of the preceding school year. The [REDACTED] Management Agreement amended and restated the 1998 Agreement to provide for the continued management and operation of you for the balance of the term of the [REDACTED]. The [REDACTED] noted that, upon the expansion of your board to include a majority of members who did not have a financial interest in [REDACTED] the new board considered the [REDACTED] and required certain changes.

The [REDACTED] both provided that the Agreements would be governed by and enforced in accordance with [REDACTED]. The [REDACTED] Agreement continued to list the same address for both [REDACTED] to receive all notices, demands, requests and consents under the Agreement.

1) Services Provided by [REDACTED]

According to the [REDACTED], the specific functions [REDACTED] include, but are not limited to:

1. implementation and administration of the Educational Program, including the selection and acquisition of instructional materials, equipment and supplies, and the administration of any and all extra- and co-curricular activities and programs;
2. management of all personnel functions, including professional development for the School Administrator and all instructional personnel and the personnel functions outlined in Article VI;
3. control, maintenance and operation of the school building, which the Board shall lease or otherwise provide to [REDACTED] and the installation of technology integral to the school design;
4. all aspects of the business administration of the [REDACTED];
5. the provision of transportation and food service for the [REDACTED] and [REDACTED];
6. any other function necessary or expedient for the administration of [you].

The 2000 Management Agreement repeated all these specific [REDACTED] functions except for the provision of transportation and food service for the [REDACTED]. Both the 1998 and 2000 Management Agreements provided that [REDACTED] and your Board are jointly responsible for the recruitment of students.

Under the [REDACTED] shall 1) determine staffing levels, select and manage personnel; 2) select, supervise, and be the employer of the School Administrator; 3) determine the number of teachers and provide those teachers; 4) determine the number and functions of support staff (i.e., counselors, bookkeepers, maintenance persons, etc.) and provide those staff, and 5) train personnel. The Management Agreements provided that, initially all staff will be employees of [REDACTED] but this determination

[REDACTED]

may change as you and [REDACTED] mutually determine whether staff will be employees of [REDACTED] or you.

The [REDACTED] indicated that [REDACTED] would manage the school consistent with the goals and methods in the school's charter (the Contract between you and [REDACTED]). These agreements stated that [REDACTED] must operate

in accordance with educational goals, curriculum, methods of pupil assessment, [REDACTED] admission policy and criteria, school calendar and school day schedule, and age and grade range of pupils to be enrolled, educational goals, and method to be used to monitor compliance with performance of targeted educational outcomes, all as previously adopted by the [REDACTED] and included in the Contract between [you] and [REDACTED].

The 1998 [REDACTED] is provided that your Board shall meet to review recommendations of [REDACTED] regarding matters within the scope of their duties. These Agreements provided that the Board shall retain the authority, as provided in the Code, to make reasonable regulations relative to anything necessary for the proper establishment, maintenance, management, and carrying on of you. The [REDACTED] Agreements also provided, however, that [REDACTED] may terminate the Agreement if you make decisions regarding personnel, curriculum, or program inconsistent with the recommendations of [REDACTED].

2) Compensation and Property Rights

Under the [REDACTED], you will pay [REDACTED] all educational program costs, an annual capitation fee, and an incentive fee. The [REDACTED] required you to pay [REDACTED] for educational program costs and an annual capitation fee but not an annual incentive fee. The educational program costs include, but are not limited to, personnel salaries, curriculum materials, textbooks, library books, computer and other equipment, software, supplies, building payments, maintenance, and capital improvements. The annual capitation fee is a percentage of the per pupil expenditures ("PPE") that the [REDACTED] receives and spends from all sources for students enrolled in the school. The PPE includes grants and donations, and also student fees for extra services such as summer programs, after school programs, and athletics. The 1998 Management Agreement stated a capitation fee is 10% of PPE for the [REDACTED] academic year, [REDACTED]% for [REDACTED], and [REDACTED]% for subsequent years. The [REDACTED] a [REDACTED]% capitation fee. The eliminated annual incentive fee was equal to [REDACTED]% of the excess of revenue over expenditures of you.

Only the 1998 Management Agreement provided that [REDACTED] may 1) lend you start up funds for costs such as curriculum development, a technology system, a school operations plan, hiring staff members, and equipping of the Academy building, 2) provide and retain the revenue from additional programs such as pre-kindergarten, summer school, latch-key programs, food service and transportation services, and 3) lease you computers and related equipment.

The [redacted] provided that [redacted] shall own all copyright and other proprietary rights to all instructional materials, training materials, curriculum and lesson plans and any other materials developed by [redacted], its employees, agents or subcontractors, or by any individual working for or supervised by [redacted], which is developed during working hours or time for which the individual is being paid." The Management Agreements stated that [redacted] has the sole and exclusive right to license such materials for use by other school districts, schools, or other customers. The [redacted] and the [redacted] Management Agreements provided that, upon the expiration or termination of the Agreement [redacted] has the right to reclaim any usable property or equipment it provided to the [redacted] or the depreciated cost of such equipment. The Agreements provided that fixtures and building alternations shall become your property.

