



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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: OCT 25 2001

[REDACTED]

NO PROTEST PERMITTED
Release to: [REDACTED]
DATE: [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. The basis for our conclusion is set forth below.

You were incorporated as a Not-for-Profit entity under the Laws of the State of [REDACTED] on [REDACTED]. Your articles of incorporation include language that sufficiently limits your activities to purposes described in section 501(c)(3) of the Code.

You seek to provide education and instruction to public school children in [REDACTED] through the operation of a charter school. [REDACTED], through its subsidiary, [REDACTED], (a [REDACTED]), a for-profit company, prepared and submitted your charter school application to the [REDACTED] School District in [REDACTED].

You have not yet opened your school for operations. You have not leased a school building at this time. You do not plan to operate a school until [REDACTED].

You are a principal to a Development and Planning Agreement ("DPA") executed with [REDACTED]. Generally, the DPA gives control of your activities prior to opening of your school to [REDACTED]. You have contracted away virtually all of your activities to [REDACTED]. You have little, if any, control over basic activities such as the negotiation of your charter contract with the Chartering Entity or the coordination, negotiation and administration of contracts entered into by you for necessary services performed by third parties.

The agreement with [REDACTED] is comprehensive in nature and provides that [REDACTED] will assume full responsibility for the education of your students. Similar to the control given to [REDACTED] in the DPA agreement for pre-opening operation, the agreement gives control over virtually all of your on-going activities to [REDACTED]. [REDACTED] will plan, implement and oversee a curriculum for

[REDACTED]

you. [REDACTED] will operate student recruitment and enrollment. Your principal, faculty and staff will be employees of [REDACTED]. [REDACTED] forbids all its employees from working for you for a period of one year after termination of this management contract. [REDACTED] will perform all your accounting and financial management including maintaining your Operating Account with signature authority.

[REDACTED] is responsible for such basic educational activities as the coordination and oversight of all organized parental involvement, including the required participation of parents of your students. [REDACTED] will also establish and work with any parent-teacher organization. [REDACTED] has authority over all your official public relations, including community outreach, press releases, and media relations.

You will compensate [REDACTED] 14% of your school revenues for its management services. School revenues are defined as gross revenues from any source including, but not limited to, funding by individuals and private corporations, government funding and any grants obtained (whether by individuals, private corporations or government entities).

Section 170(b)(1)(A)(ii) of the Code provides for the allowance of a charitable deduction for an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its educational activities are regularly carried on.

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—

- [REDACTED]
- (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.

In Better Business Bureau of Washington, D.C., Inc. v. United States, 326 U.S. 179, the Supreme Court held that the presence of a single non-exempt purpose, if substantial in nature, will destroy a claim for exemption regardless of the number or importance of truly exempt purposes.

Operating for the benefit of private parties constitutes a substantial nonexempt purpose. Old Dominion Box Co. v. United States, 477 F. 2d 340 (4th Cir. 1973), cert. denied 413 U.S. 910 (1973).

The petitioner in est of Hawaii, 71 T.C. 1067 (1979), conducted training, seminars and lectures in the area of intrapersonal awareness. Such activities were conducted under licensing arrangements with various for-profit corporations. The licensing agreements were conditioned on the petitioner maintaining tax exempt status. The petitioner argued that it had no commercial purpose of its own and that its payments to the for-profits were just ordinary and necessary business expenses. The Court did not agree.

To accede to petitioner's claim that it has no connection with International (the for-profit licensor of the educational program) is to ignore reality. While it may be true that the same individuals do not formally control them, 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, petitioner'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. Moreover, we note that petitioner's rights vis-à-vis EST, Inc., International, and PSMA are dependent on the existence of its tax-exempt status—an element that indicates the possibility, if not the likelihood, that the for-profit corporations were trading on such status...

Regardless of whether the payments made by petitioner to International were excessive, International and EST, Inc., benefited substantially from the operation of petitioner, (Emphasis added).

