Audit Technique Guide – Private and Charter Schools

Introduction
This Audit Technique Guide includes specific information for finding and developing issues common to private and charter school and colleges and universities audits. These organizations are tax-exempt and described in IRC Sections 501(c)(3), IRC 509(a)(1), and IRC 170(b)(1)(A)(ii).

The guide provides assistance and legal precedent for auditing private and charter schools and colleges and universities but is not all-inclusive.

Private Schools Defined
Schools provide the classic form of individual instruction. For IRC Section 501(c)(3) purposes, a school includes a:
- Primary, secondary, preparatory, or high school
- College or university
- Professional or trade school

A school is an educational organization per IRC Section 170(b)(1)(A)(ii) and Treas. Reg. 1-170A-9(c)(1) that:
- Has a primary function of presenting formal instruction
- Normally maintains a regular faculty and curriculum
- Normally has a regularly enrolled body of students
- Has a place where the organization conducts educational activities

Schools don’t have to establish broad public support to avoid classification as a private foundation.

Foundation Classification Concerns for Schools
Determine if the classification is accurate by assessing the four characteristics above:
- Primary Function of Presenting Formal Instruction: An educational organization per IRC Section 170(b)(1)(A)(ii) is one which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.

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<tr>
<td>Rev. Rul. 79-167, 1979-1 C.B. 335</td>
<td>A community center corporation established to provide residents: community centers, libraries, classes, club rooms, gymnasiums, camps, and music and lecture halls didn’t have, as its primary purpose, the presentation of formal instruction, even though classes were regularly held by trained instructors at the center’s local facilities.</td>
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<tr>
<td>Rev. Rul. 74-366, 1974-2 C.B. 345</td>
<td>Summer camp offering both recreational and educational activities didn’t have a primary function as the presentation of formal instruction.</td>
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- **Normally maintains a Regular Faculty and Curriculum:**

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<td>Rev. Rul. 78-82, 1978-1 C.B. 70</td>
<td>An educational organization that offered a variety of lectures, workshops, and short courses on Oriental Philosophies was not described in IRC Section 170(b)(1)(A)(ii) because it didn’t maintain a “regular” faculty and the lectures, workshops, and short courses were neither organized into an interrelated curriculum so as to constitute formal instruction nor offered on a regular basis.</td>
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<td>Rev. Rul. 64-128, 1964-1 C.B. 191</td>
<td>Organization that conducts lectures, holds conferences, and publishes research findings fails classification as an educational organization since it doesn’t normally maintain a regular faculty and curriculum, and doesn’t normally have a regularly enrolled body of students.</td>
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<td>Rev. Rul. 73-434, 1973-2 C.B. 71</td>
<td>A survival school offering interrelated courses given in a regular and continuous manner was deemed to have a regular faculty and curriculum per IRC Section 170(b)(1)(A)(ii).</td>
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- **Has a Regularly Enrolled Body of Students:**

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<td>Rev. Rul. 64-293, 1964-2 C.B. 404</td>
<td>An educational organization conducts a two-week “directors’ school” twice a year for a religious institution’s directors to develop programs for spiritual development and Christian education. The IRS ruled that although primarily educational, it didn’t normally have a “regularly enrolled” body of students in attendance.</td>
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<td>Rev. Rul. 73-434, 1973-2 C.B. 71</td>
<td>A survival school that maintained short classes on a continuous, revolving basis had maintained a regular body of students in attendance, is an educational organization per IRC Section 170(b)(1)(A)(ii).</td>
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• **Has a Place:**

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<td>Rev. Rul. 76-384, 1976-2, C.B. 57</td>
<td>An organization that operates a tutoring service for students on a one-to-one basis in their homes, and that operates a small testing center where students are tested to determine their need for individual testing, isn’t an educational organization per IRC Section 170(b)(1)(A)(ii).</td>
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**Child Care Organizations and Early Education**

For IRC Section 501(c)(3) and IRC Section 170(c)(2), educational purposes includes providing care for children away from their homes if both:

1. substantially all of the care the organization provides enables individuals to be gainfully employed
2. the organization’s services are available to the general public (IRC Section 501(k))

However, a child care organization that meets the criteria for qualification as a school under IRC Section 170(b)(1)(A)(ii) may still choose to do so, rather than to come under IRC Section 501(k). To be classified as a school, a day care organization’s primary purpose must be to educate the children, and its custodial care must be merely incidental. See *San Francisco Infant School, Inc. v. Comm’r*, 69 T.C. 957 (1978), acq. 1978-2 C.B. 2.

At first glance, a preschool or nursery that includes routine instruction in organized play appears too rudimentary to constitute a “curriculum.” However, depending on the facts and circumstances of each case, the regulations under IRC Section 501(c)(3) intend that preschools or nurseries can qualify as an entity described under IRC Section 170(b)(1)(A)(ii). However, when the primary activity of child day care centers focus on babysitting and health related concerns, the IRS may not grant a “school” designation.

**Church Related Private Schools**

Determine if the school is separately organized or incorporated and also consider:

- Does the school have its own determination letter from the IRS?
- Is it included as a subordinate on a group exemption roster?
- Does it file a separate Form 990, Return of Organization Exempt From Income Tax?

