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

Date: MAY 24 2000

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

[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.

The information submitted indicates that you were incorporated on [redacted] as a nonprofit corporation under the laws of the State of [redacted] Your purposes, as stated in your Articles of Incorporation, are charitable, religious, educational and/or scientific. More specifically, you were formed to own and operate an elementary school serving grades K-6. Your Application for Recognition, Form 1023, also states that you plan to create a series of programs with Life [redacted]. The Internet and public records reveal that [redacted] is President and Executive Director of [redacted] a 501(c)(3) corporation. The search also revealed that [redacted] and [redacted] are or were board members of [redacted] We have attached, as an addendum to the proposed denial, the information provided from the Internet and public records. Please provide any comments you may have about these documents.

Your sole incorporator is listed in your Articles of Incorporation as [redacted] Your Articles provide that [redacted] and [redacted] constitute your initial Board of Directors. Your Bylaws provide that the initial board selected by [redacted] as incorporator, will be self-perpetuating.

Your Bylaws provide that your board members elect the President, Vice President, Secretary and Treasurer. The term for all officers is one year. Any officer may be re-elected to the same position as long as the officer is also a board member.

You have entered into a Charter Contract with [redacted] School District [redacted] to establish a charter school. The contract has a 15-year term commencing on [redacted]

the first day of operation of the charter school. Your Charter Contract states that you may operate " a maximum of four sites during the second year of its charter...and a maximum of nine sites during the third year of its charter." In addition, prior approval through the amendment process must be obtained if there is a change in your chief executive officer. According to your Charter Contract, [redacted] is currently your chief executive officer.

You have also entered into a Lease Agreement with [redacted] ("Lessor"). Lessor has not executed the lease you have submitted. You have leased three designated classrooms from Lessor. The lease is for a period of [redacted] months, from [redacted] to [redacted]. For the [redacted] and [redacted] academic years, your budget for leased facilities increases significantly to reflect the additional space needed to accommodate the projected increase in students.

You provided a draft of an unexecuted Management Agreement ("Agreement") between you and [redacted] ([redacted]. [redacted] is your President as well as [redacted]. Your representative, [redacted] has stated that the parties agree to the terms and conditions of the Agreement. The initial term of this Agreement is 5 years and extends from [redacted] to [redacted].

In your application, you provided a three-year proposed budget. You stated, as one of your expenses, that purchased services for the [redacted] and [redacted] academic years will be [redacted] and [redacted] respectively. The expenses represent 19%, 29%, and 29% respectively, of the funds received from the State [redacted]. The only purchased services indicated in your application are the services to be provided by [redacted]. In return for these services, [redacted] will receive a fee as set forth in your Agreement. Your Agreement provides that compensation for such services will be provided in Exhibit B. The attached Exhibit B was blank.

Among the services [redacted] is specifically authorized to perform include planning and overseeing charter schools; managing and supervising all aspects of the operation of the facilities; marketing of educational programs; recommending policies and operating procedures; overseeing preparation of annual capital expenditure and operating budgets; retaining legal counsel; employing certified public accountant to perform annual audits; compliance; monitoring and reporting attendance; funding; fund raising; arranging health visits; preparing health reports; maintaining existing facilities; planning, negotiating, designing and overseeing construction of new facilities; debt servicing; contracting for payroll services; managing and administering; protecting charter contract, providing periodic curriculum, operations, compliance, growth and marketing in-service; financing; reporting; conduct external and internal audits; procuring, paying, insuring, maintaining, registering and inspecting vehicles; reviewing and implementing security systems; training and encouraging creation of parent advisory boards; defining and training career exploration program; applying for accreditation; and expanding your organization.

The Agreement is to be signed by [redacted] and [redacted] in their respective capacities as your President and Vice President. [redacted] will also sign as President of [redacted] You do not have a conflict of interest policy precluding you from entering into a transaction in which your directors and employees contract with you on matters in which they have a financial interest. The provisions of the Agreement that are relevant to this discussion are set forth below.