In American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989), the Tax Court was called on to decide whether benefits to third parties, who were not members, would prevent the organization from being recognized as an exempt organization within the meaning of section 501(c)(3) of the Code. The Court concluded that the organization could not confer substantial

benefits on disinterested persons and still serve public purposes within the meaning of section 1.501(c)(3)-1(d)(1)(ii) of the regulations.

Secondary benefits which advance a substantial purpose cannot be construed as incidental to the organization's exempt educational purpose. Indeed, such a construction would cloud the focus of the operational test, which probes to ascertain the purpose towards which an organization's activities are directed and not the nature of the activities themselves.

In Harding Hospital, Inc. v. United States, 505 F.2d 1068 (6th Cir. 1974), a non-profit hospital with an independent board of directors executed a contract with a medical partnership composed of seven physicians. The contract gave the physicians control over care of the hospital's patients and the stream of income generated by the patients while also guaranteeing the physicians thousands of dollars in payment for various supervisory activities. The court held that the benefits derived from the contract constituted sufficient private benefit to preclude exemption.

In Redlands Surgical Services, v. Commissioner, 113 T.C. 47 (1999), the Tax Court held that a nonprofit wholly owned subsidiary of Redland Health Systems (a 501(c)(3) organization) operated for impermissible private benefit when it ceded effective control over partnership operations to private parties who had no requirement to operate exclusively for purposes described in section 501(c)(3). The organization's sole activity was participating as co-general partner with a for-profit corporation in a partnership that owned and operated an ambulatory surgery center. An affiliate of the for-profit partner was the manager of the surgical center. It received a 6% management fee under the management agreement. The court closely examined the structure of the relationships among the parties and stated:

Clearly, there is something in common between the structure of petitioner's sole activity and the nature of petitioner's purpose in engaging in it. An organization's purposes may be inferred from its manner of operations; its "activities provide a useful indicia of the organization's purpose or purposes." Living Faith, Inc. v. Commissioner, 950 F.2d 365 (7th Cir. 1991), affd. T.C. Memo. 1990-84. The binding commitments that petitioner has entered into and that govern its participation in the partnerships are indicative of petitioner's purposes. To the extent that petitioner cedes control over its sole activity to for-profit parties having an independent economic interest in the same activity and having no obligation to put charitable purposes ahead of profit-making objectives, petitioner cannot be assured that the partnerships will in fact be operated in furtherance of charitable purposes. In such a circumstance, we are led to the conclusion that petitioner is not operated exclusively for charitable purposes...nothing in the General Partnership agreement, or in any of the other binding commitments relating to the operation of the Surgery Center, establishes any obligation that charitable purposes be put ahead of economic objectives in the Surgery Center's operations. The General Partnership agreement does not expressly state any mutually agreed-upon charitable purposes or objective of the partnership.

[REDACTED]

The court also looked closely at the governing arrangement of the partnership. It likened it to a board of directors. The court stated that the composition of the board of directors gives an indication of whether the organization is operated for public or private purposes. The court quoted with approval from "Income Tax Exempt of the Contemporary Nonprofit Hospital", Mancino, 32 St. Louis U.L.J. 1015, 1051 (1988).

The board of directors, its composition, and its functions are relevant to tax exemption...the composition of the board provides important evidence that the hospital serves public rather than private purposes. For, example, it is fair to presume that a board of directors chosen from the community would place the interests of the community above those of either the management or the medical staff of the hospital. Thus, the relevance of the board is that its process should indicate whether the hospital is operated for the benefit of the community or to secure benefits for private interests.

After a through analysis of the all of the operating agreements entered into by the petitioner, the court reached the following conclusions.