The group exemption letter issued to the United States Conference of Catholic Bishops covers organizations listed in the Official Catholic Directory.

A church related school doesn't have to file Form 990 (Treas. Reg. 1.6033-2(g)(1)(vii)). If it does file, determine the foundation status it claims. If the school claims church status, follow IRC Section 7611 rules and treat per IRC Section 7611 unless you determine the school is a separate legal entity.
Private School Racial Nondiscrimination Policy

A private school must adopt and operate under a racial nondiscrimination policy for students, as required for exemption under IRC Section 501(c)(3) and in Rev. Rul. 71-447, 1971-2 C.B. 230, and in the manner required by Rev. Proc. 75-50, 1975-2 C.B. 587.

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To determine if a private school has affirmatively adopted a policy of racial nondiscrimination for students and operates in good faith to further the policy, use professional judgment on the depth and scope of inquiry you need to make and support the conclusion.

To avoid duplication and reduce taxpayer burdens, consider facts other government agencies developed that made determinations, considering whether a school is discriminatory. For example, most government grants, loans or contracts require the school to be racially nondiscriminatory per Rev. Rul. 71-447, 1971-2 C.B. 230. Don't rely on another governmental agency’s conclusion. Rather, use its facts to make an independent determination.

A private school must establish that it:
- adopted and published its student racial nondiscrimination policy,
- published its policy in the manner under Rev. Proc. 75-50, 1975-2 C.B. 587, and
- operates by the stated policy

The ultimate question for racially nondiscriminatory operations is: does it provide equal availability to all racial and ethnic groups? Determine if attendance records validate the substantial number and variety of minority students. Also, consider the facts and circumstances of the school’s operation.

If a private school has a history of racial discrimination and few or no minority students, mere adoption and publication of a racial nondiscrimination policy won't meet the requirements for good faith operation. It must provide clear and convincing evidence that it no longer discriminates based on race, and that the current absence of minority enrollment is due to the school’s past policies.

A school may show a history of racial discrimination if it:
- Was found to be racially discriminatory in judicial or administrative proceedings;
- Was established or expanded at the time of local public school desegregation (either following court order or voluntary plan);
- Operated with racial discrimination policies for its students; or
- Refused to adopt a racial nondiscrimination policy for its students;
The school may rebut racial discrimination inference by demonstrating:
- Active and vigorous recruitment of minority students and teachers;
- Financial assistance to minority students;
- Effective communication, including publication, of a racial nondiscrimination policy for the minority population;
- Actual contact with the minority community; and
- Public repudiation of previous actions or statements inconsistent with a racial nondiscrimination policy by the school or anyone speaking or acting on its behalf.

Schools must keep certain records and establish guidelines to determine if they meet the requirement of a racially nondiscriminatory policy as to students (announced in Rev. Rul. 71-447, 1971-2 C.B. 230; confirmed in Rev. Rul. 75-231, 1975-1 C.B. 158) (Rev. Proc. 75-50, 1975-2 C.B. 587). The guidelines clearly indicate that the IRS uses thorough field audits to ensure genuine compliance with all aspects of the racial nondiscrimination requirement.

Develop enough facts about a school’s operations to determine if the school operates in good faith to further a racial nondiscrimination policy for its students.

**Private School Reference Materials**

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<tr>
<td>Compliance Report of Institutions of Higher Education</td>
<td>Required by the Office for Civil Rights of the Department of Education from colleges and universities that receive, are applicants for, or expect to be applicants for federal financial assistance. A copy of this report, which contains racial and ethnic enrollment data, should be available at the college.</td>
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<td>Assurance of Compliance with Title VI of the Civil Rights Act of 1964</td>
<td>Formal educational institutions must file with the Office for Civil Rights of the Department of Education to receive federal assistance. If the organization was required to file, it should have a copy. Review the form and verify the information on it during the examination. If the school doesn’t have a copy of the form it filed, the school can obtain one by writing the Department of Education, Office for Civil Rights, 400 Maryland Avenue, Washington, D.C. 20202.</td>
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<tr>
<td>Rev. Rul. 71-447, 1971-2 C.B. 230</td>
<td>Holds that a private school that doesn’t have a racial nondiscrimination policy as to students doesn’t qualify for exemption. A “racial nondiscrimination policy as to students” is defined as “meaning that the school admits the students of any race to all rights, privileges, programs, and activities generally afforded or made available to students at that school.” Also, the school doesn’t discriminate by race in</td>
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<td>Rev. Rul. 75-231, 1975-1 C.B. 158</td>
<td>Holds that organizations, including churches that operate schools with a policy of refusing to accept children from certain racial and ethnic groups aren’t recognized as tax-exempt charities under IRC Section 170 and IRC Section 501(c)(3).</td>
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<td>Rev. Proc. 75-50, 1975-2 C.B. 587</td>
<td>Gives guidelines and recordkeeping requirements for determining if private schools applying for recognition of exemption under IRC Section 501(c)(3), or are currently recognized exempt, have a racially nondiscriminatory policy as to students.</td>
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<td>The Family Educational Rights and Privacy Act of 1974, 20 USC (1974) cited in of section 7.02-2 of Rev. Proc. 75-50</td>
<td>Restricts an examiner’s access to certain school student educational records. The Act prohibits a school from releasing personally identifiable information in its educational records to anyone except the affected students or their parents unless the student’s parents give advance written consent, or the release is made to comply with a court order or lawfully issued subpoena, and advance notice of each release is given to the affected student and his or her parents. <strong>Caution</strong>: A school that violates these provisions can become ineligible for certain federal aid. Thus, carefully observe the Act’s restrictions.</td>
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| Pre-Audit Analysis Tools | Use these two powerful search engines before the initial field appointment:  
1. Private School Universe Survey  
2. Integrated Postsecondary Education Data System covering postsecondary institutions.  
Use data mining and look up certain individual schools and compare:  
- private institutions in that area.  
- individual schools with their Public School District.  
- pricing and tuition for that particular area.  
- admissions with other private schools.  
- student financial aid.  
- local and national graduation rates |
The Family Educational Rights and Privacy Act of 1974 does not apply to:

a) “Directory information”- the student’s name, address, telephone listing, birth date, birth place, major field of study, participation in officially recognized activities and sports, weight and height of members of athletic teams, dates of attendance, degrees and awards received, and the most recent previous educational agency or institution attended by the student.

b) Data assembled by group, or otherwise limited to information that isn't personally identifiable. So, the Act doesn't prohibit release of statistics that don't identify individuals, even though the school may collect the information from individual records.

c) Records otherwise restricted by the Act if they deleted all personal identifying information (names, social security number, address, etc.).

d) Any information about persons who have never attended the school. So, you can request information about unsuccessful applicants.

e) Personal identification information of the kind contained in school records obtained independently from sources other than the school.

Private School Legal Decisions
Some legal decisions that considered whether private schools discriminated include:

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<td><strong>Bob Jones University v. United States</strong>, 461 U.S. 574; 103 S. Ct 2017 (1983)</td>
<td>The U.S. Supreme Court upheld the scope and exercise of the IRS’s authority to deny tax-exempt status to private schools maintaining a racially discriminatory policy. The Court held that the school, which prescribes and enforces racially discriminatory standards by religious doctrine, doesn't qualify for exemption under IRC Section 501(c)(3). The Court held that racially discriminatory private schools violate a fundamental public policy and can't be viewed as conferring a public benefit within the common law standards of charity and congressional intent underlying IRC Section 501(c)(3).</td>
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<td><strong>Runyon v. McCrary</strong>, 427 US 160 (1976)</td>
<td>The Supreme Court held that the civil rights statute, which provides that all persons within the jurisdiction of the United States have the same rights to make and enforce contacts as enjoyed by white citizens, prohibits private, commercially-operated, nonsectarian schools from denying admission to prospective students because they are black.</td>
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<td><strong>Prince Edward School Foundation v. United States</strong>, 478 F. Supp. 107 (D.D.C. 1979), affirmed by unpublished order No. 79-1622 (D.C. Cir.)</td>
<td>In a suit for declaratory judgment brought by a nonprofit private school seeking a ruling declaring it to be a tax-exempt organization, the court held that schools administering a discriminatory admissions policy must be</td>
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Brumfield v. Dodd, 425, F. Supp. 528 (E.D. La. 1976) Similar criteria to the Norwood case were applied in this case to consider the eligibility of certain Louisiana private schools for state aid.

**Conditions Specific to Mississippi School**

On May 5 and June 2, 1980, the U.S. Supreme Court modified and supplemented the permanent injunction originally issued in 1971 that required the IRS to survey Mississippi private schools, including church-related schools. A test was applied to the schools, and if failed, would result in a rebuttable inference of racial discrimination. The modified order precluded the IRS from allowing or continuing exempt status of Mississippi private schools or organizations that operate schools that:

- Were determined to be racially discriminatory in adversary or administrative proceedings; or were established or expanded at or about the time the public school districts where they are located or that they serve were desegregating.
- Can't demonstrate that they don't racially discriminate in admissions, employment, scholarships, loan programs, athletics, or extra-curricular programs.

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<td><strong>Green v. Connally</strong>, 330 F. Supp. 1150 (D.D.C. 1971), affirmed per curia sub nom. Coit v. Green, 404 U.S. 997 (1971)</td>
<td>The court held that neither IRC Section 501(c)(3) nor IRC Section 170 provide for tax-exempt status or deductible contributions to any organization operating a private school that discriminates in admissions based on race. The court permanently enjoined the IRS from recognizing exemption or allowing deductions for contributions to any organization operating a private school in Mississippi that failed to adopt, publish, and operate under a racial nondiscrimination policy for its students and that failed to supply the IRS with certain information to ensure nondiscriminatory operation.</td>
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If a school has any conditions, previously discussed, raising an inference of present discrimination against minorities, it can overcome discriminatory status via clear and convincing evidence that reveals objective acts and declarations establishing that it isn't directly caused by the school's policies and practices. Evidence might include, but isn't limited to:
• Proof of active and vigorous recruitment programs to secure minority students and teachers, including students’ grants-in-aid; or proof of continued, meaningful communication between the school and minority groups and leaders in the community about the school’s nondiscriminatory policies; and
• Any other similar evidence showing that the school and all its facilities and programs are in fact open to students and teachers of all races on the same standard of admission or employment.