> 4. Compensation. As compensation for the services to be performed by Company [redacted] hereunder, School shall pay to Company a fee in the amount set forth on Exhibit B attached hereto, payable on the 15th day of each month commencing April 15, 1999. In the event that on 20th, 40th or 100th "student enrollment days" of the school year the enrollment is either 10% higher or lower than the projected enrollment upon which the budget for such school year was based, school by a vote of 75% of a duly constituted

quorum of the members of the board of directors at a properly called and noticed meeting of the board, may negotiate with Company to adjust the compensation payable to Company hereunder for the balance of such year.

5. Reimbursable Expenses. In addition to the fee described in paragraph 4 above, School shall pay to Company the net cost of purchase of necessary goods and services made solely for and on behalf of School and pursuant to School's policies, procedures and directives.

All expenses shall be documented with the billings and shall be submitted promptly to School for review prior to reimbursement. Any single purchase of goods or services in excess of $500.00 by or on behalf of School through Company, or jointly with other Company-managed facilities with the assistance of Company shall be documented prior to the acquisition with full disclosure to Company of all relevant facts, including but not limited to the gross and net costs; the manner in which the goods or services are to be divided between the purchasing parties; the manner in which the cost is to be shared by the purchasing parties; and any commission, price concession or other accommodation which company is to receive as a result of its involvement in the transaction. Reimbursement shall be made within 15 days after billing. School shall not be required to reimburse Company for any portion of Company's overhead or operating expenses, nor any other cost except as specifically described in this paragraph 5.

6. I. Consultation Prior to Major Changes. School shall not initiate expansion, sell or lease facilities, file for bankruptcy or receivership, or develop a new project without 30 days prior written notice to Company, which notice period can be waived or shortened by written statement from Company.

8. Termination Without Cause. This Agreement may be terminated by either party at any time without cause within its term by giving six (6) months notice in writing to the other party. Any such termination shall be effective upon the expiration of the six (6)-month period following the giving of the notice or on such later date as may be specified in the notice. Any termination without cause by School shall require a 75% vote of a duly constituted quorum of the board of directors at a properly called and noticed meeting of the board.

9. Termination With Cause. This Agreement may be terminated by either party in the event that the other party files or has petition or complaint in receivership or bankruptcy filed against it which has not been dismissed within sixty (60) days of such filing, in which case the other party may elect to terminate this Agreement with termination effective upon receipt of written notice of termination by the party subject to the petition or complaint. In the event that a party fails to perform the obligations imposed upon it under this Agreement, the other party may elect to terminate this Agreement, whereupon it shall give the other party written notice and such termination shall be effective sixty (60) days after the mailing thereof, unless the grounds for termination have been remedied by the other party prior to that date.

Section 501(c)(3) of the Code provides, in part, that an organization is exempt from federal income tax if it is organized and operated exclusively for charitable and educational purposes, and if no part of the net earnings of the organization insures to the benefit of any private shareholder or individual.

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 requirements of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

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

(a) The instruction or training of the individual for the purpose of improving or developing his capabilities; or

(b) The instruction of the public on subjects useful to the individual and beneficial to the community.

In Better Business Bureau of Washington, D.C., Inc. v. United States, 326 U.S. 279 (1945), 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).

Leon A. Beighly v. Commissioner, 35 T.C. 490 (1960), provided that where an exempt organization engages in a transaction with a related interest and there is a purpose to benefit the private interest rather than the organization, exemption may be lost even though the transaction ultimately proves profitable for the exempt organization.

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).*

Bubbling Well Church of Universal Love, Inc. v. Commissioner, 74 T.C. 531 (1980) concerns a church controlled completely by one family, the Herberts. The Herberts family completely controlled the Church's operations and as the only voting members were able to perpetuate that control. The Court made the following statement concerning the effect of this total control.

