

## CHARTER SCHOOL REFERENCE GUIDE

This Reference Guide is keyed to the Charter School Guide Sheet numbering.

### **Background**

Charter schools operate under a funding agreement (typically a charter) with a state or local government agency that provides them with public funds. Government involvement includes granting a charter to, funding and otherwise regulating charter schools. The charter sets forth requirements for which the school will be held accountable, but leaves the implementation of these requirements to the charter school's governing body. Typically, the governing body consists of the school's board of directors. A charter school that is operated wholly or predominantly from government funds or property under a funding agreement must meet the requirements of §§ 501(c)(3) and 170(b)(1)(A)(ii) to qualify as a tax-exempt school, except that it is not subject to the racial nondiscrimination provisions of Rev. Proc. 75-50, 1975-2 C.B. 587.

The predominant issue in charter school exemption applications is the possibility of impermissible private benefit to a management company. Therefore, the Charter School Guide Sheet is designed to examine whether the charter school is independent of the for-profit management company and whether the management agreement has been negotiated at arm's length. Arm's length describes a transaction between parties having adverse (or opposing) interests; where none of the participants are in a position to exercise substantial influence over the transaction because of business or family relationship(s) with more than one of the parties.

For example, a charter school's governing body is likely to be independent of a management company where (1) the board members are unaffiliated with the management company and consist of members of the community or persons who are otherwise qualified to serve on a school board; (2) the board members have authority over and are actively involved in major school policies, including the budget, curriculum, and hiring and firing; and (3) the board members negotiated with the management company before signing the management agreement.

Conversely, a charter school's governing body is less likely to be independent of a management company where (1) the management company was involved in forming the school and applying for its charter; (2) the board is controlled by the management company; (3) the board members have no authority under the management agreement over major school policies, including the budget, curriculum, and hiring and firing; (4) the management company directly employs key employees who provide services to the school; (5) the management agreement, or administrators' and teachers' contracts, provides that the school may not hire the administrators or teachers upon a termination of the management agreement; (6) the term of the management agreement is more than five years; and (7) the management agreement provides for a significant penalty on termination that would compromise the school's ability to terminate the agreement, such as a lump sum penalty or loss of facilities, equipment, curriculum, use of name, or similar penalty.

Since development of the issue of private benefit requires a consideration of all the relevant facts and circumstances, this is a lengthy Guide Sheet. Upon completion of the Guide Sheet, a conclusion should be drawn based on a weighing of all the relevant facts and circumstances.

### **Formation and Operation**

1.a. Has the school begun operations or has it disclosed when it will begin operations?

Generally, the expected date of enrollment for students should be within one year for the organization to receive section 170(b)(1)(A)(ii) status.

1.b. Has the school provided the current or anticipated student enrollment figures?

The school should have enrollment or, if it is not yet operational, estimated enrollment, for purposes of determining section 170(b)(1)(A)(ii) status.

2.a. Has the school provided a copy of the charter application and approved charter?

We must have an approved charter or, if it has not yet been approved, a copy of the charter application, to approve a charter school. If there is a charter, it should still be in effect, and any renewals should be provided.

2.b. Was a detailed description of the curriculum provided?

A description of the curriculum is normally included in the charter application; if not, it should be requested for purposes of determining section 170(b)(1)(A)(ii) status.

2.c. Has Internet research been conducted regarding the school and its activities?

The specialist should conduct independent research on the Internet, including the school's website, if any, to confirm or supplement information submitted with the school's application for exemption.

### **Management Company/Agreement**

3.a. Will the school engage a management company?

If the charter school will be operated directly without a management company, then you may stop here. The questions that follow in this Guide Sheet apply only to charter schools that engage management companies.

3.b. Is the management company a for-profit entity?

This Guide Sheet focuses on issues that are of special concern to a charter school that contracts with a management company, specifically the issue of private benefit. If the management company is an organization exempt under section 501(c)(3), the private benefit issue is significantly reduced. A nonprofit management company that is not exempt under section 501(c)(3) should be treated the same as a for-profit management company in a private benefit analysis.

4.a. Was a copy of the management agreement provided?