**Private School Pre-Audit Steps**

These steps can determine if a private school has adopted and operates by a racial nondiscrimination policy for its students. The audit scope depends on the facts and circumstances and the extent to which the school currently enrolls a meaningful number of minority students.

• Complete Form 5788, Private School Racial Nondiscrimination Checksheet, to ensure you made and secured all of the required checks and information.
• Request the following information and document its availability at the initial interview:
  o Current brochures, catalogues, and any other written advertisements dealing with student admissions, programs, and scholarships.
  o Blank application forms for employment, student admissions, scholarships, loans, or any other financial aid.
  o Documentation of how the racial nondiscrimination policy has been publicized and a copy of the advertisement to ensure size, location, and other elements.
  o Statistical data on the racial and ethnic composition of students and staff.
  o Correspondence files relating to fund solicitations, contributions received, acceptance and rejection of students, and denial or approval of scholarships, loans, or other student aid.
  o Schedule for tuition and fees.
  o Copy of the Assurance of Compliance with Title VI of the Civil Rights Act of 1964 by the Office for Civil Rights of the Department of Education, and any other applications or agreements concerning federal aid from, through, or under the Veterans Administration; Department of Health and Human Services; National Defense Education Act; National Science Foundation; or Food and Nutrition Service of the Department of Agriculture (e.g., Department of Agriculture Form 67, relating to the national school lunch program). This assumes that the school is receiving federal funds.
  o Copies of any other government agency reports of investigation or audit of the school’s compliance with any federal, state or local law requiring racially nondiscriminatory operations. If the school claims to have been investigated or audited by another government agency but doesn't have a copy of the report, ask the school to help obtain a copy of the report and relevant background information.
Document Analysis

Review all items above to the extent needed to determine if the school operates on a racially nondiscriminatory basis and that it otherwise qualifies for exemption. Request documentation to support conclusions.

Review governing documents and bylaws to determine if the school has adopted a racial nondiscrimination policy for its students. The school must affirmatively show this policy adoption via a statement in the school’s charter, bylaws, or other governing instrument, or by a resolution of its governing body. (Rev. Proc. 75-50, section 4.01).

Review meeting minutes of the Board of Directors and other committees for any statements or actions that show whether the school complies in good faith with its racial nondiscrimination policies or activities.

Identify when the school was formed and when any significant changes occurred in the size and racial composition of the student body. Compare these dates to the dates of court-ordered or voluntary local public school desegregation. Contact the local school board or state department of education, if necessary, for information on public school desegregation orders or voluntary plans, including the dates of actions and the relevant minority groups in the area.

Determine if the school has made any special efforts to disseminate application forms, brochures, or information about the school’s scholarship programs or other programs, and its racial nondiscrimination policy.

Review Board minutes from two or three prior years to learn how the school actually carries out its policies and programs.

Determine the effect on the nondiscrimination policy of any changes in:

- Governing documents
- Bylaws
- Board resolutions
- Admissions policy
- Tuition rates
- Recruitment practices
- Employment policies
- Property holdings
- Scholarship, loan or financial aid programs
- Standards regarding the implementation of the school's nondiscriminatory policy.

Obtain sources of information that can show if the school operates in good faith compliance with its racial nondiscrimination policy. Conversely, if the school explicitly or tacitly discourages any minority groups from attending or takes actions to make any minority groups feel unwelcome, review the following:

- News releases or news articles
- Articles about the school’s efforts to promote its racially nondiscriminatory policy and to recruit students from racial and ethnic minority groups
- Athletic, or extra-curricular activities with other discriminatory or nondiscriminatory organizations
• Seminars or speeches at the school by minority group leaders
• Brochures, yearbooks and other student publications
• School correspondence files and publicity scrapbooks

If the school uses newspapers to notify the public of its nondiscrimination policy, determine if it published the notices in a newspaper of general circulation that serves all racial segments of the community (section 4.03 of Rev. Proc. 75-50), and determine whether:
• The notice:
  o meets the format type and size requirements.
  o includes the approved statement identified in Rev. Proc. 75-50 or other acceptable statement; and
• The publication was distributed annually during the registration period or student solicitation period.

If the school publicized its racially nondiscriminatory policy by broadcast media, review copies of tapes, transcripts, or records showing the number, duration, and time periods the policy statement was broadcast to determine if it was effectively communicated to all segments of the general community served by the school.

Determine if the notice was broadcast during the school's registration period(s), or student solicitation period(s). Determine if the broadcast announcement used a language reasonably equivalent to the language in the suggested newspaper statement per Rev. Proc. 75-50 section 4.03-1(a).

Determine if the school has communicated its racial nondiscrimination policy statement directly to leaders of minority groups. If the school does it in addition to meeting the newspaper or broadcast publicity requirements of Rev. Proc. 75-50, 1975-2 C.B. 587, it would suggest good faith compliance to a nondiscrimination policy.

Determine if the school has included the required statement of its racially nondiscriminatory policy in its admissions programs, its scholarship brochures & catalogues. The following statement is acceptable:

“The M School admits students of any race, color, and national or ethnic origin to all the rights, privileges, programs, and activities generally accorded or made available to students at the school. It doesn't discriminate on the basis of race, color, national or ethnic origin in administration of its educational policies, admissions policies, scholarship and loan programs, and athletic and other school-administered programs.”

