COMMERCIALITY, CHARTER SCHOOL MANAGEMENT ORGANIZATIONS, AND SOCIAL ENTERPRISE

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The imprecise application of a troubled doctrine leaves worthy organizations stuck in the middle.

East is east and west is west and never the twain shall meet.

—Rudyard Kipling, *The Ballad of East and West*

It seems that hardly a day goes by in the life of an advisor to tax-exempt organizations without a mention of social enterprise or its counterpart in capital: social investment. Commentators ruminate on new models and funders seek to spark innovation through grantmaking and impact investments. This energy is creating waves across sectors and inspiring new forms of enterprise, but the nonprofit corporation still remains as one of the principle choices for the aspiring social entrepreneur. When it comes to tax exemption, however, nonprofit social enterprises potentially face the substantial barrier posed by the commerciality doctrine, which can be invoked to deny tax-exempt status when the activities of the organization take on too much of a "commercial hue." There are many examples of how the commerciality doctrine has derailed tax exemption, but the recent experience of charter school management organizations (CMOs) may be particularly instructive for social enterprises. CMOs are unique organizations, but their documented (and undocumented) story with the IRS demonstrates the pernicious nature of the commerciality doctrine and provides some insight into how it can be overcome.

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Social enterprise and the middle space

Social enterprise is the subject of wide-ranging and at times unhelpfully imprecise conversations. Depending on the perspective, the term "social enterprise" could be illustrated by any number of concepts, including a nonprofit venture employing members of a charitable class, a workers' cooperative, a B-Corp certified local business, an Etsy-like vendor platform for artisans, a nonprofit pharmaceutical research and development institute, or a social impact bond/pay-for-success arrangement. Context and meaning get further muddied by new hybrid legal forms of enterprise, like the benefit corporation[1] and the low-profit limited liability company (L3C).[2] It is sometimes hard to have a coherent conversation with such varied enterprises, each with different rationales, structures, sources of funding, and economic arrangements.

That being said, the big tent of social enterprise is a natural result of why and how it has developed. Many practitioners may recall from

their studies the key rationales for the nonprofit sector, including the inability of the free market to effectively monetize a collective good, and the sometimes concurrent failure of the government to address a social need.[3] Seen as the third leg of American civil society, the nonprofit sector fills gaps created by such market and government failures, thus contributing critically to our democracy, economy, and social and spiritual wellbeing.

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As illustrated from time to time in a Venn diagram, social enterprise shares many of the same rationales as the nonprofit sector. In the Venn diagram in Exhibit 1 on page 5, social enterprise occupies the space where the private, governmental, and nonprofit sectors overlap. This middle space represents both the overlapping functions and weaknesses of the sectors—the place where the free market can only partially meet an important need or reduce a collective cost, where the government's role is limited or it performs incompletely or unsatisfactorily, and where the nonprofit sector has difficulty with scalable alternative solutions. For instance, in many locations, the traditional housing market is woefully inadequate in providing affordable options for low- to moderate-income individuals. Federal, state, and local governments attempt to pick up the slack through tax credits and other incentives, and often partner with nonprofit housing developers to fill in the gaps of the private market. While helpful, these solutions have limits, and the need for affordable housing continues to far outpace supply in many areas. As a result, social entrepreneurs seek new and creative ways of developing and financing properties that blend market practices with the nonprofit mission.[4] The middle space is full of other meaty social issues as well, such as social and economic stratification, public health, and climate change, to name a few.

This perspective helps explain why there are so many variations in form and purpose of social enterprise. For-profit and hybrid forms tend to spring up where social value can be partially, if not substantially, monetized or realized by commercial means, or where there is an opportunity to efficiently limit social costs of enterprise. Often their activities are commercial in nature, and they seek to return profits to owners and investors.[5] They are not interested in, nor would they qualify for, tax exemption. Nonprofit social enterprises, on the other hand, seek to monetize the value of activities primarily to more efficiently further a tax-exempt purpose; they are not designed to return profits to private interests.[6] The discussion below focuses on nonprofit social enterprises that wish to seek tax exemption and will be less relevant, although perhaps still of interest, for those primarily concerned with for-profit social enterprise.

Nonprofit social enterprise

There are many variations of nonprofit social enterprise, and it is helpful to review some key distinctions before exploring issues they face in obtaining exemption.

Types of enterprises. Given the significant overlap in rationales, it is no surprise that for many decades, nonprofits have been innovators in community economic development, public health, arts, education, and social services in ways that would be

[1] A benefit corporation is required to include some type of social or environmental benefit as one of its corporate purposes, consider social impact in addition to shareholder value in decisionmaking, and, in most jurisdictions, report to shareholders their overall social or environmental impact based on third-party standards. Benefit corporations are created pursuant to specific legislation currently adopted by 31 states. See www.benefitcorp.net.

[2] The low-profit limited liability company is designed to facilitate social investing by meeting—by operation of law—the technical requirements to be a recipient of a private foundation program-related investment. It has not yet gained the traction enjoyed by the benefit corporation.

