

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:TEGE:EOEG:EO1:MLSchäffer  
PRENO-119747-07


date: July 9, 2007

to: David L. Fish  
Acting Manager, SE:T:EO:RA:G

from: Michael B. Blumenfeld   
Senior Technician Reviewer, CC:TEGE:EOEG:EO2

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subject:  - Final Denial Letter







By memorandum dated 23 April 2007, you requested this office's concurrence in the issuance of a final adverse ruling to the subject organization. 



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**BACKGROUND**

 was formed as a not-for-profit educational management company to operate charter schools in . The charters at issue in this case are held by three tax-exempt organizations ("foundations"). These charters, issued by the  ("board"), authorize the foundations to organize and operate public charter schools. This authority includes the power to contract with third parties for services, equipment, and educational programs. The charters require that each such third-party service contract be submitted to the board for review and that it be subject to, and incorporate by reference, the terms and conditions of the pertinent charter. Each service contract must clearly delineate the respective roles and responsibilities of the service provider and the charter school.

 has management agreements with the foundations, under which it operates  schools, subject to the direction, oversight, and policies of the foundations.  operates an  school under direct agreement with the board. All of the public charter schools served by  are located in economically disadvantaged, inner city communities. The services  provides includes the development of specialized curriculum for inner city children, as well as providing curriculum materials; recruiting



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organization fails to meet either the organizational test or the operational test, it is not exempt.

Section 1.501(c)(3)-1(c)(1) 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 the exempt purposes specified in § 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)(i) provides that an organization may be exempt as an organization described in § 501(c)(3) if it is organized and operated exclusively for, *inter alia*, charitable or educational purposes.

Section 1.501(c)(3)-1(d)(2) provides that the term "charitable" is used in § 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in § 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of "charity" as developed by judicial decisions. Such term includes relief of the poor and distressed or of the underprivileged; advancement of education or science; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or, *inter alia*, to combat community deterioration and juvenile delinquency.

Section 1.501(c)(3)-1(d)(3)(i) provides that the term "educational", as used in § 501(c)(3), relates to (a) the instruction or training of the individual for the purpose of improving or developing his capabilities; or to (b) the instruction of the public on subjects useful to the individual and beneficial to the community. .

As an example of an organization which, if it otherwise meets the requirements of this section, is educational, § 1.501(c)(3)-1(d)(3)(ii), Example (1), provides a primary or secondary school, a college, or a professional or trade school, which has a regularly scheduled curriculum, a regular faculty, and a regularly enrolled body of students in attendance at a place where the educational activities are regularly carried on.

Section 1.501(c)(3)-1(e)(1) provides that an organization may meet the requirements of § 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of that trade or business furthers the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in § 513. In determining the existence or nonexistence of such *primary purpose*, all the facts and circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which further one or more exempt purposes.

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Section 509(a)(1) excludes from private foundation status organizations described in § 501(c)(3) other than an organization described in § 170(b)(1)(A) (other than in § 170(b)(1)(A)(vii) and (viii)).

Section 170(b)(1)(A)(ii) defines the term "educational organization" (the deduction for the charitable contribution to which is limited to 50 percent of the taxpayer's contribution base) as an organization which 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.

Section 170(c)(2)(B) provides that, for purposes of the deduction provided in § 170(a)(1), the term "charitable contribution" means, in part, a contribution or gift to or for the use of an organization organized and operated exclusively for charitable or educational purposes.

Section 1.170A-9(b)(1) provides that an educational organization is described in § 170(b)(1)(A)(ii) if its primary function is the presentation of formal instruction and it 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. The term includes institutions such as primary, secondary, preparatory, or high schools, and colleges and universities. It includes Federal, State, and other public-supported schools which otherwise come within the definition. It does not include organizations engaged in both educational and noneducational activities unless the latter are merely incidental to the educational activities.

## DISCUSSION & ANALYSIS

In determining whether █████ satisfies the operational test under § 1.501(c)(3)-1(c)(1), EO analyzed █████ activities in light of the three questions found pertinent by the court in University Medical Resident Services v. Comm., T.C. Memo 1996-251 (1996): whether the activities of the organization—

- contributed to the advancement of education;
- were substantially below cost; and
- were an integral part of achieving the exempt purpose of another organization exempt under § 501(c)(3).<sup>1</sup>

<sup>1</sup> The choice of University Medical as a template for analyzing and resolving the issue at hand might not be appropriate, since the organizations in that case never claimed to qualify independently as educational organizations, but rather to share in the exempt status of related organizations (a medical school, a dental school, and affiliated teaching hospitals) by application of the integral part test. █████ in contrast, is not claiming derivative exemption, but rather exemption as an educational organization and school in its own right under §§ 501(c)(3) and 170(c)(2)(B).