> Preliminarily we note that petitioner, at all pertinent times, was completely dominated by the Herberts family --a father, mother, and son. Because they were the only voting members and they composed the board of directors, the Herberts were in a position to perpetuate this control of petitioner's operations and activities indefinitely. Petitioner had no affiliation with any denomination or ecclesiastical body and, therefore, the Herberts family was not subject to any outside interference or influence in the control of petitioner's affairs. This means that the Herberts, without challenge, could dictate petitioner's program and operation, prepare its budget, and spend its fund, and could continue to do so indefinitely.

The Court of Appeals, in Bubbling Well Church of Universal Love, Inc. v. Commissioner, 670 F. 2d 104 (1981) affirmed the decision of the Tax Court. In addition, the Court addressed the issue of the taxpayer's burden to provide full and complete information.

> We agree with the Tax Court that the potential for abuse created by the Herberts' control of the church required open and candid disclosure of facts bearing on the exemption application.

In P.L.L. Scholarship v. Commissioner, 82 T.C. 196 (1984), an organization operated bingo at a bar for the avowed purpose of raising money for scholarships. The board included the bar owners, the bar's accountant, also a director of the bar, as well as two players. The board was self-perpetuating. The Court reasoned that since the bar owners controlled the organization and appointed the organization's directors, the activities of the organization could be used to the advantage of the bar owners. The organization claimed that it was independent because there was separate accounting and no payments were going to the bar. The Court was not persuaded.

A realistic look at the operation of these two entities, however, shows that the activities of the taxpayer and the Pastime Lounge were so interrelated as to be functionally inseparable. Separate accountings of receipts and disbursements do not change that fact. The Court went on to conclude that the organization had a substantial nonexempt purpose.

In Church by Mail, Inc. v. Commissioner, (1985) the Court affirmed a Tax Court decision. Church by Mail sent out sermons in numerous mailings. This required a great deal of printing services. Twentieth Century Advertising Agency provided the printing and the mailing. Twentieth Century was controlled by the same ministers. It also employed family members. The services were provided under two contracts. The contracts were signed by the two ministers for both Church by Mail and Twentieth Century. Church by Mail business comprised two-thirds of the business of Twentieth Century. In deciding for the government, the Court makes the following statement.

> There is ample evidence in the record to support the Tax court's finding that the Church was operated for the substantial non-exempt purpose of providing a market for Twentieth's

services. The employees of Twentieth spend two-thirds of their time working on the services provided to the church. The majority of the Church's income is paid to Twentieth to cover repayments on loan principal, interest, and commissions. Finally, the potential for abuse created by the ministers' control of the Church requires open and candid disclosure of facts bearing upon the exemption application. Moreover, the ministers' dual control of both the Church and Twentieth enables them to profit from the affiliation of the two entities through increased compensation.

The Church argued that the compensation to Twentieth was reasonable. The Court's statement on the subject is very significant.

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

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 proves to ascertain the purpose towards which an organization's activities are directed and not the nature of the activities themselves.

In International Postgraduate Medical Foundation v. Commissioner, TCM 1989-36 (1989), the Tax Court considered the qualification for exemption under section 501(c)(3) of the Code of a non-profit corporation that conducted continuing medical education tours. The petitioner had three trustees. Mr. Helin, who was a shareholder and the president of H & C Tours, a for-profit travel agency. Mr. Regan, an attorney, and a third director who was ill and did not participate. Mr. Helin served as executive director. The petitioner shared offices with H & C Tours. The petitioner used H & C Tours exclusively for all travel arrangements. The petitioner's contract with H & C Tours permitted it to acquire competitive bids, but provided that H & C Tours would always get the bid if it was within 2.5%. There is no evidence that the petitioner ever sought a competitive bid. The Court found that a substantial purpose of the petitioner was benefiting the for-profit travel agency. It concluded that:

> When a for-profit organization benefits substantially from the manner in which the activities of a related organization are carried on, the latter organization is not operated exclusively for exempt purposes within the meaning of section 501(c)(3) even if it furthers other exempt purposes.
>
> We find that a substantial purpose of petitioner's operations was to increase the income of H & C Tours. H & C Tours benefits from the distribution and production of brochures which solicit customers for tours arranged by H & C Tours. Approximately 90 percent of petitioner's total revenue for 1977 were expended on production and distribution of brochures. The terms of the Travel Service and Administrative Support Agreement further insured that H & C Tours would substantially benefit from petitioner's operations. Petitioner did not solicit competitive bids from any travel agency other than H & C Tours.

In KJ's Fund Raisers, Inc. v. Commissioner, T.C. Memo 1997-424 (1997), affirmed 82 AFTR 2d 7092 (1998), the Tax Court found that another gaming organization

was not exempt. While the organization raised money for charitable purposes, it also operated for the substantial benefit of private interests. The organization's founders, Kristine Hurd and James Gould, were the sole owners of a bar, KJ's Place. The organization, through the owners and employees of KJ's Place, sold lottery tickets exclusively at KJ's Place during regular business hours. While in KJ's Place, the lottery ticket purchasers were sold beverages from the bar. The initial directors were Hurd, Gould, and a related individual. The initial board was replaced several times until Hurd and Gould were no longer on the board. At all times Hurd and Gould were the organization's officers. Salaries had been paid to Hurd and Gould and rent had been paid to KJ's Place. The organization maintained that the fact that salaries and rent were no longer paid in this fashion indicated the independence of the board. The Court took another view.

> Although those practices ceased and are not in issue here, the current board of directors is composed of at least the majority of the same members who allowed those amounts to be paid. This strongly suggests that Hurd and Gould are free to set policy for their own benefit without objection from the board. Nothing in the record since July 1, 1994, indicates otherwise.

The Court concluded that KJ's Fund Raisers was operated for substantial private benefit and did not qualify for exemption. The Court of Appeals affirmed the decision. It found that the organization had served the private interests of its directors in maintaining and augmenting their business interests.

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 governs its participation in the partnerships is 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.

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 Exemption 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.

In Rev. Rul. 61-170, 1961-1 C.B. 112, an association composed of professional private duty nurses and practical nurses which supported and operated a nurses' registry primarily to afford greater employment opportunities for its members was not entitled to exemption under section 501(c)(3) of the Code. Although the public received some benefit from the organization's activities, the primary benefit of these activities was to the organization's members. Rev. Rul. 61-170 can be contrasted with Rev. Rul. 65-298, 1965-2 C.B. 163. In Rev. Rul. 65-298 a non-membership organization provided seminars to members of the medical profession. These seminars were designed to lessen the time between the discovery of medical knowledge and its practical application. Unlike the organization in Rev. Rul. 61-170, the benefits flowing from the activities of the medical seminar organization were of direct benefit to the general public.

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

Rev. Rul. 76-441, 1976-2 C.B. 147, presents two situations concerning school operations. In the first scenario a nonprofit school succeeded to the assets of a for-profit school. While the former owners were employed in the new school, the board of directors was completely different. The ruling concludes that the transfer did not serve private interests. Part of that

conclusion was based on the independence of the board. In the second scenario, the for-profit school converted to a nonprofit school. The former owners became the new school's directors. The former owners/new directors benefited financially from the conversion. The ruling concludes that private interests were served. The conclusion is stated as follows:

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

Rev. Rul. 98-15, 1998-12 I.R.B. 6, concerns the effect on the exempt status of a hospital that forms a limited liability company with a for-profit corporation in order to operate the hospital. The revenue ruling makes the following statement concerning management contracts.