Verify whether the school has made the mandatory reference to its racially nondiscrimination policy in other written advertising to inform prospective students of its programs.

Determine if the school has publicly disavowed or repudiated any statements purportedly made on its behalf, after November 6, 1975, that contradict its current stated policy of racial nondiscrimination to the extent that the school or its principal
officials revealed as they were aware of such statements. (See Rev. Proc. 75-50, section 4.03-2).

Interview community members, such as leaders of minority groups and members of the public school board, about their perception of the school’s admission policies. Any “investigative disclosure” is authorized by IRC Section 6103(k)(6) and Treas. Reg. 301.6103(k)(6)-1. (See Part 11, Communications and Disclosure.)

Verify that the organization has executed all annual certifications required by Rev. Proc. 75-50, section 4.06 as a part of any required Form 990, Return of Organization Exempt From Income Tax. If the organization isn't required to file Form 990, verify the organization filed Form 5578, Annual Certification of Racial Nondiscrimination for a Private School Exempt from Federal Income Tax.

Determine if the school has satisfied the record keeping requirements of Rev. Proc. 75-50, 1975-2 C.B. 587, such as, independent records or copies of reports filed with any federal, state, or local government agency that show the racial composition of the student body, faculty and administrative staff for each academic year. They may estimate based on the best information available without requiring student applicants, students, faculty or administrative staff to submit information that the school otherwise doesn’t require.

Agencies requiring the above racial composition information include state boards of education, city or county school districts, Equal Employment Opportunity Commission, Department of Labor Office of Federal Contract Compliance, Office for Civil Rights of the Department of Education, federal or state courts, Department of Veterans Affairs, or the Food and Nutrition Service of the Department of Agriculture.

Verify that the school keeps copies of all fund solicitations and brochures, catalogues and advertisements dealing with student admissions, programs and scholarships, as required by Rev. Proc. 75-50, section 7.01.

Verify documentation showing scholarships and financial assistance as awarded on a racially nondiscriminatory basis.

Check class photographs on school walls or in student yearbooks for evidence of racial and ethnic composition of students.

**Parochial and Religious School Considerations**

Parochial and religious schools may present special challenges when it comes to keeping the required records. They must maintain a written track record to comply with the school’s racial nondiscriminatory policies and practices in recruiting and admitting students.

Determine if the school:

- Regularly recruits minority students.
- Confines any promotion or recruitment efforts to students of one or more minority group. If possible, review records of rejected and accepted applicants to compare the racial composition of the rejected applicants to the racial composition of those accepted.
• Adjusts its admission standards in an effort to increase minority enrollment. Schools that favor racial minority groups in admissions, financial aid, or facilities and programs aren't discriminating by race if their purpose is to promote the establishment and maintenance of the school's racial nondiscrimination policy.

• Intentionally sets tuition beyond the practical reach of all or nearly all of the families in a particular racial or ethnic group.

• Requires the Board of Directors to review some or all applications for admission and document the reasons for the required review.

• Requires parents to appear at the school or elsewhere to apply or register. If so, determine if this is a subtle means to identify and block minority applicants.

Identify any enrollment limits the school has set. Determine how they set the limits and enforces the limits. Determine any exceptions made to enrollment limits.

Review the school’s practices for waiting lists. Identify any applicants accepted out of sequence and if so, why.

Determine the cash deposit required at the time of registration or application. Determine if all applicants are required to pay the same amount and if a refund policy exists.

Follow up with any leads tending to show either presence or absence of discrimination towards students and document any information. Compare the school’s racial mix with other private schools in the same general area and determine the reasons for any notable disparities.

Review the student application form for any evidence of a racially discriminatory admissions policy. Determine whether the application requires a photo or information about race.

Determine if the school has adequately publicized its registration period and whether it allows advance registration or other priority for children of founders or contributors. If the school allows any advance registration, determine if this significantly reduces the spaces available during the “official” registration period.

Determine if the school asserts religious tenets to reject applicants from certain racial or ethnic groups, or to prohibit or restrict interracial relationships among students.

Determine if the school operates any facilities or programs, such as cafeterias, athletic events, community events (i.e. parades and marching band demonstrations), adult evening classes, or any other extracurricular activities in a racially discriminatory manner.

Determine if the school has invited any racial and ethnic groups or leaders to attend or participate in any of the school’s activities and, if not, why.

Determine if the school restricts extracurricular activities, including athletics, to public or private schools that have no students from racial or ethnic minority groups.

Determine the criteria for granting the use of its facilities to outside groups. Identify the reasons for denying any groups permission to use school facilities.
Review the school’s faculty and staff hiring policies and practices to determine if they are racially nondiscriminatory:

- Determine the racial and ethnic composition of the faculty, staff, and administrators. Review student yearbooks for evidence of racial and ethnic composition of faculty, staff, and administrators.
- Review employment applications and related correspondence for rejections based on racial and ethnic reasons. Determine whether the application form asks for a picture or information about race.
- Determine whether standards for employment are higher for minorities.
- Determine if compensation is a factor of race.
- Determine if the school actively recruits faculty and staff. If so, determine if it recruits only among one or more specific racial or ethnic groups. If the school concentrates its recruiting at specific colleges or universities, determine if it recruits at any predominately black colleges or universities. If not, determine if there are any predominately black institutions within the same distance from the school as the colleges or universities where it does recruit.
- Determine if the school contracts with private agencies to hire employees. If so, determine if the agencies recruit on a racially nondiscriminatory basis.
- Determine the reason for no minority employees, if applicable.

