

J. CHARTER SCHOOLS

by

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1. Introduction

The charter school movement has garnered publicity and stimulated debate as it has moved across the nation. According to Department of Education statistics, thirty-five states, the District of Columbia and Puerto Rico have already sanctioned charter schools and 3,300 charter schools are expected to be approved and begin operations in 1999. In an effort to assist these schools in obtaining tax exemption, the IRS has participated in the Department of Education's 1999 Charter Schools National Conference, offered training to our District personnel, and held several informal conferences with individuals in the planning stages of creating new charter schools. We plan to continue our educational outreach efforts and are pleased to highlight our concerns.

2. What are Charter Schools?

Created by state law, charter schools are 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 with respect to the number of schools that may be established and the degree of autonomy they are permitted to exercise. Requirements for charter school applicants and teachers as well as accountability criteria that charter schools must meet also vary from state to state. Charter schools do not charge tuition and are, for the most part, open enrollment, nondiscriminatory, nonsectarian educational institutions. They 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. What is different is that charter schools generally are not operated directly by the public school district but under a separate charter, a contract with a state or local agency that provides them with public funds. The charter sets forth essential conditions for which the school will be 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. Some states require a separate entity to run the school. For-profit as well as 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 501(c)(3).

3. Exemption Under IRC 501(c)(3)

For-profit businesses operating charter schools are not eligible for exemption under IRC 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 will not qualify for exemption under IRC 501(c)(3), as it has no separate existence from the municipal government. The income of a municipal government 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 may be recognized under IRC 501(c)(3) provided it otherwise meets the requirements for exemption.

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 a myriad of services including, among others, curriculum design, financial management, office management, and special education services. Comprehensive school management companies are a growing presence in the educational sector and offer a complete program of both management and educational services. For a charter school to establish exemption under IRC 501(c)(3), whether it purchases some or all of the services required to operate, it must establish that it is organized and operated for the benefit of the public and not for the benefit of any private person, such as a service provider.

When considering exemption with respect to charter schools that have contracted with for-profit entities for management services, the Service is particularly interested in 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 without raising the issue of whether the organization is operating for the private benefit of that company. The following discussion highlights some of the factors the Service considers when looking at a charter school application and discusses the concerns regarding independence of the board of directors and the arms-length negotiation of contracts.

A. Independent Board of Directors

A charter school board of directors composed of parents, teachers and community leaders provides structural independence. A board appointed or dominated by a comprehensive management company raises questions as to whether the school will be operated for the benefit of the management company. In considering exemption under IRC 501(c)(3), the Service looks to whether a structurally independent board is involved in active oversight of the school's operations or whether the board has delegated its duties and responsibilities to the management company.

To establish active oversight, the Service evaluates all the facts and circumstances. A board must show that it is not a front for the benefit of the management company. While it is impossible to specify every duty and responsibility a board should undertake, the following are some indicia of independence:

(1) Regular Meetings

Regular board meetings enable directors to play an active role in the direct activities of the school as well as to exercise continual oversight of the management company carrying out its wishes under contract. One or two meetings per year are generally insufficient to establish that the board members are exercising any independent control. Board meeting minutes should reflect the decisions of the board and items considered at each meeting.

(2) Conflict of Interest

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. Procedures for determining when a conflict of interest exists, for addressing the conflict and for recording the resolution of the conflict should be included in the school by-laws. See CPE-2000, Tax-Exempt Health Care Organizations Revised Conflicts of Interest Policy, topic E, for additional information regarding conflicts of interest.

(3) Oversight

The board should oversee the operations of the management company and retain the ultimate responsibility for meeting the terms of its charter. 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.

(4) Fiscal Responsibility

Boards should have the responsibility and take appropriate action to ensure the fiscal health of the school.

B. Arm's Length Negotiation

To establish exemption under IRC 501(c)(3), a charter school must show that contracts, especially comprehensive management contracts, have been negotiated at arm's length and are for the benefit of the school rather than the service provider. Boilerplate contracts may be an indicia that the terms of the contract were not the subject of negotiations between independent parties. Representation of both the school and the management company by the same attorney is also an indication of the absence of arm's length negotiations.

C. Contract Terms

When reviewing a charter school contract for management services, the Service is concerned that the terms be consistent with fulfillment of the school's exempt purposes. Some contract terms, may result in a finding that the school is operated for the benefit of the management company and preclude exemption. Areas of concern include:

(1) Length of Contract

The contract's term greatly influences the board's ability to monitor and evaluate the management company's performance. There is a need to balance the management company's interest in a long-term contract with the school's need for flexibility in changing companies and meeting its fiduciary responsibility.

(2) Board Policies

The general policies concerning the operation and management of a charter school should not be contracted away. These broad policies help define the school's identity.

(3) Services

Comprehensive school contract packages place much of the control of the day-to-day operations in the hands of the management company. Responsibilities of both the company and the school should be stated in the contract.

(4) Personnel

Principals, teachers and staff may be employed directly by the school or may be employees of the management company. However, the existence of an anti-compete clause prevents a school from hiring the personnel that it has utilized in operating its school (principals, teachers, etc.) for a specific length of time after termination of the management contract. This practice usually serves the private interests of the management company and limits the school's ability to terminate the contract.

(5) Compensation

Management company fees must be reasonable and commensurate with the services provided. A management fee structure should not be based on total income (i.e., all fees, grants, contributions, and unusual receipts). Compensation should not be above the market rate generally charged for the service provided. This can be established through evidence of comparative shopping for services.

(6) 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 options of the school are evidence of private benefit to the service provider.

D. Name Identification

In many cases, contractual provisions require a charter school to attach the management company's name to the school (i.e., 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 company. A "name branding" requirement may be an indicator of private benefit depending upon the facts and circumstances.

E. Ancillary Services

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 Service recognizes that such services are essential for start up schools. However, the Service will examine these 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.

4. Rev. Proc. 75-50

Rev. Proc. 75-50, 1975-2 C.B. 587, sets forth guidelines and recordkeeping requirements for determining whether private schools have a racially nondiscriminatory policy as to students. As public schools, subject to open enrollment, charter schools are not required to meet the specific guidelines set forth in Rev. Proc. 75-50. These guidelines and recordkeeping requirements are discussed further in Topic N. Private School Update of this CPE text.

5. Filing Requirements

Charter schools must file Form 990, Return of Organization Exempt From Income Tax, or Form 990EX, Short Form Return of Organization Exempt From Income Tax. Their annual gross receipts are generally more than \$25,000, and they rarely meet the filing exception contained in Rev. Proc. 95-48, 1995-2 C.B. 418. (See, Topic N. Private School Update of this CPE text.) Ordinarily charter schools are not treated as governmental units or affiliates of governmental units because they are not "operated, supervised, or controlled by" a governmental unit. Most charter schools operate under a contract with the governmental unit and the governmental unit does not elect or appoint the school's board of directors.

6. Conclusion

States are adopting and refining charter school legislation at a remarkable rate. As this area develops, the Service's guidelines will continue to evolve. However, the general methods used for evaluating public purposes over private interests continue to be applicable. The Service will continue to be concerned that charter schools applying for exemption under IRC 501(c)(3) operate for exclusively charitable purposes and do not operate for the benefit of private management companies and service providers.