> Similarly, a section 501(c)(3) organization may enter into a management contract with a private party giving that party authority to conduct activities on behalf of the organization and direct the use of the organization's assets provided that the organization retains ultimate authority over the assets and activities being managed and the terms and conditions of the contract are reasonable, including reasonable compensation and a reasonable term. Broadway Theatre League of Lynchburg, Virginia, Inc. 293 F. Supp. 348 (W.D.Va.1968). However, if a private party, and the benefit is not incidental to the accomplishment of exempt purposes, the organization will fail to be organized and operated exclusively for exempt purposes.

Section 501(c)(3) of the Code sets forth two tests for qualification for exempt status. An organization must be both organized and operated exclusively for purposes described in section 501(c)(3). If you fail either the organizational or operational test, you will not be recognized as exempt from taxation as a 501(c)(3) organization.

Your Articles of Incorporation satisfy the organizational test. You must, however, also satisfy the operational test. The regulations under section 501(c)(3) expand on the requirements for satisfaction of the operational test. The key requirement 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 that 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 serves a public rather than a private interest. If even one of your substantial activities has a private purpose, such as benefiting private parties, you will not qualify for exemption. See, Better Business Bureau, supra.

You were incorporated to operate a charter school for elementary school students. The operation of a school in the manner you described may further educational purposes within the meaning of section 1.501(c)(3)-1(d)(3)(i) of the regulations. However, the existence of a "single noneducational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes." Better Business Bureau v. United States, 326 U.S. 279, 289 (1945). Your operation includes a substantial nonexempt purpose that confers impermissible benefits to the teachers, Life Management and Mr. Alverson. We will discuss, in greater detail, the impermissible benefits received by each party.

Your submission provides that the total amount of salary payable to a teacher would be determined on a "per-pupil over operating expense" formula. This translates to higher salaries for teachers with high student enrollment and low operating expenses. You also provide that teachers will be responsible for "matters of compliance, facilities, and district-level operations (insurance, attendance, special education, payroll, accounting, legal, auditing, etc.) as well as educational outcomes and parental satisfaction. Each teacher will operate within his or her own

budget, balancing available revenues against operating expenses". The responsibilities you have assigned to the teachers are identical to some of the services you purchased from [redacted] In effect, you have two levels of management. One provided by the teachers and the other provided by [redacted]

Because of your structure, you can not insure that your teachers will not cut operating expenses and place profits before the quality of education. This compensation arrangement subjugates the quality of educational services to the reduction of operational expenditures. Perhaps to safeguard against private benefit, you established a subjective standard of parental satisfaction. You apparently feel that this standard will insure that each teacher will place quality of education ahead of the bottom line. You can not abrogate your responsibility to insure that you provide educational programs by using this parental satisfaction standard. Parents are not educators. What is apparent is that you have created a system to keep student enrollment high so you can receive more state funds. In return for increased enrollment, you reward the teachers with higher compensation. In effect, you have created for-profit objectives for your teachers. This for-profit motive is inconsistent with your charitable mission.

It is well established that a tax-exempt organization may pay reasonable compensation for services provided to it without violating the requirements of exemption. Excessive compensation can result in private benefit. Your compensation arrangement is structurally deficient in that 1) it incorporates subjective, in lieu of objective, standards; 2) it fails to provide the maximum dollar amount paid to each teacher; and 3) it grants teachers the power to control the amount of compensation received.

High student enrollment benefits not only the teachers but [redacted] as well. The Agreement provides that subject to approval by 75% of a quorum of the board members, an adjustment in [redacted]'s compensation will be made "In the event that on 20th, 40th or 100th 'student enrollment days' of the school year the enrollment is either 10% higher or lower than the projected enrollment". This adjustment corresponds with the 40th and 100th day headcount that [redacted] Department of Education requires when determining the amount of apportionment. The State factors these figures into its funding. [redacted] appointed himself and the remaining directors as members of your self-perpetuating board. [redacted] also controls [redacted]. In light of this fact, board approval is clearly not an obstacle in obtaining an upward adjustment in compensation and as such, excessive compensation could result. This is especially true since your Agreement does not provide a limit on the amount of compensation that may be earned. Furthermore, this provision also provides that compensation for [redacted]'s services will be set forth on Exhibit B. The Exhibit you submitted is blank. Based on all the factors stated above, you have failed to establish that compensation is reasonable under the Agreement and as such impermissible benefits may be realized.