Determine if the school is accredited and, if so, by what organization. Does the accrediting organization:

- Embrace a policy of racial segregation.
- Consist of all or nearly all member schools who have a common feature of having no students from racial or ethnic minority groups.
- Provide prospective employment lists or job referral services for their members and whether the recruitment or referral system is racially nondiscriminatory.
- Associate with, or work with local or state governmental agencies.

Determine if the school has any diversity awareness training or similar programs to prepare current students and staff for minorities in the future. Also, determine if the school has taken any special steps to prevent harassment of minority students who enroll, or attempt to enroll in the school, or if it has made efforts to help minority students adjust to their new environment. Determine any instances of racial harassment at the school, and determine what disciplinary or other steps school officials have taken to prevent reoccurrence.

**Grants and Awards To and From Private Schools**

For grants of financial aid, determine if grants are awarded on a racially nondiscriminatory basis. Determine if the school publicizes the availability of aid and whether preferential treatment is given to members of one or more racial groups. See Rev. Proc. 75-50, section 4.05.

Review all applicable requirements for each form of financial aid and obtain sample application forms.

Identify the aggregate number and the amount of all scholarships and loans awarded to each racial or ethnic group for the year(s) under audit.
Determine if the school announces the availability of financial aid on a racially nondiscriminatory basis in catalogues, brochures, published newspaper notices, broadcast media notices, or other written advertisements. Consider student aid of free housing, books or not enforcing tuition debts financial aid for this purpose.

Review the school’s policy on collecting bad debts to determine if a lax policy is used as an indirect financial aid. If so, determine who benefits from the lax policy.

Determine if independent sources provide tuition assistance to students. Foundations or funds in the area may provide financial assistance. If so, determine if the assistance furthers or hinders a racial nondiscrimination policy.

For rented or free textbooks provided by a state or local government, determine if:

- The school participates in the program. If not, find out why and to what extent textbooks used by the school differs from those available from governmental sources.
- The school participates in any other federal, state or local government assistance program available to it and, if not, why not.
- There were rejections of any of the school’s applications for federal, state or local government assistance.
- State certification is required for state textbook assistance.

Determine if any contributions (such as land, buildings or other property) made to the school subjects them to covenants or other conditions by restricting certain racial or ethnic groups from using them. If so, determine if the conditions prevent the school from operating in furtherance of a racial nondiscrimination policy.

Determine if the facts and circumstances surrounding the contribution warrant a referral to Large Business & International (LB&I), for considering disallowing a deduction for the gift.

For any gift or bargain sale transactions, inspect all documentation. Determine if the gift or bargain sale had the intent of fostering a racial discrimination policy.

**Corrective Action on Private School Cases**

Don’t propose revocation of a school's exempt status based solely on a failure to comply with a particular requirement of Rev. Proc. 75-50, 1975-2 C.B. 587. Consider facts and circumstances. Rather, the appropriate action may be to give the school an opportunity to correct to conform to the particular requirement of Rev. Proc. 75-50.

If, for example, you have information from a private school audit that shows, because of its racial constituency or other facts, the school practices a racial nondiscrimination admissions policy, and the school has satisfied all the requirements of Rev. Proc. 75-50 except that their brochures don’t contain a statement concerning its racial nondiscrimination admission policy. The school can then revise the brochures to include the racial nondiscrimination statement.

For all cases in which a private school agrees correct to conform to the private school compliance requirements of Rev. Proc. 75-50, 1975-2 C.B. 587, make every attempt to have the school fully comply with all the requirements of Rev. Proc. 75-50 before you
close the audit. If not feasible, prepare a no-change advisory letter, advising the organization of the corrective action it has agreed to take. Prepare Form 5666, TE/GE Referral Information Report, for follow-up action within the year following the audit year.

Follow-up action is mandatory on all cases involving corrective action. The follow-up action may be an audit, if warranted, or it may simply involve contacting the private school and soliciting certain information. For example, if the corrective action is similar to the example above, in which the private school ensures that future brochures will contain a statement about its racially nondiscriminatory admissions policy, it may be enough to contact the private school and secure the brochures.

If a school doesn’t comply with the guidelines, it ordinarily results in proposed revocation of exemption (Rev. Proc. 75-50, section 4.08). Therefore, if a school won’t agree to make correction necessary to comply with the guidelines, consider proposing adverse action. However, if you’re uncertain what the appropriate actions should be, request technical advice.

Don’t consider corrective action when a proposed revocation is warranted. If the facts and circumstances adequately show a school has actually practiced racial discrimination, propose revocation of the school’s exempt status, even though the school agrees to change its policy and practice in the future.