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Regarding the advancement-of-education test, EO states that the responsibility and authority to run the charter schools rest with the foundations, and nothing in the management agreements transfers any of the ultimate authority and fiduciary responsibility for the schools to [REDACTED]. [REDACTED] is simply a management company that has contracted with unrelated schools to provide comprehensive educational services for a fee, subject to foundation oversight. These services are provided to the foundations and further the exempt purpose of the foundations. [REDACTED] primary activity is the provision of services ordinarily conducted by commercial ventures for profit. Thus, [REDACTED] is not operated exclusively for an exempt purpose within the meaning of § 501(c)(3).

The crux of EO's argument in this case seems to be that the exempt purpose served by [REDACTED] activities (the education of elementary school children) is that of the foundations and not of [REDACTED]. In essence, [REDACTED] activities are attributed to the foundations for purposes of applying the operational test. We can find no authority for such a position, unless it is the common law of agency. We think EO is giving more significance than it should to the fact that [REDACTED] is providing services under contract to organizations directly responsible for running the charter schools, rather than conducting the educational activities under its own authority. EO most certainly is right in asserting that the management contracts under which [REDACTED] operates do not transfer responsibility for the schools to [REDACTED]; responsibility can not be delegated. By that standard, however, it is the charter-issuing authority (the school board) that retains ultimate responsibility for the educational activities being conducted at the charter schools – not [REDACTED], not the foundations. Authority, on the other hand, can be delegated. In this case, authority to carry out the exempt purpose of educating inner city children necessarily is delegated to [REDACTED].

Maintaining that [REDACTED] provides its educational services to the foundations holding the charters rather than to the children actually attending the charter schools is counterintuitive. At the very least, such a position presents a substantial litigating hazard in that a sympathetic court will see it as nothing more than a way to disqualify [REDACTED] and similar firms *ab initio*. See *B.S.W. Group v. Comm.*, 70 T.C. 352, 359 (1978) (“[W]e would be sympathetic to petitioner if... the research conducted... in fact furthered exclusively exempt purposes.”). EO states that [REDACTED] is not an educational organization because it does not directly provide instruction or training of the individual, as required by 1.501(c)(3)-1(d)(3)(i). However, the facts in the administrative record show that [REDACTED] develops the curricula and directly hires, supervises, and compensates the teachers who teach the children. EO states that [REDACTED] is not a school because it does not provide educational activities carried on through a regularly scheduled curriculum, etc., as required by § 1.501(c)(3)-1(d)(3)(ii) Ex.1 [§ 170(b)(1)(A)(ii)]. However, the record shows that for each school, [REDACTED] maintains a regular faculty, has

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Thus, any analysis under the integral part doctrine appears to be irrelevant.

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developed a specialized curriculum, has a regularly enrolled student body, and provides its school activities in a regular facility. It would be tough to argue before a court that the foundations are the actors here – the ones that conduct these activities – when the facts on the ground demonstrate otherwise.

Citing B.S.W. Group, 70 T.C. at 358, EO states that [REDACTED] primary activity is commercial in nature because it competes with for-profit educational management companies. This, too, seems counterintuitive, rooted as it is in the same assumption that [REDACTED] services are provided to the foundations and not to the children. The most obvious characterization of the services rendered by [REDACTED] is educational, and education, especially that of elementary school children, is not an activity ordinarily conducted by commercial ventures for profit, at least historically. Does the fact that commercial firms are venturing into this area due to the apparent failure of some local governments to provide an adequate education to all children (to children in certain urban areas, for example) mean that currently exempt schools and educational organizations now face disqualification on the basis of competition from these commercial firms? We think that commercial competition is stronger evidence of nonexempt commercial purposes where an organization's activities are not among those that further purposes expressly listed in § 501(c)(3) (the court in B.S.W. Group did not find the petitioner's consulting services in the area of rural-related policy and program development to be inherently charitable, educational, or scientific; 70 T.C. at 359).

All of [REDACTED] activities advance education, one of the purposes specifically listed as exempt under § 501(c)(3). However, case law tells us that it is not the nature of an organization's activities but the purpose toward which those activities is directed that ultimately is dispositive of an organization's claim for tax exemption. See, for example, B.S.W. Group, 70 T.C. at 356-357. This is a necessary corollary of the operational test under § 1.501(c)(3)-1(c)(1): to be exempt from tax under § 501(c)(3), an organization must engage primarily in activities that accomplish an exempt purpose specified in § 501(c)(3). A single substantial activity for a nonexempt purpose disqualifies an organization from exemption, despite the presence of any other exempt purpose. Better Business Bureau v. U.S., 326 U.S. 279, 283, aff'd 148 F.2d 14 (1945). However, an organization that operates a business as a substantial part of its activities may qualify under § 501(c)(3) as long as the conduct of that business furthers the organization's exempt purpose, and the organization is not organized and operated for the primary purpose of carrying on an unrelated business. Section 1.501(c)(3)-1(e).