In your application, you stated that your principal source of funding is state school aid from the [redacted]. You charge students no tuition. You added that you may apply for federal grants and obtain funds from various fund raising activities. The application also stated that, while there is no fund raising planned at this time, it would most likely be organized by your parent-teacher organization.

The Management Agreements indicated that you were paying [redacted] an incentive fee for early years and a capitation fee for all years. There were no management fees reported in the application reports but these fees may have been included in the contracted services portion of the separate schedule in the file. The financial data in the application for exemption reported only two expenses: "other salaries and wages" and "occupancy (rent, utilities, etc.)". The April [redacted] application reports other salaries and wages of \$ [redacted] for [redacted] to [redacted] tax year, [redacted] for [redacted] to [redacted] tax year, and [redacted] for [redacted] to [redacted] tax year. A separate schedule stated estimated expenses of \$ [redacted] for payroll, \$ [redacted] for professional and contracted services, \$ [redacted] for supplies and materials, \$ [redacted] for other operating costs, and \$275,000 for debt expense.

The June 2 [redacted] Lease Agreement provided with your application listed the [redacted] as the lessee of the premises [redacted]. The Member leased [redacted] net rentable square feet of space in a shopping center. The lease provided a monthly rental rate of \$ [redacted] for [redacted] through [redacted], no rental rate from 9/1 [redacted] through [redacted], and a monthly rental rate of \$ [redacted] from [redacted] through [redacted]. A [redacted] amendment to the lease agreement added 4,018 net rentable square feet for a total of [redacted] net rentable square feet. The lease provided a monthly rental rate of [redacted] for [redacted] through [redacted], no rent listed from [redacted] through [redacted], and a monthly rental rate of \$14,110.80 from 1/9/99 through [redacted]. In both leases, the annual rental rates quoted appear to be the amount that would be charged for the entire several year life of the lease.

The occupancy expenses were much higher than these rental charges. The financial data reported in the [redacted] application reported occupancy expenses (rent, utilities, etc.) of [redacted] to [redacted] tax year, \$ [redacted] for [redacted] to [redacted] tax year, and [redacted] for [redacted] to [redacted] tax year.

LAW

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for educational purposes.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations states that, in order to be exempt as an organization described in section 501(c)(3) of the Code, an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations states that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Section 1.501(c)(3)-1(d)(3)(i) of the regulations provides that the term "educational", as used in section 501(c)(3), relates to—

- (a) The instruction or training of the individual for the purpose of improving or developing his capabilities; or
- (b) The instruction of the public on subjects useful to the individual and beneficial to the community.

Section 4958(a) of the Code imposes a tax on excess benefit transactions, to be paid by any disqualified person referred to in subsection (f)(1) with respect to such transaction.

Section 4958(f)(1) of the Code defines the term "disqualified person" to mean with respect to any transaction, any person who was, at any time during the 5-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization, a member of the family of such an individual, or a controlled entity.

In Rev. Rul. 61-170, 1961-1 C.B. 112, an association composed of professional private duty nurses and practical nurses which supported and operated a nurses' registry primarily to afford greater employment opportunities for its members was not entitled to exemption under section 501(c)(3) of the Code. Although the public received some benefit from the organization's activities, the primary benefit of these activities was to the organization's members. Rev. Rul. 61-170 can be contrasted with Rev. Rul. 65-298, 1965-2 C.B. 163. In Rev

[REDACTED]

Rul. 65-298 a non-membership organization provided seminars to members of the medical profession. These seminars were designed to lessen the time between the discovery of medical knowledge and its practical application. Unlike the organization in Rev. Rul. 61-170, the benefits flowing from the activities of the medical seminar organization were of direct benefit to the general public.

Rev. Rul. 66-360, 1966-2 C.B. 228 concerns a sorority that is created and controlled by a business corporation engaged in furnishing services and supplies to the sorority and its member chapters. The corporation had control over the sorority and member chapters because it had control over the national sorority's governing board. The corporation used this control to carry on a commercial enterprise consisting of furnishing services and supplies to the national sorority, its chapters, and individual members. Neither the sorority nor its chapters qualified for exemption from income tax under section 501(c)(4) or section 501(c)(7) because it served the financial interests of the corporation.

Rev. Rul. 76-91, 1976-1 C.B. 149, concerns the purchase, in a transaction not at arm's length, of all the assets of a profit-making hospital by a nonprofit hospital corporation at a price that includes the value of intangible assets, determined by the capitalization of excess earnings formula. The ruling concludes that the transaction does not result in the inurement of the hospital's net earnings to the benefit of any private shareholder or individual or serve a private interest precluding exemption under section 501(c)(3) because an acceptable method was used to value the assets. The revenue ruling states that where the purchaser is controlled by the seller or there is a close relationship between the two at the time of the sale, there can be no presumption that the purchase price represents fair market value because the elements of an arm's length transaction are not present.