[3] Fishman, Schwartz, and Mayer, *Nonprofit Organizations: Cases and Materials* (Foundation Press, 2015) pages 25-33 (citing the works of, among others, Lester Salamon and Henry Hannsmann).

[4] See, e.g., Stevens, "Using Wall Street Tactics to Preserve Affordable Housing," Next City, 10/31/14 (discussing the use real estate investment trusts by nonprofit affordable housing organizations), available at https://nextcity.org/daily/entry/affordable-housing-invesment-reit.

[5] Indeed, some household names, including publicly traded companies, are certified B-Corps. See McGregor, "What Etsy, Patagonia and Warby Parker Have in Common," Wash. Post, 4/20/15, available at www.washingtonpost.com/news/on-leadership/wp/2015/04/20/what-etsy-patagonia-and-warby-parker-have-in-common/.

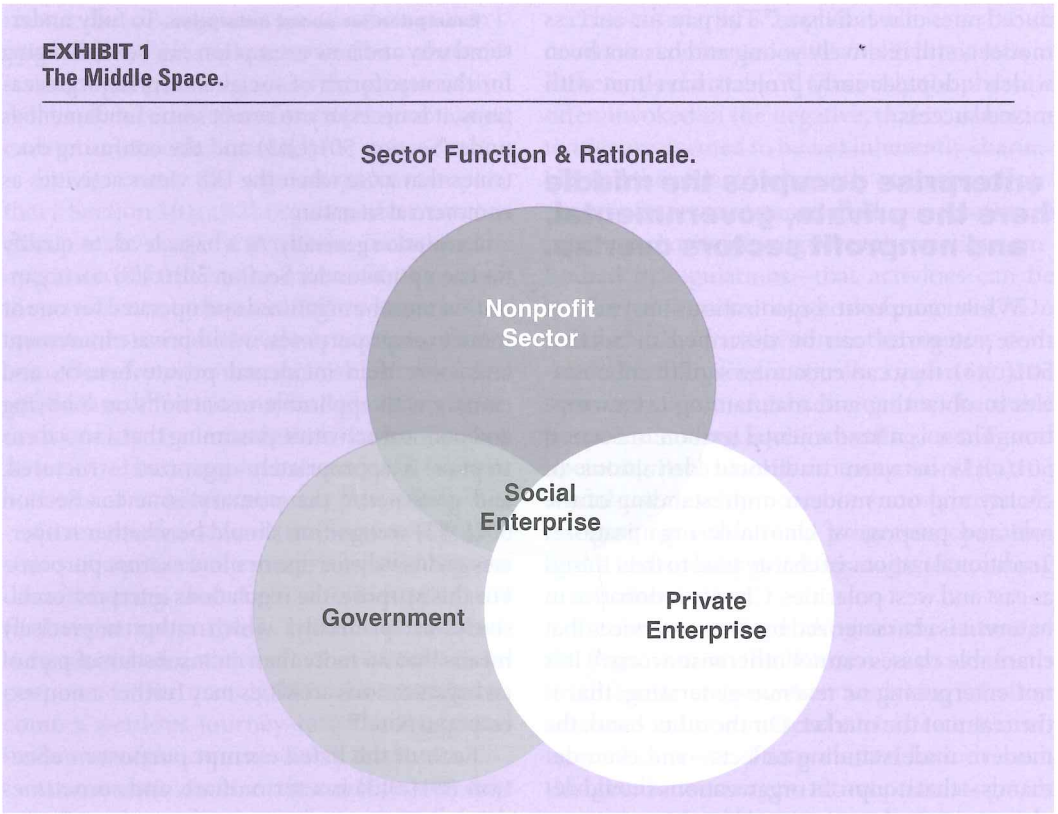
[6] The classic example is the microfinance institution (such as Grameen Foundation and FINCA International) that provides lending and other financial services to individuals and business—often in developing countries—that historically have been denied access to commercial financial services.

[7] McKeever and Pettijohn, "The Nonprofit Sector in Brief 2014," Urban Institute. October 2014, page 5, available at www.urban.org/sites/default/files/alfresco/publication-pdfs/413277-The-Nonprofit-Sector-in-Brief—.PDF.

[8] See, e.g., *Industrial Aid for the Blind*, 73 TC 96 (1979), *acq.* 1980-2 CB 1; Ltr. Rul. 9338043. See also Reg. 1.513-1(d)(4)(ii).

[9] There are a number of tax-exempt organizations devoted driving innovation and product development in vaccines, pharmaceuticals, and other public health biotechnologies, such as PATH, the Sabin Vaccine Institute, and the International Partnership for Microbicides.

EXHIBIT 1
The Middle Space.



lauded as social enterprise today. Moreover, economic measures of the nonprofit sector suggest the extent to which nonprofits are able to monetize their social value. The National Center for Charitable Statistics reports that in 2012, the sector brought in nearly 73% in revenue from the performance of services (including government contracts), compared to just 22% in donative support.[7] The health care and education sectors account for a good portion of that program service revenue, but the remaining portion reflects a variety of revenue-generating charitable programs.