If the school is unable to provide a signed or draft management agreement, this is evidence that the school is not in a position to be able to fully describe its proposed activities.

4.b. Was the management agreement negotiated at arm's length?

The school should be asked to describe how the management agreement was negotiated at arm's length, including descriptions of any provisions that were resolved to ensure that the school was benefited rather than the management company. If the management agreement solely contains boiler-plate terms that are not specific to the school, this may be an indication that the terms of the contract were not the subject of negotiations between independent parties.

The following questions are intended to elicit whether the management company formed the school to purchase the services of the management company or whether two existing or otherwise independent organizations entered into a contract for services.

5.a. Did the management company apply for the charter, form the corporation, draft the by-laws, mail in Form 1023, or send the check for the user fee?

5.b. Was the management agreement entered into before the corporation was formed or the charter was applied for?

5.c. Did the same person sign the management agreement for the school and the management company?

5.d. If the school has legal representation, is it the same as the management company?

Representation of both the school and the management company by the same attorney may also be an indication of the absence of arm's length negotiations and perhaps the absence of an independent board.

5.e. Is the school's primary contact or power of attorney affiliated with the management company?

5.f. Were other management companies considered? Did they submit bids?

Competitive bidding, where the organization asks for bids from a number of different companies and selects the lowest bidder with the best services, presupposes an arm's-length relationship. Conversely, if the management company was instrumental in the creation of the school, the likelihood is increased that private interests will be served. While a formal competitive bidding process is not always necessary, the failure to consider the relative costs and services of different management companies is another indicator of private benefit.

5.g. Does the management company provide comprehensive services?

The provision of 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 of the school in the hands of the management company, increases the amount payable by the school, and makes the school reliant on one supplier for almost everything, which makes it more difficult to terminate the contract with the management company.

5.h. Does the school have to be a 501(c)(3) in order to obtain a charter under that state's law?

Review the management agreement to determine whether there is a requirement that the school maintain its exempt status to qualify as a charter school. This circumstance is only troublesome if there is also evidence that the management company formed the school corporation, applied for the charter, or signed the management agreement on behalf of the school because it would further explain why the school operates as an arm of the management company.

### **Franchise Indications**

These questions concern whether the formation of the school by the management company is part of a franchise where the agreements are all boilerplate, allowing little or no negotiation, the schools must all use a brand name, and the management company derives fees from the name and the curriculum, in addition to other compensation. A franchise would indicate a greater possibility for private benefit, because it allows the company to draw goodwill from the relationship, provides a form of free advertising, and builds name recognition without additional expense. It also makes it more difficult for the school to terminate the relationship with the management company, since it could lose rights to its name and the curriculum. See est of Hawaii, 71 T.C. 1067 (1979).

6.a. Were multiple applications filed at the same time, involving schools managed by the same management company?

6.b. If there are other similar schools who are applying at the same time, are the provisions in the agreements identical (boiler-plate)?

6.c. Is the address for the school the same as the address of the management company?

6.d. Does the management company require the use of a name by the school and payment of a fee for such use?

6.e. Does the school provide free advertisement of the management company's name on the website or facility?

6.f. Does the school have rights to use the curriculum for free?

6.g. Is the school allowed to keep any improvements it makes to the curriculum?

### **Term and Termination Provisions**

These questions concern term and termination provisions in the management agreement. The crucial questions are whether the school has the ability to remove itself from the management agreement and continue operations, or whether that ability is severely impaired by the management and other agreements.

7.a. Is the term of the management contract equal to or longer than the term of the charter?

7.b. Is the term of the management contract longer than five years?

7.c. Is the management contract automatically renewable?

The length of the contract, and any automatic renewal provisions, greatly influence the school board's ability to monitor and evaluate the management company's performance and need for flexibility to change companies, if necessary.

7.d. Are the termination provisions biased in favor of the management company?

If the management agreement is terminated, will the school have a facility, equipment, teachers, administrators, staff, and rights to its name and curriculum to allow it to continue operations?

7.e. Is there a non-compete clause in the management agreement or administrators' and teachers' contracts?