Rev. Rul. 76-441, 1976-2 C.B. 147, presents two situations concerning school operations. In the first scenario a nonprofit school succeeded to the assets of a for-profit school. While the former owners were employed in the new school, the board of directors was completely different. The ruling concludes that the transfer did not serve private interests. Part of that conclusion was based on the independence of the board. In the second scenario, the for-profit school converted to a nonprofit school. The former owners became the new school's directors. The former owners/new directors benefitted financially from the conversion. The ruling concludes that private interests were served. The conclusion is stated as follows:

The directors were, in fact, dealing with themselves and will benefit financially from the transaction. Therefore, (the applicant) is not operated exclusively for educational and charitable purposes and does not qualify for exemption from Federal income tax under section 501(c)(3) of the Code.

Several cases considered the issue of whether organizations asking to be recognized as described in section 501(c)(3) were created and operated to further the private commercial interests of related for-profit organizations. These cases indicate that the organization may further the private commercial interests of related for-profit organizations in several ways: 1) the applicant exempt organization markets a related for-profit's services to the ultimate consumer, 2) the applicant exempt organization acts as a consumer of the goods or services of the related

[REDACTED]

for-profit, or 3) the applicant exempt organization promotes the for-profit's business by conducting a charitable activity side-by-side the for-profit's activity.

Summary of Applicable Cases

- 1) Applicant exempt organization markets a related for-profit's services to the ultimate consumer

In est of Hawaii v. Commissioner, 71 T.C. 1067 (1979), the Tax Court concluded that est of Hawaii was not described in section 501(c)(3). Est of Hawaii was incorporated by est graduates with the objective of developing the principles of est, providing est training, developing and selling est publications, and pursuing other est educational efforts. Est programs dealt with intrapersonal awareness and communication. Est of Hawaii members, officers, and directors must have received est training. These officers and directors did not receive compensation for their services.

Est of Hawaii occurred as part of a broader plan by three for-profits with rights to est material to have tax-exempt organizations present this est material to the public. On August 9, 1973, three for-profit corporations-Erhard Seminars Training (EST, Inc.), Presentaciones Musicales, S.A. (PMSA), and EST International (International)-entered into an agreement entitled "STANDARD EST ROYALTY AGREEMENT" (royalty agreement) with the sole objective of establishing a system for the presentation of est to the public through tax-exempt corporations covering different geographical areas throughout the United States. In royalty agreements, EST, Inc., which had all est rights in the United States, relinquished these rights in Hawaii to PMSA who relinquished these Hawaii rights to International. The royalty agreement covered the original est material developed by Werner Erhard and all new material developed therefrom. New materials may be copyrighted in the name of the tax-exempt organization, but copyrights must be assigned to PMSE or International if the license is terminated. Each tax-exempt organization must agree not to become involved in any activity resembling est in a geographical location where a tax-exempt organization licensed to present est programs is functioning for 2 years after the termination of its licensing agreement.

EST, Inc. agreed to supply trainers, materials, and management services to local tax-exempt corporations. Trainers, employed by EST, Inc. must agree not to become involved in any activity resembling est in any geographic area where a local corporation is conducting est programs for 2 years after the trainer leaves EST, Inc.

On August 15, 1973, est of Hawaii entered "EST Licensing Agreement" (licensing agreement) with International which incorporated the royalty agreement. Under the licensing agreement, International licensed est of Hawaii for ten years (unless 90 days written notice is give) to use est materials under the direction of an est trainer in the State of Hawaii. Est of Hawaii agreed to conduct no less than six trainings between August 1973 and August 1974 and to charge not less than two hundred dollars for tuition for training. Under the licensing agreement, one half of all of the gross proceeds of any est event, other than regular monthly seminar series from and after August 1973 would be paid by est of Hawaii to International as the sole consideration the licensing agreement. Est of Hawaii would conduct regular est

seminars but could determine the seminar charges and retain the seminar charges. Est of Hawaii would sponsor and host special appearances of est trainers and speakers and retain the proceeds of such events. International would supply est trainers to est of Hawaii to carry out est trainings. EST, Inc. supplied a trainer, acceptable to est of Hawaii, who would be executive secretary for est of Hawaii and act as overall administrator of its day-by-day activities. International would supply management services through EST, Inc. for a period not to exceed twenty four months from August 1973. The trainer's procedures and conduct would be subject to the approval of est of Hawaii. EST, Inc. would pay the salaries of the trainers it supplies, but est of Hawaii must pay their expenses. If est of Hawaii was denied tax-exempt status, then International could cancel the agreement with 30 days written notice. Est of Hawaii was to pay International 50% of the gross receipts collected by est of Hawaii for est training courses.

Est of Hawaii argued that it has no connection with EST Inc. or International and that its transactions with International were at fair market value. The IRS argued that est of Hawaii was part of a franchise system which was operated for private benefit and that its affiliation with this system tainted it with a substantial commercial purpose. The Tax Court agreed with the IRS noting, that there was a connection between est of Hawaii and International and that whether payments were reasonable or excessive was not the critical inquiry. The Tax Court looked at three factors when analyzing the facts: 1) International's control over est of Hawaii, 2) the substantial benefit to International and EST, Inc. from est of Hawaii's operation, and 3) other indications of commercial purpose.

