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IRS Update: Revised Charter School Reference Guide

The Internal Revenue Service recently released a Charter School Reference Guide, providing guidance in the processing of federal tax exemption (Form 1023) applications filed by charter schools seeking exemption under Internal Revenue Code Section 501(c)(3).

The IRS identified its primary issue of concern as the possibility of impermissible private benefit to a for profit management company involved in a charter school's operation (however, a nonprofit management company's operation of a charter school can also trigger IRS scrutiny and possible denial of tax exempt status). For this reason, the Charter School Reference Guide and accompanying Guide Sheet are designed to examine whether a charter school is independent of the management company, and whether the management agreement has been negotiated at arm's length.

The IRS will review the charter school's application using this Charter School Guide as a check list and may deny tax exempt status to a charter school that fails too many of the criteria. There is no bright line test for determining private inurement. For example the IRS will be looking at the following:

- Will the charter school engage a management company for services?
- Is the management company a for-profit entity?
- Did the management company apply for the charter, form the corporation, draft the bylaws, mail in the Form 1023 application for federal tax exemption, or send the check for the user fee?
- Do any of the charter school's board members have, or have they had, a family or business relationship with the management company?

Accordingly, the following are some recommendations for charter schools operating as nonprofit corporations that are seeking tax exempt status with the IRS and that are currently contracting with or intend to contract with a management company for services:

- If the management company is a nonprofit organization exempt under section 501(c)(3), the IRS considers the private benefit issue significantly reduced.
- Negotiate management agreements at arms length; consideration of multiple management companies and/or use of a competitive bidding process presupposes an arm's length relationship.
- Contracting with a management company that provides comprehensive services increases the likelihood of private benefit to the management company because it places much of the control over the day-to-day operations in the hands of the management company, increases the amount payable by the school, and makes the charter school reliant on one supplier for almost everything.

- The charter school should have an independent board of directors; in other words, structural independence from the management company.
- The charter school board of directors should be actively involved in the oversight of the operation of the school and the performance of the management company. Regular meetings (more than two times a year), detailed minutes of each board meeting, and independent decision-making as well as accountability oversight of the management company by the board are ways to demonstrate active oversight.
- The charter school should retain responsibility for financial matters of the school.
- The charter school should have a conflict of interest policy to assure that the charter school will be operating to benefit students rather than private interests.
- Compensation arrangements with the management company should be consistent with industry practices and market rates for the services provided.

Any charter school contemplating a contract with a management company should review the guidelines in the “[Charter School Reference Guide](#)” and accompanying “[Charter School Guide Sheet](#)” and contact its legal counsel with any questions.

If you have any questions regarding this update, or need assistance with preparing a federal tax exemption application (Form 1023), please contact any member of our corporate legal team: Paul C. Minney (pminney@smymlaw.com), Kimberly Rodriguez (krodriguez@smymlaw.com) or Andrea C. Sexton (aseyton@smymlaw.com) at the Law Offices of Spector, Middleton, Young & Minney, LLP at (916) 646-1400.

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