The information you provided also indicates your inability to control [redacted] to insure that your charitable objectives will be met. Provisions 8 and 9 provide that your Agreement is terminable with and without cause. Termination with cause involves specific circumstances of receivership, bankruptcy and breach. In the event of receivership or bankruptcy, either party may terminate upon receipt of written notice. However, your rights to terminate under these circumstances are much narrower than the rights of [redacted] You can only terminate after 30 days written notice prior to your intent of filing for bankruptcy or receivership. In the event of breach, the other party may terminate after 60-day written notice unless such breach is cured within the 60-day period. In either event, a party may terminate without cause after 6 month written notice. However, in addition to the written notice, you are also required to obtain approval by 75% of a quorum of your board. Again, your rights to terminate are more onerous. The requirement for a board vote is an unusual management contract provision. You have not demonstrated the necessity of ceding your right to terminate. Although the Agreement provides for termination without cause, termination would be unlikely since [redacted] not only sits on your self-perpetuating board but he also appointed the remaining board members. Under the terms of your Agreement, [redacted] failure to advance your charitable objectives would

[redacted]

not be grounds to terminate the Management Agreement. In effect, you are locked in for the 5-year term without any recourse to insure that your charitable activities are met.

The domination that the Court found unacceptable in Bubbling Well is equally apparent in the way you are operated. [redacted] controls your operation. This is demonstrated by the restrictive nature of the management agreement.

As a consequence of your limited ability to unilaterally terminate the Agreement without cause, you lack control to insure that [redacted] will manage your activities in a manner consistent with the requirements of section 501(c)(3) of the Code. Since [redacted] is a for-profit entity, it is motivated to maximize profits. Consequently, we looked elsewhere in your Agreement for an express provision obligating [redacted] to place charitable purposes ahead of economic purposes

Your Agreement requires that [redacted] "shall discharge such duties all in accordance with the terms herein set forth". What is notably absent from the terms of your Agreement is any statement that expressly provides for a binding obligation on [redacted] to serve charitable purposes. You have made no effort to establish that [redacted] must manage the schools in keeping with your responsibility to continually satisfy the requirements of section 501(c)(3) of the Code. Absent any explicit provision of this requirement [redacted] has primary responsibilities to maximize profits and no obligation to put charitable purposes ahead of pecuniary gain. A major factor for the Redlands court in denying exemption under 501(c)(3) was that the partnership was under no obligation to conduct the surgical center as a charitable endeavor. If you should determine that [redacted] is managing your activities in a manner inconsistent with your charitable objectives, you could not be assured of any remedy.

Provision 5 of the Agreement addresses reimbursable expenses. Under this provision, you must reimburse [redacted] for any single purchase of goods or services in excess of [redacted] made jointly with other [redacted] managed facilities. This provision is subject to "full disclosure to Company [redacted] of all relevant facts, including but not limited to...the manner in which the goods or services are to be shared by the purchasing parties; the manner in which the cost is to be shared by the purchasing parties...". The fact that only [redacted] receives full disclosure of joint purchases is evidence of its control over you. Furthermore, the Agreement fails to provide how joint purchase of goods or services lesser than or equal to [redacted] will be shared between you and [redacted]'s other facilities. In either event, [redacted] is under no obligation to insure that you will receive an equitable interest in exchange for your contribution. [redacted] is in a position to further its profit motive by having you absorb the majority of the costs for goods or services to be used predominately by [redacted]'s other facilities. Under this provision, you may confer impermissible benefits to [redacted].