With regard to International's control over est of Hawaii, the Tax Court stated

While it may be true that they are not formally controlled by the same individuals, International exerts considerable control over petitioner's activities. It sets the tuition for the standard training and requires a minimum number of such trainings. It requires petitioner to conduct regular seminars and to host special events. It controls the programs conducted by petitioner by providing trainers who are salaried by and responsible to EST, Inc., and it further controls petitioner's operations by providing management personnel who are paid by and responsible to EST, Inc. In short, [est of Hawaii's] only function is to present to the public for a fee ideas that are owned by International with materials and trainers that are supplied and controlled by EST, Inc..

With regard to the substantial benefit to International and EST, Inc. from est of Hawaii's operation, the Tax Court stated

Upon termination [of the licensing agreement which could last a up to 10 years], all copyrighted material, including new material, is required to be transferred to EST, Inc., or International. Although [est of Hawaii] would be reimbursed at cost for all new developments, it has no right to the continued use of such developments. Furthermore, [est of Hawaii] is required to use its excess funds for the development of "est" or related educational and scientific research. To the extent that petitioner's activities increase interest and participation in "est" and to the extent petitioner further develops "est," the ultimate beneficiaries are EST, Inc., International, PMSA, the corporations in which the rights to 'est' remain...-

With regard to other indications of commercial purpose, the Tax Court noted

Trainers and local organizations are required to sign an agreement not to compete with "est" for 2 years after terminating their relationship with "est" organizations. [Est of Hawaii] does not expect to derive funds from donations, as is typical of section 501(c)(3) organizations, but rather will depend upon tuition and lecture fees. ... Moreover, tuition for the standard training is set by a for-profit corporation and fees for lectures are set, not with regard to recouping cost, but with regard to the eminence of the speaker.

Although conducting educational activities, the Tax Court concluded that the est of Hawaii was not conducting a nonexempt activity incidental to its exempt purposes. The Tax Court concluded that est of Hawaii "was simply the instrument to subsidize the for-profit corporations and not vice versa and had no life independent of those corporations."

A later case, International Postgraduate Medical Foundation v. Commissioner, T.C. Memo 1989-36 (1989), also considered an organization asking to be described in section 501(c)(3) that marketed the services of a related for-profit organization. In this case, an organization conducted continuing medical educational tours abroad for physicians. Foundation's brochures, however, emphasized the sightseeing activities of the tours without describing the continuing medical education courses. Mr. Gelin, one of the three Foundation directors and the executive director controlling the Foundation's daily operations, was a shareholder and president of H & C Tours. Another Foundation trustee was counsel to H & C Tours. The Foundation used H & C Tours exclusively for all travel arrangements. The Tax Court concluded that a substantial purpose of the Foundation's operations was to benefit the for-profit tour agency H & C Tours by soliciting customers for the tours of H & C Tours. In reaching this conclusion, the Tax Court noted "When a for-profit organization benefits substantially from the manner in which the activities of a related organization are carried on, the latter organization is not operated exclusively for exempt purposes within the meaning of section 501(c)(3), even if it furthers other exempt purposes."

Bob Jones University Museum and Gallery, Inc., v. Commissioner, T.C. Memo 1996-247 (1996), provides an example of a case in which the applicant exempt organization marketed the for-profit's assets to the public but did not provide the for-profit with a commercial private benefit. In this case, Bob Jones University ("University") (a taxable organization who had lost its tax exemption) created a separate organization to take over operation of the free museum and art gallery hosting over 20,000 visitors a year from the University. The new organization had a three year building lease from the University at below market rates, had a three year lease of the museum art work and personal property for free, and had a Board of Directors consisting of five members two of whom were University employees. The Tax Court concluded that the new organization was described in section 501(c)(3) with no insubstantial private benefit or any inurement to the University. In this case, the Tax Court noted that "the mere founding of an organization by a for-profit entity and its obvious continuing ties did not prevent the tax-exempt entity from obtaining a favorable ruling."

2) Exempt organization provides a market for the services of a for-profit organization

[REDACTED]

In Church By Mail, Inc. v. Commissioner, T.C. Memo 1984-349 (1984), aff'd, 785 F.2d 1387 (9th Cir. 1985), the organization Church by Mail was determined not to be described in section 501(c)(3) because of a nonexempt purpose of providing a market for the services of a for-profit organization (benefiting a private interest) and inurement. Church by Mail ("Church") had the primary activity of preparing, printing, and mailing various religious messages, most of which included a request for money. 785 F.2d at 1388. Twentieth Century Advertising Agency ("Twentieth") contracted for the printing and mailing services for the Church's mass mailings. *Id.* The Church and Twentieth were both controlled by Rev. Ewing and Rev. McElrath. *Id.* These two men also owned Twentieth. *Id.* Various family members of Rev. Ewing and Rev. McElrath also worked for and received compensation from these organizations. *Id.* At 1388, 1389 Twentieth subcontracted out the printing and billed the Church at cost plus a 15% commission. *Id.* at 1389. Any bills unpaid after ninety days accrued interest charges of 1 1/2% per month. *Id.* As evidence of this non-exempt private purpose, the Court of Appeals noted that Twentieth employees spent two-thirds of their time providing services to the Church, and the majority of Church income was paid to Twentieth to cover repayments on loan principal, interest, and commissions.