The United States District Court for the District of Columbia has ordered specific guidelines and record keeping requirements for Mississippi private schools. Green v. Connally, 330 F. Supp. 1150, affirmed sub nom. Coit v. Green, 404 U.S. 997 (1971). Don’t consider corrective action if a Mississippi private school hasn’t complied with the requirements of the Court’s order; propose revocation of the school’s exempt status.

**Charter Schools**

Charter schools provide an example of a public/private partnership designed to enhance educational opportunities for public school students. State charter school laws and policies vary widely. There are differences in the number of schools that may be established and their degree of autonomy. Requirements for charter school applicants and teachers and accountability criteria also vary from state to state.

Charter schools don’t charge tuition and are, for the most part, open enrollment, nondiscriminatory, nonsectarian educational institutions.

Charter schools are funded primarily by per-pupil allocations from the chartering agency (usually the public school district) equal to the per-pupil allocations made to the public schools.

Charter schools are considered public schools. The difference is charter schools generally aren’t operated directly by the public school district but under a separate charter or contract with a state or local agency that gives them public funds. The charter sets essential conditions for which the school is held accountable, but leaves the implementation of these terms to the charter school's board of directors. This frees the charter school from a number of regulations that otherwise apply to public schools and leaves room for innovation and experimentation.
There are several different operational models for charter schools. In some states, these schools are under the direct control of the school district. The school district contracts directly for management and educational services. Other states require a separate entity to run the school. For-profit and non-profit entities may be eligible to apply for a charter. State law may or may not require that the chartering organization be tax exempt under IRC Section 501(c)(3).

**Charter Schools Exempt Status**

The primary concern for charter schools is determining if they operate for exclusively charitable and/or educational purposes and don't operate for the benefit of private management companies and service providers.

For-profit businesses operating charter schools are ineligible for exemption under IRC Section 501(c)(3). If the public school district is an integral part of the municipal government, the public school and any charter school it operates doesn't qualify for exemption under IRC Section 501(c)(3), because it doesn't exist separately from the municipal government. The municipal government’s income is exempt from federal income tax under the theory of implied intergovernmental immunity. If the school district is separately organized and satisfies the requirements of Rev. Rul. 60-384, 1960-2 C.B. 172, the district merits recognition under IRC Section 501(c)(3) as long as it otherwise meets the exemption requirements.

Charter schools claiming the exclusion from gross income under IRC Section 115 should request a private letter ruling.

Organizations, whether for-profit or non-profit, operating schools under a charter agreement may have little or no experience in managing or establishing a school and often contract for services including, curriculum design, financial management, office management, and special education services. Comprehensive school management companies are growing in the educational sector. They offer a complete program of both management and educational services.

When auditing a charter school that has contracted with for-profit entities for management services, determine whether the charter school board remains in control and continues to exercise its fiduciary responsibility to the school.

The board may not delegate its responsibility and ultimate accountability for the school's operations to a for-profit management company. Otherwise, it raises the issue of whether the organization is operating for the private benefit of that company.

**Charter School Audit Guidelines**

Determine if an Independent Board of Directors governs the charter school. A charter school board of directors substantially made up of parents, teachers, and community leaders provides structural independence. A board appointed or dominated by a comprehensive management company, on the other hand, raises questions as to whether the school operates for the benefit of the management company.

Determine the degree in which a structurally independent board is actively involved in overseeing the school's operations or whether the board delegated its duties and responsibilities to the management company.
Evaluate all the facts and circumstances. A board must show true independence, rather than serving as the front for a management company. While it’s impossible to specify every duty and responsibility of a board, these actions demonstrate independence:

- Regular meetings
- Conflict of interest policies
- Oversight
- Fiscal responsibility

Regular board meetings enable directors to play an active role in the school’s direct activities and continually oversee the management company, who carries out its wishes under contract. One or two meetings per year are generally insufficient to establish that the board members are exercising independent control. Board meeting minutes should reflect the board decisions and items considered at each meeting.

The board should have a conflict of interest policy requiring members to disclose all financial interests they have in any service provided to the school. Review the by-laws to determine how conflicts of interest are resolved or recorded.

The board should oversee the management company’s operations and retain the ultimate responsibility for meeting the charter terms. The board, rather than the management company, should set and approve broad school policies such as the budget, curriculum, admissions procedures, student conduct, school calendars, and dispute resolution procedures.

The board should be responsible for and take appropriate action to ensure the school’s fiscal health.

Review contracts and agreements to determine arm’s length negotiation. A charter school must show that they’ve negotiated contracts, especially comprehensive management contracts, at arm’s length and they benefit the school rather than the service provider.

Boilerplate contracts may indicate that the terms of the contract weren’t negotiated between independent parties. If the same attorney represents both the school and the management, it’s also an indication that negotiations weren’t at arm's-length.

Review the terms of the contract. When reviewing a charter school contract for management services, determine whether the terms are consistent with fulfilling the school’s exempt purposes. Some contract terms may evidence that the school is operated for the benefit of the management and preclude exemption.