The fact that you are entering into a management agreement does not in of itself establish that you have conferred benefits to impermissible private parties. The critical factor in determining whether this activity arises to substantial nonexempt purpose is determined under all the facts and circumstances. Although the operation of a school is a charitable activity, the manner in which you have chosen to operate your school is not in furtherance of an exempt purpose. Your activities are directed toward both exempt and nonexempt purposes. In this case, the facts indicate that you bestow significant benefits to [redacted] and [redacted] who is your President, Director and incorporator. Your Bylaws were drafted to permit you to enter into such contracts in which your directors and officers have a financial interest. [redacted] in his various positions, has direct and indirect control over your assets. In his capacity as President, [redacted] also has control over [redacted] a for-profit corporation. By agreeing to the Management Agreement with [redacted] under the terms of the Agreement, you have demonstrated that you are operated for private rather than public purposes.

In KJ's Fundraisers, supra, the Court focused on the role of the Board of Directors. The organization had dropped some of its most offensive activities prior to Court consideration. But, because the majority of the same board members who approved the offensive activities still remained, the Court determined that private interests were still in control of the for-profit corporation. In your case, your board of directors allowed you to enter into an Agreement in which impermissible benefits are conferred to [redacted] and [redacted] This strongly suggests that you are not controlled by an independent board.

Furthermore, as incorporator, [redacted] selected your Board of Directors. He is a member of your board as well as [redacted] and [redacted] Your bylaws provide that the board is self-perpetuating. [redacted] and [redacted] are also board members of [redacted]. In addition to serving as President of your organization, [redacted] is also President of [redacted] and [redacted] As your President / Administrator, your budget states that [redacted] will receive compensation in the amount of $[redacted] and $[redacted] for the [redacted] and [redacted] academic years. Moreover, [redacted] is recognized as President / Chief Executive Officer for a period of 15 years under your Charter Contract. In the event you wish to replace [redacted] as President, you are mandated by the Charter Contract to obtain prior approval through the amendment process. The amendment process requires board approval at a public meeting and signature by both you and [redacted] School District. Due to the composition of your board and their roles in electing and approving replacements for your President, your ability to terminate your relationship with [redacted] would be difficult. In effect, [redacted] will serve as your President for a minimum of 15-years, which is the term of the Charter Contract.

Through his various positions, [redacted] is in a position to exercise substantial influence over you to enter into an Agreement with [redacted] Your board has, in fact, allowed you to enter into an Agreement with [redacted] a for-profit corporation which [redacted] is President. This is evident by the execution line in the Agreement that provides for the signature of [redacted] in his dual capacity as your President and [redacted] This strongly suggests that [redacted] can enter into agreements or contracts in which he has a financial interest without objections from your board. Rather than establishing a high degree of fiduciary responsibility, it is clear that from your submission that your Board of Directors has no power to act as a fiduciary to protect you from exploitation. Furthermore, the application and the attached documents do not reveal that the Agreement was negotiated at arms length. You have not established that competitive bids from any other management corporation were solicited.

Even assuming, arguendo, that your board was independent, the private benefit to [redacted] and [redacted] in of itself, would disqualify you from exemption under section 501(c)(3). est of Hawaii, supra, concerned a franchise arrangement in which the exempt organization purchased its programs and staff from for-profit entities. Although there was no structural relationship between the entities, the Court inferred from the totality of benefits flowing from the exempt organization to the for-profits that they had substantial influence over the non-profit's operations. The Court ruled that est existed for the benefit of the for-profit entities and could not be exempt.

Your application also indicates your plans to "create a series of programs with [redacted] (grades 7 through 12)". These plans are also evident in the Agreement which states that [redacted] as one of its many services, will provide management and administration of your K through 12 campuses. Since you only serve K-6, it can be inferred from your application that 7-12 will be served by one of [redacted]'s five campuses. Public information revealed that [redacted] is also President and Executive Director of [redacted] Based on the Management Agreement you have submitted and the relationships between you and [redacted] it is clear that you are operating for the benefit of private parties that is not incidental to the operation of your school. In fact, you are similar to the organization discussed in Old Dominion Box Co. and Leon A. Beeghly, supra. This leads us to

[redacted]

conclude that you were created for the substantial purpose of fostering the entry of Life Management into the profitable charter school management arena.