Both the Tax Court and the Appeals Court agreed that decisive issue in considering whether the Church has a non-exempt private purpose is the structure of the Church and not whether the Church alone (or in combination with related organizations) provided excessive compensation to Rev. Ewing and Rev. McElrath. Regarding non-exempt private purpose, the Court of Appeals, citing *est of Hawaii*, stated

The critical inquiry is not whether particular contractual payments to a related for-profit organization are reasonable or excessive, but instead whether the entire enterprise is carried on in such a manner that the for-profit organization benefits substantially from the operation of the Church.

The Tax Court found that consideration of the reasonableness of the arrangement between the Church and Twentieth was subordinated to considerations of the ministers' pervasive control of the arrangements and organizations, and the benefits accruing to them.

While stating that they agreed with the Tax Court's conclusions, the Appeals Court made several instructive distinctions in how they explained their agreement with the Tax Court's conclusions on the following topics: whether they distinguish between nonexempt purpose and private benefit, who is the recipient of the private benefit, and how to determine the salary amount used for the inurement test.

First, the Tax Court listed nonexempt purpose and private benefit as separate grounds for denial while the Appeals Court described a nonexempt purpose which is providing a private benefit. The analysis, however, by both courts merged the two concepts of nonexempt purpose and private benefit so that the nonexempt purpose was benefitting private interests. The Court of Appeals stated that "the Church is operated for the substantial non-exempt purpose of providing a market for Twentieth's services." While assuming that the Church was operated, at least in part, for religious purposes, the Tax Court stated the Church "has not convinced us that

[REDACTED]

a substantial, if not principal, purpose of [the Church's] operations was not to generate income for the private benefit of Rev. Ewing and Rev. McElrath and their families."

Second, although agreeing with the Tax Court regarding a substantial non-exempt purpose, the Court of Appeals stated that the recipient of the benefit was the for-profit Twentieth while the Tax Court stated that the benefit was to Rev. Ewing and Rev. McElrath. Both courts concluded that there was inurement to Rev. Ewing and Rev. McElrath because of their excessive compensation. While the Tax Court did not separate the non-exempt private purpose discussion from inurement, the Court of Appeals distinguished between the private benefit to the for-profit Twentieth and inurement to Rev. Ewing and Rev. McElrath.

Third, the Tax Court and Court of Appeals differed on how to determine the sources of the insider salary amounts used for the inurement test. While the Tax Court added the income of three organizations related to Rev. Ewing and Rev. McElrath, the Appeals Court limited the income to two organizations related to Rev. Ewing and Rev. McElrath. Both courts considered amounts paid to Rev. Ewing and Rev. McElrath by the Church (the applicant exempt organization) and by Twentieth (the for-profit contracting organization) for interrelated activities. The Tax Court also considered amounts received by Rev. Ewing and Rev. McElrath from another organization operated by them called Rev. Ewing's Evangelistic Ministries, Inc. ("Ministries"). The Appeals Court did not consider amounts from Ministries. In addition to Rev. Ewing and Rev. McElrath, the only link between Ministries and the Church was similar literature and co-sponsoring certain revival meetings. The Court of Appeals stated that "Because Twentieth funnels income received from the Church to the ministers and their families, it was proper for the tax court to consider evidence of the salaries received from Twentieth as well as those received directly from the Church." The Appeals Court stated "In *Hall v. Commissioner*, 729 F.2d 632 (9th Cir. 1984), we held that when a second organization is created which serves to funnel income to the individual who controls the purportedly exempt organization and the income exceeds a reasonable salary, the income inures to the benefit of a private person with the meaning of I.R.C. § 501(c)(3)."

3) Exempt organization helps promote the for-profit's business by side-by-side activity

In P.L.L. Scholarship Fund v. Commissioner, 82 T.C. 196 (1984) and K.J. Fund Raisers, Inc. v. Commissioner, T.C. Memo 1997-424 (1997), the court concluded that the applicant organizations were described in section 501(c)(3) because their charitable gambling activity benefitted the for-profit lounge where the gambling was conducted. Both courts noted that the operations of the applicant organization conducting the charitable gambling and the related for-profit business were so interrelated as to be functionally inseparable.

In P.L.L. Scholarship Fund, the corporation was formed to raise money for college scholarships by conducting bingo games in the Pastime Lounge, a for-profit organization. Bingo games were conducted during the Lounge's regular business hours by the owners of the Lounge. The two lounge owners, a person acting as accountant and director of the Lounge and two bingo players were the five Lounge directors. The court concluded that more than an insubstantial purpose of the organization's activities were to use the bingo games to attract persons to the Lounge expecting that they would purchase food and beverages while playing

[REDACTED]

bingo. Separate accounting for charitable and lounge receipts and the absence of payments to the Lounge and its employees did not change the substantial nonexempt purpose of the organization.