Although principals, teachers and staff may be employed directly by the management company rather than the school, the existence of a non-compete clause prevents the school from hiring the personnel that it has utilized in operating its school for a specific length of time after termination of the management agreement.

7.f. Does the agreement provide for an installment or lump-sum fee or other termination penalty based on start-up expenses, such as development and organizational costs?

7.g. Does the school have any rights to the curriculum if the management agreement is terminated?

7.h. If the management company requires the use of a name by the school, does the school have any rights to the name if the management agreement is terminated?

### **Board of Directors**

These questions are directed to whether the school has an independent board of directors; in other words, structural independence from the management company.

8.a. Do any of the school board members have, or have they had, a family or business relationship with the management company or any of the owners of the management company?

The terms "family" and "business relationship" are defined in Appendix C: Glossary of Terms, Instructions for Form 1023.

8.b. Are the board members selected or appointed by the management company?

A board comprised of significant representation from the management company or members appointed by the management company increases the likelihood that the board is not independent.

8.c. Have résumés of the board of directors been provided?

Assurance that the school will be managed to achieve educational purposes and not for impermissible private benefit is strengthened when the board has experience relevant to the educational purposes.

8.d. Are they members of the local community, including parents, teachers and community leaders?

A board comprised of parents, teachers and community leaders helps to assure structural independence.

8.e. Are the board's meetings held in the community where the school is located and open to the general public?

Board meetings open to the public and held in the community where the school is located help ensure that the community is actively involved in school matters.

8.f. Is there an advisory committee?

An advisory committee assists the board in obtaining expert opinion.

8.g. Is the board involved in the active oversight of the management company, the operations of the school, and major decisions concerning the school?

8.h. Does the board have the authority to set and approve the following major school policies: budget, curriculum, admissions procedures, student conduct, school calendars, and dispute resolution procedures?

8.i. Does the board have any responsibility for the day-to-day operations of the school?

8.j. Are the school's administrators, teachers, and similar key personnel employed by the school?

8.k. Does the board have the authority to hire and terminate school administrators, teachers and similar key personnel?

If the school does not retain a right to hire and terminate or a right of approval over hiring and terminating decisions involving the school's administrator, teachers, and similar key personnel, this means that the management company controls essential decisions that affect the accomplishment of the charitable program.

8.l. Does the board meet more than 2 times a year?

The board should be actively involved in the oversight of the operations of the school and the performance of the management company. One way to demonstrate active oversight is regular board meetings (two a year are not sufficient) evidenced by minutes of the meetings.

8.m. Have the minutes of each board meeting to date been provided?

8.n. Do the minutes reflect independent decision-making by the board?

The minutes should document in some detail the issues discussed and the decisions made at each meeting.

8.o. Is the management company a liaison between the school and the chartering authority?

The board must retain ultimate responsibility for meeting the terms of the charter. If the management company acts as a liaison between the school and the chartering authority, this delegates responsibility from the school to the management company.

8.p. Does the management company have the right to attend or vote at board meetings?

While the presence of the management company at board meetings would be appropriate at the discretion of the board, a right to attend board meetings or to vote at board meetings would raise issues involving whether board operates independently from the management company.

### **Fiscal Matters**

These questions concern whether the school board retains responsibility for the financial matters of the school and therefore is likely to take appropriate action to ensure the fiscal health of the school.

9.a. Does the board have procedures in place to ensure the fiscal health of the school?

Procedures would include periodic reviews of financial statements and the employment of an auditor that is independent of the management company.

9.b. Does the management agreement state who bears the risk that expenses will exceed revenues?

If the answer is No, the organization should be asked to clarify this aspect. The school should explain who bears the risk that expense will exceed revenues, and how any shortfall will be financed. Often, any excess of expenses over revenues will be deemed a loan financed by the management company payable upon termination of the agreement, rather than a contribution by the management company. In this circumstance, the school bears the risk that expenses will exceed revenues. This should be clarified in advance since it may indicate that the school is not capable of acting independently from the management company.

9.c. If the management company bears the risk that expenses will exceed revenues, is the excess of expense over revenues considered a loan to the school?

