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Person To Contact:

ID No.

Telephone Number:

Refer Reply To:

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Date:

November 10, 2004

Legend

X =
B =
C =
D =
State
E =
F =
G =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Year A =
Act =

Dear

This is in response to your request dated July 13, 2004, as supplemented on September 7, 2004, in which you request a letter ruling on whether X is an instrumentality of State E under Internal Revenue Code (Code) section 3121(b)(7)(F) such that services provided by employees of X are exempt from taxation as employment for purposes of the Old-Age, Survivors, and Disability Insurance (OASDI) portion of Federal Insurance Contributions Act (FICA) taxes.

FACTS

On Date 1, the sole elementary school in D was ordered closed by the Superintendent of B in order to consolidate operations and save money. In order to preserve the local elementary school, X was incorporated on Date 2 as a non-profit State E corporation. On Date 5, X was granted a charter to operate an open-enrollment charter school pursuant to the State E Education Code. X's Articles of Incorporation (Articles) adopted on Date 2 provide that X is organized for the promotion and maintenance of current public school facilities in D and to foster public education for the local school children. Prior to its charter, the local school was a member of B, the local school district and the traditional means of providing public education in State E.

X's Articles provide that X shall not carry on any activities not permitted to be carried on by a corporation exempt from Federal income tax under Code section 501(c)(3). The Articles provide that no part of the net earnings of X will inure to the benefit of any private persons and provide that upon its dissolution, remaining assets shall be distributed for one or more tax-exempt or public purposes.

X's Bylaws, as revised on Date 3, provide that the management, business and affairs of X and all corporate powers shall be exercised by or under authority of the nine member Board of Directors. Vacancies on the board are filled by Members of the Board of Directors at the Annual Meeting. Members may include parents, guardians, teachers, as well as local residents and landowners of the D area. The directors hold office until removed or their successors are elected or installed. The State E Commissioner of Education retains the right to appoint a board of managers to exercise the duties of the board of trustees if the school fails to satisfy certain requirements. An annual report of X's financial activity is required. All funds are required to be handled pursuant to the Act of State E.

X received a favorable letter of determination dated Date 4 from the Internal Revenue Service recognizing it as a federally tax-exempt Code section 501(c)(3) organization.

On Date 5, X was granted a charter to operate an open-enrollment charter school by C, offering state supported free public education to students in grades kindergarten through grade eight in the area of D. The charter recites that X is a State E public school. The charter requires X to obtain an annual audit of the financial and programmatic operations of X by a certified public accountant holding a permit from the State E Board of Public Accountancy which shall be filed with F. The charter may not be revised without the approval of the State E Commissioner of Education. X is subject to the authority of the State E Commissioner of Education and is subject to investigations by F to determine compliance with the terms of the charter. With regard to accountability for student performance, the school is subject to specific rules of the State E Education Code and is required to provide an annual written evaluation of X's

compliance with these requirements with the State E Commissioner of Education. X is required to fully comply with the financial accounting principles published by F for the management and operation of charter schools.

X was granted the charter pursuant to the provisions of the State E Education Code relating to charter schools. The recited purposes of charter schools in general include:

- (1) improve student learning;
- (2) increase the choice of learning opportunities within the public school system;
- (3) establish a new form of accountability for public schools; and
- (4) encourage different and innovative learning methods.

The specific rules governing open-enrollment charter schools provide that an organization exempt from taxation under Code section 501(c)(3) may be granted a charter by C to operate an open-enrollment charter school to provide instruction to students at one or more elementary or secondary grade levels as provided by the charter.

A charter school is subject to many of the same requirements imposed on other State E public educational institutions, and with permission may participate in any state program available to school districts, the traditional means of providing public education in State E. An open-enrollment charter school is subject to the same operational requirements that apply to a school district. An open-enrollment charter school is immune from liability to the same extent as a school district. Participation in the State E Retirement System is available on the same basis to employees of open enrollment charter schools as to employees of school districts. An open-enrollment charter school does not have the authority to impose taxes. However, open-enrollment charter schools receive state funding and are entitled to available grants on the same basis as school districts. The charter of a school may be modified, placed on probation, revoked, or denied renewal by G for material violation of the terms of the charter, failure to satisfy generally accepted accounting standards of fiscal management, or failure to comply with an applicable law or rule.

X's Financial Statements and Independent Auditor's Report from the year ended Date 6, indicate that for that year X received 85.32% of its funding from State E, 12.19% from the Federal Government, and 2.48% from local support. X leases its facilities from B for a nominal annual fee which is currently \$1.00 per year. The facility used by X is the same one used when elementary education was provided by B. B is responsible for major repairs to the building; routine maintenance is provided by X.

The original charter of X expired in Year A. The charter has been renewed with F for an additional ten years.