In KJ Fund Raisers, Kristine Hurd and James Gould, the sole owners of KJ's Place, created KJ's Fund Raisers, Inc.. KJ's Place was a lounge serving alcoholic beverages. KJ's Fund Raisers, Inc. raised funds for charity by having KJ's Place owners and employees sell lottery tickets at KJ's Place during the lounge's regular business hours with separate accounting for KJ's Place and KJ Fund Raisers. The Tax Court concluded that although KJ's Fundraisers contended that it had a board independent from Hurd and Gould, these owners of KJ's Place controlled sales of the lottery tickets at KJ's Place. At one time, Hurd and Gould received wages and KJ's Place received rent from KJ's Fundraisers. The Tax Court held that KJ's Fundraisers was operated for the substantial private benefit of KJ's Place and its owners inducing those who liked the lottery to come to KJ's Place.

Principles from Applicable Cases

The above cases concern organizations that furthered charitable purposes (i.e., educational, religious, and charitable fundraising) but also were created and operated to provide a substantial private commercial benefit to related for-profit organizations precluding these organizations from being described in section 501(c)(3). These cases indicate that an exempt organization may further the private commercial interests of related for-profit organizations in several ways: 1) market a related for-profit's services to the ultimate consumer, 2) act as a consumer of the goods or services of the related for-profit, and 3) promote the for-profit's business by conducting a side-by-side charitable activity. In dealing with the issue of whether an organization provides a substantial private commercial benefit to related for-profit organizations, the above cases considered the following common factors: 1) control, and 2) the benefit to the related for-profit. Below, we consider each of these factors.

1) Control

While control alone was not sufficient to preclude an organization from being described in section 501(c)(3), it was considered in combination with other evidence of private benefit in the above cases. Control of the applicant exempt organization by the related for-profit in the above cases was established by overlapping directors but also by contracts between the organizations and by operations of the organizations. In International Postgraduate Medical Foundation, Church by Mail, and P.L.L. Scholarship Fund, there were overlapping directors for the applicant exempt organization and the related for-profit organization. In est of Hawaii and KJ's Fundraisers, there were not overlapping directors but other circumstances evidenced the control of the for-profit organization over the applicant exempt organization's activities. Under the licensing agreement in est of Hawaii, the related for-profit organization places the following restrictions on est of Hawaii: sets the tuition for the standard training, requires a minimum number of these trainings, requires the conduct of regular seminars, requires the hosting of special events, provides trainers who are salaried by and responsible to EST, Inc.; and provides management personnel who are paid by and responsible to EST, Inc. The Tax Court concluded that est of Hawaii's "only function is to present to the public for a fee ideas that are owned by

[REDACTED]

International with materials and trainers that are supplied and controlled by EST, Inc." In KJ's Fundraisers, the Tax Court noted that the owner's of the related for-profit Lounge controlled the applicant exempt organization's activities (i.e., the sale of lottery tickets) even though the owners of the lounge were not on the applicant exempt organization's board.

2) Benefit to the related for-profit

(a) The benefit: In est of Hawaii, the applicant exempt organization benefited the for-profit est organizations by increasing interest and participation in est and by developing est or related educational or scientific research. The applicant organization had to expend its resources to develop est material with requirement that copyrighted material had to be transferred back to the related for-profit organizations at the termination of the licensing agreement. In International Postgraduate Medical Foundation, the Tax Court concluded that a substantial purpose of the Foundation's operations was to benefit the for-profit tour agency H & C Tours by soliciting customers for the tours of H&C Tours. Moreover, the brochures emphasized the sightseeing activities of the continuing medical educational tours. In Church by Mail, the applicant organization benefited a for-profit organization contracting for the printing and mailing services used for the applicant's mailings of religious messages with requests for money. The mailing of these messages was the primary activity of the applicant exempt organization. The charitable gambling conducted by the applicant exempt organizations in related for-profit lounges P.L.L. Scholarship Fund and K.J. Fund Raisers benefited these lounges by attracting customers to the lounges.

(b) Excessive payments not the issue: Several courts indicated that whether payments to insiders are excessive is not the decisive issue in these cases where there is a private benefit problem that reflects the defective structure of the organization. This structure is organized around providing a commercial benefit to a related for-profit organization. Whether payments are reasonable was considered in the inurement discussion of the Appeals Court in Church by Mail, but not when determining private benefit. The Appeals Court cited est of Hawaii when concluding that

The critical inquiry is not whether particular contractual payments to a related for-profit organization are reasonable or excessive, but instead whether the entire enterprise is carried on in such a manner that the for-profit organization benefits substantially from the operation of the Church.

We distinguish between the structural issues regarding the way that these organizations are set up and individual issues regarding the persons involved in the organizations. The structural issues exist regardless of the reasonableness of the compensation to for-profit entities. The individual issues regarding compensation such as inurement and now section 4958 are very much tied to the reasonableness of compensation. The structural problem (i.e., private commercial benefit) does not require excessive compensation to insiders. Similarly, a good organizational structure may still exist where there is excessive compensation to insiders resulting in inurement.