Where the management company gets almost all of the per pupil allocations from the school and is responsible for paying all the costs of the school, the management agreement should clarify whether the management company actually bears the risk of loss. On the other hand, if the management agreement requires the school to pay the shortfall, either during the term of the agreement or immediately at the termination of the agreement, this arrangement raises control and private benefit concerns.

**Conflict of Interest Policy**

The existence of a conflict of interest policy, substantially in the form recommended by the Service, helps to provide assurance that the school will be operating to benefit the students rather than private interests.

10.a. Does the school have a conflict of interest policy covering its officers, directors, trustees, and members of committees with board-delegated authority that is similar to the policy recommended by the Service?

10.b. If the school has a conflict of interest policy, was a copy submitted?

**Reasonable Compensation**

11.a. Is the compensation arrangement with the management company consistent with industry practices and market rates?

The compensation arrangement with the management company is an indication of whether the management agreement was negotiated at arm's length, and therefore whether the school board is independent of the management company. The school board should explain how it arrived at the compensation arrangement in terms of both the specific arrangement and how it determined that the arrangement is consistent with industry practices and market rates.

11.b. Is the compensation based on total income, including all fees, grants, contributions, and unusual receipts?

Compensation based on total income irrespective of expenses creates the opportunity for the management company to reduce costs in order to increase its compensation, possibly at the expense of the education of the students. This method of compensation allows for the possibility of private benefit.

11.c. Does the agreement provide for an incentive fee (a percentage of the excess of revenues over expenditures of the school)?

Compensation based on the payment of an incentive fee creates the opportunity for the management company to reduce costs in order to increase its compensation, possibly at the expense of the education of the students. This method of compensation allows for the possibility of private benefit.

11.d. Does the management company keep most or all of any funds raised for the school?

With regard to the management company receiving the funds raised for the school, the management company should only be permitted to keep a reasonable portion of grants and contributions in the form of a fee for its services where it is directly responsible for the solicitation of, or otherwise provides services in connection with, grants, contributions, or fundraising events.



## Ancillary Services/Contracts

Businesses typically deal with a number of different entities to purchase and lease the property and services they need. If most goods and services are purchased from one entity or a group of related entities, private benefit is more likely. Where the school has a web of related contracts with the management company and its affiliates, not only is the amount payable to the management company increased, it also makes the school reliant on one supplier for almost everything, and therefore the school's ability to remove itself from the management company is severely impaired. The school is completely dependent on one for-profit organization for its operations, to which it cedes so much control, that it only operates at the management company's sufferance. Therefore, agreements between the school and the management company (and its related entities) should be examined carefully to determine whether the terms were negotiated at arm's length or whether they are, in effect, compulsory contracts with a captive school board.

12.a. Does the management company or an affiliate provide any ancillary services to the school, such as cash advances, capital loans, facility or equipment leasing, technology contracting, furnishings, fixtures, textbooks, food, transportation, etc.?

12.b. If item 12a is Yes, were copies of any leases or other contracts provided?

12.c. If item 12a is Yes, were the leases or other contracts negotiated at arm's length?

The school should be asked to describe how the agreements were negotiated at arm's length, including descriptions of any provisions that were resolved to ensure that the school was benefited, rather than the provider.

12.d. If leased from the management company or an affiliate of the management company, is there a reason the facility is not leased directly by the school?

If the school is not leasing real and personal property directly from the owner of the property, but the management company or an affiliate is acting as a middleman, the reasons for doing so should be scrutinized. Frequently, the management company or an affiliate acts as a middleman between the owner of the facility and the school. The management company leases the premises and then subleases to the school. This is an opportunity for the management company or an affiliate to benefit by making an unreasonable profit from the sublease. It may be charging too much for the sublease or the sublease may have not been necessary. For example, the school may have been able to lease the facility directly from the owner. If the school could not lease appropriate property directly because of its financial situation, a sublease would be acceptable. But the profit to the management company shouldn't be more than that reasonably necessary to cover its additional administrative costs in connection with the sublease.

12.e. Is the cost of the lease to the management company or affiliate the same as the cost of the sublease to the school?