LAW

Code section 3101(a) imposes a tax on employees for OASDI (i.e. the social security tax) on the income of every individual received by such individual with respect to employment. Code section 3111(a) imposes the social security tax on employers, calculated as a percentage of wages with respect to employment. Subject to certain exceptions not applicable in this case, Code section 3121(b)(7)(F) provides that the definition of “employment” includes service in the employ of a state, or any political subdivision thereof, or of any instrumentality of the foregoing, by an individual who is not a member of a retirement system of such state.

Whether X is an instrumentality within the meaning of Code section 3121(b)(7)(F) is determined using the factors found in Revenue Ruling 57-128, 1957-1 C.B. 311. Revenue Ruling 57-128 provides that the following factors are taken into consideration in determining the status of an organization as an instrumentality of one or more states or political subdivisions:

- (1) whether it is used for a governmental purpose and performs a government function;
- (2) whether performance of its function is on behalf of one or more states or political subdivisions;
- (3) whether there are any private interests involved, or whether the states or political subdivisions involved have the powers and interests of an owner;
- (4) whether control and supervision of the organization is vested in public authority or authorities;
- (5) if express or implied statutory or other authority is necessary for the creation and/or use of such an instrumentality, whether such authority exists; and
- (6) the degree of financial autonomy and the source of its operating expenses.

ANALYSIS

An analysis of the facts of this case using the factors identified in Revenue Ruling 57-128 follows.

1. Governmental Purpose and Function

State E has promulgated rules and standards applicable to open-enrollment charter schools as an alternative to standard or traditional public education in State E provided by school districts. X is used for a governmental purpose and performs a governmental function, as the provision of public education is a governmental purpose and function. The State E statute governing open-enrollment charter schools makes them subject to many of the same requirements to which public schools in State E school districts are subject. X is subject to the direct authority of the State E Commissioner of Education.

X's charter is granted by C and is renewed by C, an agency of State E. The original charter expired in Year A and the charter has been renewed for an additional ten years.

2. Function Performed on Behalf of a State

State E statute recites the intention that open-enrollment charter schools increase the choice of learning opportunities and encourage different and innovative learning methods within the public school system. As such X provides an alternative form of public education through the open-enrollment charter school and encourages different and innovative learning methods. X performs an educational function on behalf of State E. X is performing functions previously performed by B. X took over these educational functions when the elementary school in D was ordered closed by the Superintendent of B in order to consolidate operations and save money.

3. Private Interest versus Government Ownership.

X's Articles of Incorporation provide that no part of the net earnings of X will inure to the benefit of any private person. The annual financial report indicates that over 95% of its annual operating expenses come from federal and state sources. Pursuant to the laws of State E, State E retains an ownership interest in property purchased by X with State E funds. State E law further provides that, in the event that X's charter becomes forfeited or is not extended, the Commissioner of Education of State E shall take possession of all of X's property.

4. Public Control and Supervision

The control of X is in the board of directors subject to the State E Commissioner of Education. X is subject to many of the same requirements imposed on other State E institutions and may participate in other state programs available to school districts and has the same operational requirements that apply to school districts. Although the day-to-day management of X is by the board of directors, X is subject to numerous statutory requirements. X may not revise its charter without the approval of the State E Commissioner of Education. X is subject to investigations by F to determine charter compliance. In accordance with State E rules, X is required to furnish a copy of its annual audit to F. X is also subject to the State E Education Code rules governing student performance accountability and accreditation.

5. Statutory Authority

State E statute authorizes G to grant a charter for an open-enrollment charter school to a Code section 501(c)(3) organization. X was chartered pursuant to the authority in the State E Education Code as an open-enrollment charter school.

6. Financial Autonomy/Source of Operating Funds

X's Financial Statements and Independent Auditor's Report from the year ended Date 6, indicates that for that period X received 85.32% of its funding from State E, 12.19% from the Federal Government, and 2.48% from local support. Virtually the entire operating budget of X comes from State E or the federal government. While the charter school does not have the authority to impose taxes it receives state funding and is entitled to grants on the same basis as State E school districts.

CONCLUSION

Based upon the above analysis, we conclude that X satisfies the criteria of Revenue Ruling 57-128, and is an instrumentality of State E. The services performed by X employees who are qualified participants in a retirement system within the meaning of Code section 3121(b)(7)(F) are excluded from employment for purposes of Code sections 3101(a) and 3111(a).

No opinion is expressed on whether the employees of X participate in a retirement system within the meaning of Code section 3121(b)(7)(F). The above analysis is based on the assumption that X's employees are not covered by a section 218 agreement.

The ruling contained in this letter is based upon information and representations submitted by the taxpayer's representative and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for a ruling, it is subject to verification on examination.

This ruling is directed only to the taxpayer requesting it. Code section 6110(k)(3) provides that this ruling may not be used or cited as precedent.

Sincerely,

LYNNE CAMILLO
Branch Chief, Employment Tax Branch 2
CC:TEGE:EOEG:ET2
(Tax Exempt & Government Entities)