(c) Trace salaries funneled from particular exempt organization: In Church by Mail, the

[REDACTED]

Appeals Court looks only at salaries and other benefits provided by the applicant exempt organization to its insiders directly by the applicant exempt organization and indirectly funneled through a related for-profit organization for interrelated activities. The Appeals Court considered payments to Church insiders from Church and Twentieth, but not from Ministries. The applicant exempt organization (Church) provided a market for the services of the related for-profit organization (Twentieth). In contrast, the only link between the applicant exempt organization and a third organization (Ministries) controlled by Rev. Ewing and Rev. McElrath was similar literature, and co-sponsoring certain revival meetings.

(d) Central activity: This marketing or consuming of the for-profit organization's goods or services by the applicant exempt organization must be central to the applicant organization's operations. It must be more than insubstantial and incidental such as selling office supplies to the applicant exempt organization. While printing and mailing services usually would not be a significant part of an applicant exempt organization's activities, these services provided by the related for-profit organization in Church by Mail constituted a significant part of the applicant exempt organization's activities. As evidence of this non-exempt purpose, the Court of Appeals noted that Twentieth employees spent two-thirds of their time providing services to the Church, and the majority of Church income was paid to Twentieth to cover repayments on loan principal, interest, and commissions. While the activity may not be the major activity of the for-profit organization, it should be a major activity of the applicant exempt organization. In Church by Mail, KJ's Fundraisers, and P.L.L. Scholarship Fund, the activity was the major activity of the applicant exempt organization and the for-profit. In est of Hawaii, however, the activity was only the major activity of the applicant exempt organization marketing the for-profits' products.

(e) Bob Jones University Museum commercial-type benefit: The holding in Bob Jones University Museum indicated that an applicant exempt organization must not only relieve a taxable organization from the costs of conducting a charitable activity, it should provide a commercial-type benefit. Here, the taxable organization rented a building from the applicant exempt organization at below market rates and rented the museum art work and personal property for free. The fact that the for-profit organization owned the assets used by the applicant exempt organization did not lead to a loss of exemption. This fact was significant in est of Hawaii where the for-profit organizations were gaining revenue from the applicant exempt organization's operations and not simply saving the cost of doing the activity themselves as in Bob Jones.

In applying the preceding principles of law to your specific purposes and activities, we have concluded that you are not organized and operated exclusively for exempt purposes. You have been organized and operated to 1) market a related for-profit's services to the ultimate consumer, 2) act as a consumer of the goods or services of the related for-profit, and 3) promote the for-profit's business by conducting a side-by-side charitable activity.

Organized and Operated Exclusively for Exempt Purposes

Both you and [REDACTED] freely admit that [REDACTED] principals (presumably the [REDACTED]) were instrumental in your creation, having incorporated you, appointed (through [REDACTED]) your initial board of directors, prepared your applications with authorizing bodies for the contracts to

[REDACTED]

become charter schools, and prepared the curriculum and related documents with the applications and essential for the operation of the schools. Both you and [REDACTED] freely admit [REDACTED] principals (presumably the [REDACTED] were instrumental in creating other charter schools (i.e., incorporation, recruiting the initial board of directors, preparing the charter schools applications along with the curriculum and other related documents submitted with the application). Finally, it has been indicated that the formation of similar corporations is contemplated in many other states (presumably states that enacted charter school statutes).

Given your own statements, it is appropriate to assume that your formation and operation is, in part, part of a coordinated effort by [REDACTED] to expand their reach in the area of charter school management. You were therefore created for the dual purpose of operating an educational organization and providing business to [REDACTED]. If providing [REDACTED] a market for its services is more than an incidental purpose, based upon the facts and circumstances, exemption is precluded.

Control -- [REDACTED] retains substantial control over your operations

On [REDACTED] were approved and sworn in as members of your board by motion of [REDACTED] and seconded by [REDACTED]. On September 18, 2000, you accepted the resignations of the [REDACTED] from your governing board and [REDACTED] were appointed to fill the vacancies. The [REDACTED] even agreed not to serve on your board while they held a financial interest in your service provider. However, upon close scrutiny of your new Board of Directors, it cannot be said to be independent from [REDACTED].

First, you indicate that [REDACTED] were recommended by your Advisory Board for membership on your Board of Directors, however; you have not provided any documentation of any action by the Advisory Board with regard to Board recommendations. Additionally, irrespective of the absence of a formal recommendation by the Advisory Board, the Advisory Board cannot be viewed as being independent from [REDACTED]. Your by-laws provide that your board [REDACTED] (at that time) appoint the members of the Advisory Board. Additionally, [REDACTED], in their capacity as your board members, retain sole authority to appoint new board members. Therefore, the [REDACTED] appointed Advisory Board recommended individuals for membership on your board and the [REDACTED] exercised their authority to appoint the individuals. Additionally, it can be assumed that [REDACTED] were appointed by either the [REDACTED] but in any case the decision was made by the [REDACTED]. Therefore, the [REDACTED] have had influence in the selection of all your Board of Directors. Finally, future members of your Board of Directors are appointed by current members, thereby perpetuating the problem.