The key to determining whether an organization, which might appear to be engaged in disqualifying commercial activities (for example, an organization providing services to an exempt organization under contract and in competition with commercial ventures), is qualified for exemption is whether any business purpose of the organization's activities is incidental to its charitable purpose, or vice versa. American Institute for Economic

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Research v. U.S., 157 Ct. Cl. 548, 555; 302 F.2d 934, 937-38 (1962), cert. denied, 372 U.S. 976 (1963). In other words, can such an organization be distinguished from a commercial venture?

Courts have identified factors that characterize a nonexempt commercial operation. See, for example, Easter House v. U.S., 12 Cl. Ct. 476 (1987), aff'd in unpub. opinion, 846 F.2d 78 (Fed. Cir.), cert. denied, 488 U.S. 907 (1988); Nonprofits' Insurance Alliance of Calif. v. U.S., 32 Fed. Cl. 277 (1994); B.S.W. Group, *supra*; American Institute, *supra*. These factors include:

- the commercial hue of the organization's activities;
- substantial profits;
- substantial accumulation of capital surplus in comparison to direct expenditures for exempt purposes;
- competition with commercial firms organized for profit (or the commercial nature of an organization's activities);
- lack of solicitation of contributions, grants, or government funds, or the lack of plans to make such solicitations (lack of resemblance to the financing of the typical tax-exempt organization);
- funding solely by substantial fixed fees (lack of financing resemblance);
- fees not being subject to downward adjustment to account for the ability of service recipients to pay (lack of financing resemblance);
- lack of coordination of activities with any government agencies;
- clientele not limited to exempt organizations;
- operating a business of a type typically carried on for profit, like the operation of a conference center (Airlie Foundation v. I.R.S., 283 F. Supp. 2d 258 (D.D.C. 2003) or the selling of insurance (Nonprofits' Insurance, *supra*); and
- structured and operated like a commercial organization.

Viewed in light of these factors, we think it would be very difficult to convince a court that [REDACTED] primary purpose is the conduct of a nonexempt commercial enterprise. [REDACTED] does compete with commercial companies organized for profit. In fact, one of the foundations under whose charter [REDACTED] operates [REDACTED] schools has contracts with a for-profit educational services company to run some of its other charter schools. [REDACTED] represents that this arrangement is for the purpose of allowing the foundation to compare the services rendered by a for-profit firm with those of a nonprofit organization. Arguably, this competition gives a commercial hue to [REDACTED] activities, which is evidence of a forbidden dominant purpose. As discussed earlier, however, this factor is of limited value when applied to activities that are inherently educational and are of the sort not traditionally conducted by commercial ventures.

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Three of the factors above – those having to do with a lack of resemblance to the financing of the typical tax exempt organization – relate to the substantially-below-cost test applied by EO in its analysis of █████ activities. EO itself, however, in its letter to █████ last █████ recognized the limited applicability of this test: “The ‘cost / below cost’ issue... is relevant only in comparatively few cases in which the activities of an organization are not uniquely suited to the accomplishment of a charitable purpose but, rather, are of a commercial nature.” We agree with this assessment. The provision of free or below-cost services seems to be particularly important in establishing donative intent for organizations whose activities are not inherently charitable. But where an organization’s activities further an expressly exempt purpose, such as education, the below-cost test is of limited value. See, for example, Rev. Rul. 77-272, 1977-2 C.B. 191, and Rev. Rul. 72-101, 1972-1 C.B. 144, in which the Service ruled that organizations operating vocational schools under contract, and whose only source of income was contractual cost-based fees, qualified for tax exemption under § 501(c)(3).

Practically every factor above for identifying a commercial operation weighs in favor of recognizing █████ qualification for tax exemption. From its funding and plans for funding to its structure and operation, █████ can be distinguished from the typical commercial enterprise. For example, █████ does not work to maximize shareholder value, to achieve economy of scale (by opening many schools), or to build a brand name (with █████ appearing in the name of each school). It does not pay dividends to shareholders (it has no shareholders), provide incentive compensation to officers or teachers for financial performance, or include non-competition provisions in its employment contracts. In fact, as a commercial operation, █████ would likely be judged a failure. The primary goal of most businesses is to make money for its owners and investors. A person seeking a respectable return on his investment would find little if any reason to invest in █████

We understand EO’s reluctance to approve the applications for tax exemption from educational services firms, more and more of which are running charter schools, and most of which are for-profit. We share your wariness, especially regarding organizations that exert inordinate control over schools with the goal of maximizing their profits from such control (for-profit educational management companies) and organizations that seemingly delegate (abdicate) their educational responsibilities (the schools themselves). █████ presents a different case, however. The facts on the record show that this organization’s purpose is to advance education, while the same facts fail to show any profit motive on █████ part. These facts show, also, that █████ qualifies as a school.

We note █████ failure to file its application for tax exemption within █████ months of its formation. Therefore, we agree that exemption under § 501(c)(3) should be effective from the date █████ filed its Form 1023.



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Contact Martin Schäffer at 2-3905 or Michael Blumenfeld at 2-7103 if you have any questions.

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