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<th>Area of Concern</th>
<th>Description</th>
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<td>Length of Contract</td>
<td>A contract’s length can greatly influence the board’s ability to monitor and evaluate the management’s performance. There is a need to balance the management’s interest in a long-term contract with the school's need for flexibility in changing companies and meeting its fiduciary responsibility.</td>
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<tr>
<td>Board Policies</td>
<td>A charter school’s general policies on operation and management shouldn't be contracted. These board</td>
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| **Services** | Comprehensive school contract packages place much of the control of the day-to-day operations in management’s hands. Responsibilities of both the company and the school should be stated in the contract. |
| **Personnel** | Principals, teachers and staff may be employed directly by the school or may be employees of the management. However, the existence of an anti-compete clause prevents a school from hiring the personnel used to operating its school (principals, teachers, etc.) for a specific length of time after the management contract terminates. This practice usually serves the management’s private interests and limits the school's ability to terminate the contract. |
| **Compensation** | Management fees must be reasonable and commensurate with the services provided. A management fee structure shouldn't be based on total income (in other words, all fees, grants, contributions, and unusual receipts). Compensation shouldn't be above the market rate generally charged for the service provided. Determine this by comparing compensations and services. |
| **Termination** | A service contract should specify the provisions for termination and the procedure for evaluating when the terms of the contract are in default. Termination provisions that unreasonably restrict and limit the school’s options show private benefit to the service provider. |

Consider name identification. In many cases, contracts require a charter school to attach the management's name to the school (for example, Company X Charter School or Charter School, a Company X affiliate). “Name branding” has no clear exempt purpose. It links management companies to exempt schools and allows the company to draw goodwill from the relationship. It allows the management companies to build name recognition without additional expense. It also places a contractual burden on the charter schools, making it more difficult for the school to terminate the relationship with the management. A “name branding” requirement may be an indicator of private benefit depending upon the facts and circumstances.

Analyze ancillary services provided. Comprehensive school management companies may provide other services directly or through affiliates. These services may include cash advances for start-up funds, capital loans, facility leasing, technology contracting, furnishings, fixtures, textbooks, and just about anything else a charter school may need. The IRS recognizes that these services are essential for start-up schools.

Scrutinize agreements carefully to determine whether the terms were the result of arm's-length negotiation with an independent charter school board or are, in effect, adhesion contracts with a captive school board.
Charter Schools Filing Requirements
Charter schools must file Form 990, Return of Organization Exempt From Income Tax, or Form 990-EZ. Their annual gross receipts generally exceed $50,000, and they rarely meet the filing exception in Rev. Proc. 95-48, 1995-2 C.B. 418.

Ordinarily, charter schools aren't treated as governmental units or affiliates of governmental units because they aren't “operated, supervised, or controlled by” a governmental unit. Most charter schools operate under a contract with the governmental unit and the governmental unit doesn't elect or appoint the school's board of directors.

Universities and Colleges
A university is an institution for higher learning with teaching and research facilities comprising an undergraduate school that awards baccalaureate degrees and one or more graduate schools that award masters or doctoral degrees.

A college is an institution of higher learning that grants baccalaureate degrees. The institutions also frequently used the term to describe undergraduate divisions or schools of a university that offer courses and grant degrees in a particular field such as liberal arts or law. "College" as used in these guidelines also includes institutions that offer two-year educational programs, such as junior or community colleges.

UBI Considerations for Private and Charter Schools
Identify each unrelated business income (UBI) activity reported separately to determine whether there is a gain or loss in the year under exam for that activity.

Calculate UBI by totaling the UBI from all activities and subtracting the total allowable deductions. Losses from one activity can offset profits from another. Accordingly:

- Investigate the source of all allocated expenses.
- Identify the allocation method used to allocate the expenses between related and unrelated use.
- Determine if the activity is directly connected to the unrelated business activity.
- Determine the history behind UBI activities which resulted in losses. A pattern of losses for five or more years indicates a lack of profit motive, justifying a disallowance of that activity from the return.
- Check the calculations which led to net operating losses reported on returns.
- Substantiate the expenses the business incurred over the years resulting in net operating losses. Look beyond the calculations.
- Audit each UBI activity to determine if each “unrelated” activity is properly classified.

Identify UBI activities reported that involve dual use of facilities.

Review the organization’s activities to ensure that it reported all unrelated business activities producing income on Form 990-T, Exempt Organization Business Income Tax Return.
Excessive Compensation and Excess Benefit Considerations for Private and Charter Schools

When evaluating excessive compensation and excess benefit transactions under IRC Section 4958, focus on:

- Determining whether the comparability data closely matches the school based on location, endowment size, revenues, total net assets, number of students and selectivity.
- Identifying whether comparability studies documented the selection criteria for the schools in the study. The study has to explain how those schools compared to the school under audit. Merely providing charts of data is inadequate.
- Identifying if a compensation survey specifies whether amounts reported include only salary or total compensation. See Treas. Reg. 53.4958-4, which spells out all forms of cash and non-cash compensation. (An organization may shift the burden of proving unreasonable excess compensation to the IRS by following the rebuttable presumption standard.)

When conducting employment tax audits, verify if:

- Reported employee income includes the personal use of automobiles, housing, social club memberships and travel.
- Employees were erroneously classified as independent contractors.
- Employers withheld Social Security and Medicare taxes on wages paid to non-resident aliens.
- Graduate tuition waivers and reimbursements were included in wages.

See IRC Section 117(d)(1) which discusses the tuition reduction benefit being primarily for education below the graduate level, including exceptions.