Based on all of the facts and circumstances, we hold that petitioner has not established that it operates exclusively for exempt purposes within the meaning of section 501(c)(3). In reaching this holding, we do not view any one factor as crucial, but we have considered these factors in their totality: The lack of any express or implied obligation of the for-profit interests involved in petitioner's sole activity to put charitable objectives ahead of non charitable objectives, petitioner's lack of voting control over the General Partnership; petitioner's lack of other formal or informal control sufficient to insure furtherance of charitable purposes; the long-term contract giving SCA Management control over day-to-day operations as well as a profit-maximizing incentive; and the market advantages and competitive benefits secured by the SCA affiliates as the result of this arrangement with petitioner. Taken in their totality, these factors compel the conclusion that by ceding effective control over its operations to for-profit parties, petitioner impermissibly serves private interests.

Section 501(c)(3) of the Code sets forth two main tests for qualification for exempt status. An organization must be both organized and operated exclusively for purposes described in section 501(c)(3). You have included sufficient limiting language in your organizing document as to your purposes. You also require a dissolution clause stating that your assets will be transferred to another section 501(c)(3) organization in case you are dissolved. You have this clause in your organizing document as well. Therefore, the organizational test has been met.

Another key requirement under section 501(c)(3) is that an organization be operated exclusively for one or more exempt purposes. To determine whether this test is satisfied, section 1.501(c)(3)-1(c)(1) of the regulations directs the Service to determine if the organization engages primarily in activities which accomplish one or more exempt purposes. Section 1.501(c)(3)-1(d)(1)(ii) of the regulations expands on the operated exclusively concept by providing that an organization is not operated exclusively to further exempt purposes unless it

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serves a public rather than a private interest.

Your method of operating a charter school provides a substantial benefit to ██████████ a for-profit organization. The presence of a single non-exempt purpose, if substantial in nature, will destroy a claim for exemption regardless of the number or importance of truly exempt purposes. Better Business Bureau of Washington, supra. Based on the facts that you have provided in your application for recognition of exemption, we are not able to conclude that you are operated exclusively for public rather than private purposes.

Additionally, your management agreement with ██████████ provides comprehensive services to you, and relinquishes control of your operations to ██████████ For example:

1. ██████████ will negotiate your charter agreement with the Chartering Authority. Thus; you have no ability to shape or control how your activities will be structured.
2. ██████████ is responsible for the implementation and administration of your curriculum and the administration of all extra- and co-curriculum activities and programs. You have no ability to determine how your students will be educated.
3. ██████████ is responsible for the selection and acquisition of all instructional materials, equipment, supplies and services required for operation of the school.
4. ██████████ is the employer of the administrators, faculty and staff of your school and has sole authority to hire, fire, and supervise the personnel.
5. ██████████ has responsibility and authority to determine staffing levels, and to select, evaluate, assign, discipline and transfer personnel. You have no control over any personnel who will be carrying out your educational mission.
6. ██████████ is responsible for all aspects of the business and financial administration of the school including signature authority of your bank account. Other than approval of a ██████████ prepared budget at the beginning of the year, you have no control over your revenues.
7. ██████████ is given responsibility to set up your marketing plan including parent orientation, student marketing and the preparation, management, supervision, and implementation of your school's opening.
8. ██████████ is given authority to perform any function necessary or expedient for the administration of the school including binding you to contracts with third parties.
9. ██████████ is given approval rights to all official public relations communications.
10. ██████████ is given responsibility to establish and work with parent-teacher groups. You have retained little, if any, ability to create an identity for yourself by allowing ██████████ to act as a buffer between you and the people you are supposed to be

[REDACTED]

school for operations. You have no lease for any building. You are not planning to open your school for operations until [REDACTED] at the earliest. All of this shows a lack of operation. Thus, you have failed the operational test under this code section. You requested classification under section 170(b)(1)(A)(ii) in your application. You do not meet the requirements of this code section, and therefore your request to be classified under this section is denied.

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]
T:EO:RA:T:4, Room 3E5
1111 Constitution Ave, N.W.
Washington, D.C. 20224

[REDACTED]

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

Sincerely,

(signed) **Gerald V. Sack**

Gerald V. Sack
Manager, Exempt Organizations
Technical Group 4

[REDACTED]

T:EO:RA:T:4

[REDACTED]