12.f. Is the lease at market rate?

12.g. Was an independent appraisal completed to determine a reasonable rental value for the property?

12.h. If so, was a copy of the appraisal provided?

12.i. Are any of the agreements for services contingent upon the simultaneous execution of the management agreement, or do any agreements automatically terminate if any other agreement is terminated?

If any agreements are contingent upon the execution of other agreements, or that automatically terminate if another agreement is terminated, this is a factor that is indicative that the private interests of the management company are served. For example, if a termination of the management agreement by the school causes a default or termination of a loan agreement or real or personal property lease, the school could lose its facility and equipment, and immediately owe any money it had borrowed. The existence of such provisions would deter the school from terminating the relationship with the management company where it had valid reasons to do so out of fear of inability to continue operations.

### **Government Involvement**

13. Does the school have reporting requirements to the chartering authority regarding the management company?

The governmental agency that grants the charter to the charter school, commonly called the chartering authority usually requires the school to submit curriculum, student performance, and financial reports to the chartering authority. Any governmental regulation over the management company and the management company's agreement with the school would help to alleviate concerns with any potential private benefit. The provisions of the charter or charter agreement should be looked at to determine the level of governmental regulation over the management company or agreement, if any. For example, is the charter agreement concerned primarily with the curriculum, students, and finances of the school, or does it also impose performance standards or other obligations on the part of the management company?

### **Management Company is the Applicant**

14.a. Is the applicant a management company that provides services to one or more charter schools?

If the applicant is a non-profit entity that provides management services to one or more charter schools, the focus of the case is on the structure of the relationship between the applicant and the organizations to which it provides services. An organization formed to provide managerial services not substantially below cost to unrelated exempt organizations does not qualify for exemption under section 501(c)(3) of the Code since the provision of such services is a trade or business ordinarily carried on for profit. See Rev. Rul. 72-369, 1972-2 C.B. 245.

14.b. If item 14a is Yes, is there common structural and financial control among the charter schools and the management company?

Under the rationale of Rev. Rul. 78-41, 1978-1 C.B. 148, the management company may qualify for exemption if it is an integral part of the charter schools to which it provides services. A management company could derivatively qualify for exemption as an integral part if (1) it performs essential services for the schools, and the services, if performed by the schools themselves, would not be an unrelated trade or business, and (2) the schools exercise sufficient control and close supervision, based on all the facts and circumstances, to establish the equivalent of a parent and subsidiary relationship. Facts and circumstances would include common control over the governing boards between the schools and the management company (structural control) and centralized authority over major financial decisions (financial control). See also Rev. Rul. 75-282, 1975-2 C.B. 201, and section 1.502-1(b)(1) and (2) of the Income Tax Regulations.

14.c. If item 14b is No, does or will the management company provide services at substantially below cost?

If the management company is providing services to unrelated section 501(c)(3) organizations, it could qualify for exemption if it is providing services to the schools at substantially below its cost. See Rev. Rul. 71-529, 1971-2 C.B. 234.

14.d. If item 14a is Yes, does the applicant hold any charters to operate any schools?

If the applicant, in addition to providing management services to unrelated charter schools also directly holds charters to operate schools, it would have to be determined whether the primary purpose and function of the applicant is the operation of schools or whether the primary purpose is the provision of management services. In the latter case, the applicant would not qualify for exemption unless it was providing management services to tax-exempt schools at substantially below cost. This question recognizes that an organization may engage in multiple activities, such as to both hold a charter and operate a school and to provide management services to unrelated schools.

14.e. If item 14a is Yes, is the management company claiming exemption as a “school” under sections 509(a)(1) and 170(b)(1)(A)(ii)?

Generally, a management company will not be classified as a “school” under sections 509(a)(1) and 170(b)(1)(A)(ii) since its primary activity is not the operation of a school, but, rather, it carries out specified functions on behalf of the school pursuant to a contractual relationship with the school in exchange for fees. If the management company otherwise qualifies for exemption under section 501(c)(3), it is more likely that its foundation status will be determined under section 509(a)(2) or (3).