Second, all your business is filtered through [REDACTED]. Your books and records are held by [REDACTED]. All your correspondence including board business is sent to [REDACTED]. Your legal representation is located in [REDACTED]. You explain this as [REDACTED] performing its responsibilities as your manager. However, this inhibits your board's ability to effectively control your own activities. [REDACTED] is given first notice to all your business, including business that may be adverse to [REDACTED] itself. Such control over your business activities

[REDACTED]

reduces the effectiveness of your "independent" Board of Directors.

Third, [REDACTED] effectively control the actions of your Board of Directors through the use of ancillary agreements. The [REDACTED] control your facilities through a sub-lease arrangement. The Member [REDACTED] hold a promissory note executed on your behalf in excess of \$ [REDACTED]. Several facts concerning the promissory note prove to be very telling. The note was executed on [REDACTED], three months after the IRS issued you a proposed denial outlining problems with the relationship between you, [REDACTED] and just prior to the reshuffling of your Board of Directors. [REDACTED] executed the note as president of the [REDACTED] and as your president, a problem noted in the denial concerning the management agreement. There appeared to be no official action taken by your Board of Directors with regard to this promissory note. No board discussion of the amount or terms of the loan or of attempts to obtain financing from other parties.

Fourth, actions taken by the new "independent" Board of Directors should be closely examined for signs that it is, in fact, independent. There is no evidence to indicate that the board took any steps to review the management agreement with [REDACTED]. In fact, the agreement was executed prior to the board officially meeting for the first time. There is no evidence that the board took any steps to review the loan with [REDACTED]. There is no evidence that the board has done anything but rubberstamp the status quo. The independence of your Board of Directors is, based upon the facts and circumstances, questionable at best. Additionally, the notion that you may remove [REDACTED] as your manager at the end of the contract term fails to recognize the interaction between the [REDACTED] of the board and the affects of having several separate agreements with ties to the [REDACTED].

Finally, even assuming your Board of Directors are independent and you are structured to prohibit control by the [REDACTED] your management agreement gives [REDACTED] impermissible control of your operations. You have contracted away your responsibility to implement and administer your educational program, including the selection and acquisition of instructional materials, equipment and supplies, and the administration of any and all extra- and co-curricular activities and programs. You have contracted away your responsibility to manage all personnel functions, maintenance and operation of the school building, and the installation of technology integral to the operation of the school. You have contracted away your responsibility for all aspects of your business administration. You have contracted away any other function necessary or expedient for the administration of your school. You have, in effect, handed the keys to your operations to a for-profit management company, one which has been intimately tied to you since your formation.

Private Benefit - [REDACTED] receives a substantial private benefit from your organization and operation.

[REDACTED] (and its principles) is in the business of providing school operations management services. These services are targeted primarily to charter schools. Your formation by [REDACTED] and the immediate contractual relationship created with [REDACTED] for substantially all your activities provides [REDACTED] with a substantial private benefit. [REDACTED] was enabled to create its own customer, eliminate competition for your business, experiment and gain competence with your

[REDACTED]

students, establish goodwill, improve its intellectual property, substantially reduce school board pressures, create economies of scale to name just a few. Such benefits go beyond merely incidental benefits derived by a for-profit entity that contracts with a completely unrelated exempt organization.

Like the organizations cited above, while you have an exempt purpose and activities, you also have a purpose and activities that provide [REDACTED] with a substantial private benefit. As with those organizations, you are not organized and operated exclusively for exempt purposes.

Accordingly, you do not qualify for exemption as an organization described in section 501(c)(3) of the Code and you must file federal income tax returns.

Contributions to you are not deductible under section 170 of the Code.

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views to this office, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days from the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that person will need to file a proper power of attorney and otherwise qualify under our Conference and Practices Requirements.

If you do not protest this ruling in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies. Section 7428(b)(2) of the Code provides, in part, that a declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service.

If we do not hear from you within 30 days, this ruling will become final and a copy will be forwarded to the Ohio Tax Exempt and Government Entities (TE/GE) office. Thereafter, any questions about your federal income tax status should be directed to that office, either by calling 877-829-5500 (a toll free number) or sending correspondence to: Internal Revenue Service, TE/GE Customer Service, P.O. Box 2508, Cincinnati, OH 45201. The appropriate State Officials will be notified of this action in accordance with Code section 6104(c).

When sending additional letters to us with respect to this case, you will expedite their receipt by using the following address:

Internal Revenue Service
[REDACTED]

[REDACTED]

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

[REDACTED]

[REDACTED]

✓ bcc: Original to Organization .

✓ bcc: [REDACTED]

✓ bcc: [REDACTED]

bcc: [REDACTED]

✓ bcc: Yellow (file)

	Initiator	Reviewer	Reviewer	Reviewer	Reviewer	Reviewer
CODE	[REDACTED]	[REDACTED]				
SURNAME	[REDACTED]	[REDACTED]				
DATE	[REDACTED]	[REDACTED]				