Your situation is somewhat analogous to International Post Graduate Medical Foundation, supra, where the Tax Court considered the relationship between an exempt organization and a related for-profit travel agency. The contract was written so as to exclusively favor the for-profit, H& C Tours. The relationship created a captive market for the travel agency in the business generated by the exempt organization. As a consequence of this substantial benefit, exemption was denied. In your case, the Agreement serves the private interests of [redacted] and [redacted] and [redacted] through their ties with you and [redacted] have created a captive market in section 501(c)(3) charter schools. Because of their relationships with you, they are in a unique position to reap the benefits of the emerging commercial charter school management market. Moreover, your relationship with [redacted] bears a striking similarity to the relationship between [redacted] and [redacted] As in [redacted] signed a management agreement on behalf of you and [redacted] to further the for-profit interests of your incorporator as well as [redacted]

Furthermore, your Agreement with [redacted] indicated your plans for expansion. Your Charter Contract states that you may operate a maximum of one site during the first year of your contract, four sites during the second year, and nine sites during the third year. You failed to provide any information with regards to campus expansion. Information such as the location of future sites and whether [redacted] will manage all of your future campuses.

You also submitted a Lease Agreement with your application. You provided that the amount of your proposed budget allocated to leasing facilities for your school is [redacted] and [redacted] for the [redacted] and [redacted] academic years, respectively. The lease you submitted has since expired. You have not indicated whether the lease will be renewed or whether you intend to lease facilities from another organization. An Internet search indicates that you have relocated to [redacted] in [redacted] The search also revealed that this is a residential address for [redacted] If you did enter into a Lease Agreement with another organization or with [redacted] you have failed to establish that the transaction does not violate the proscription against impermissible private benefit.

Section 4958 of the Code imposes tax liability on any individual in a position to influence an exempt organization who receives an excess benefit from that organization. If you were recognized as exempt, it is most likely that [redacted] and [redacted] would be liable for tax under section 4958 because of their substantial influence over you and the excessive nature of the benefits flowing to them.

Based on the totality of factors described above, we conclude that you are not operated exclusively for exempt purposes within section 501(c)(3) of the Code. While there is no prohibition against a non-profit from entering into agreements with private parties, such transactions must be done without serving private interests. You have structured two compensation agreements, one for the teachers and the other for [redacted] which do not comply with the proscription against serving private benefits. The structure of the agreement fails to incorporate a ceiling on the amount a teacher or [redacted] can earn. Under your compensation structure, each teacher and [redacted] are in a position to receive excessive compensation for their services. Furthermore, such economic windfall does not correspond with benefits you receive in return.

You have also agreed to the terms under which the Agreement: (1) fails to give you effective control that ensures charitable purposes are met; (2) fails to impose any binding obligations on [redacted] to place charitable objectives ahead of maximizing profits; and (3) secures market advantages for [redacted] and [redacted] As discussed above, you are not in a position to cause [redacted] to carry out your exempt objectives. We conclude

[redacted]

that you have surrendered effective control over your operation to [redacted] and [redacted] a for-profit manager.

Your activities substantially serve private interests. You have conferred on the teachers, [redacted] and [redacted] significant private benefit and therefore are not operating exclusively for educational purposes within section 501(c)(3) of the Code.

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 made to your organization 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 judgement 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
T:EO:RA:T:4 Rm. 6238
1111 Constitution Ave, N.W.
Washington, D.C. 20224

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

Sincerely,
[redacted]

Gerald V. Sack
Manager, Exempt Organizations
Technical Group 4