Nonprofit social enterprises can perform many functions and take many forms, but it is possible to categorize some by characteristics. One group consists of organizations that assist a defined charitable class in developing economic or social independence by way of job training or an employment program. For instance, a number of organizations operate one or more businesses to provide skills training and reentry programs for recovering addicts or differently abled individuals. These organizations are unique among social enterprises because the value they add to society—employment skills and opportunity for a charitable class—is not necessarily directly tied to the products or services being produced. As a result, these organizations can operate businesses that would likely be considered an unrelated trade or business for any other type of tax-exempt organization, subject to some limitations.[8]

In contrast, a second category of nonprofit social enterprise contains organizations that produce goods or services that directly further their exempt purposes. In other words, the product or service itself—not the manner in which it is produced—is meant to address the social need that underlies the organization's mission. Examples include a micro-lending program for local low-income entrepreneurs, or a developer of vaccines or other public health technologies that primarily benefit developing nations ignored by the market.[9] Such organizations sometimes can look very much like, and occupy the same space as, commercial enterprises.

A third variation of nonprofit social enterprise seeks to monetize the savings to society or government that results from a social service through a pay-for-success contract, often referred to as a social impact bond. In this arrangement, the government agrees to pay the enterprise a portion of the savings from a social program if the program achieves certain outcomes. For example, the very first model program sought to capture the savings from re-

duced rates of recidivism.[10] The pay-for-success model is still relatively young and has not been widely adopted; early projects have met with mixed success.

Social enterprise occupies the middle space where the private, governmental, and nonprofit sectors overlap.

While nonprofit organizations in each of these categories can be described in Section 501(c)(3), they can encounter significant obstacles in obtaining and maintaining tax exemption. There is a fundamental tension in Section 501(c)(3) between traditional definitions of charity and our modern understanding of the role and purpose of charitable organizations. Traditional notions of charity tend to treat things as east and west polarities. Charity is donative in nature; it is characterized by alms or services that charitable classes cannot otherwise access.[11] It is not enterprising or revenue-generating; that is the realm of the market. On the other hand, the modern understanding reflects—and even demands—that nonprofit organizations should deploy ingenuity, creativity, and business acumen to solve—or at least more effectively address—intractable social issues. As illustrated by the example of the charter school management organization, explored in depth below, this tension often manifests in the commerciality doctrine that makes exemption challenging for nonprofit social enterprises.

Exemption for social enterprise. To fully understand why and how exemption can be challenging for the new forms of social enterprise organizations, it is necessary to revisit some fundamentals under Section 501(c)(3) and the confusing doctrines that arise when the IRS views activities as commercial in nature.

Exemption generally. At a basic level, to qualify for exemption under Section 501(c)(3), an organization must be organized and operated for one or more exempt purposes, avoid private inurement and more than incidental private benefit, and comply with applicable restrictions on lobbying and political activities. Assuming that a social enterprise is appropriately organized, structured, and governed,[12] the primary issue for Section 501(c)(3) recognition should be whether it operates exclusively for one or more exempt purposes. For this purpose, the regulations interpret "exclusively" as "primarily," which rather imprecisely means that no more than an insubstantial part of an organization's activities may further a non-exempt purpose.[13]

Each of the listed exempt purposes in Section 501(c)(3) is a term of art, and sometimes the definitions and contours for each can be excruciatingly nuanced.[14] Some purposes can be supported by different activities in a way that can materially affect exemption, particularly in the middle space. For instance, an organization created to research and develop biotechnologies that primarily benefit developing nations may qualify for exemption as a scientific organ-

[10] Kohli et al., "From Cashable Savings to Public Value," Center for American Progress, 9/1/13, page 2, available at www.americanprogress.org/issues/economy/report/2015/09/01/120300/from-cashable-savings-to-public-value. This paper also argues that governments should consider factors other than savings when monetizing the value of services of a pay-for-success contract.

[11] For a thorough historical exploration of the meaning of charity as it pertains to U.S. tax law, see Kelley, "Rediscovering Vulgar Charity: A Historical Analysis of America's Tangled Nonprofit Law," 73 Fordham L. Rev. 6 (2005), page 2437.

[12] Sometimes this can be a big assumption, particularly with issues of private benefit and inurement. However, this article focuses on charitability and it will not explore these other issues in any depth.

[13] Reg. 1.501(c)(3)-1(c)(1).

[14] See, e.g., Rev. Proc. 96-32, 1996-1 CB 717.

[15] See, e.g., Ltr. Rul. 201233017 (5/25/12). *Cf.*, Ltr. Rul. 200603031 (authorizing private foundation grants to for-profit companies for the purposes of stimulating research and development for global health interventions).

[16] Reg. 1.501(c)(3)-1(e).

[17] A trade or business will be considered unrelated if it does not bear a substantial causal relationship to the achievement of the organization's exempt purposes (other than the through the production of income). In other words, the trade or business must "contribute importantly" to the purposes for which exemption is granted, as determined under the facts and circumstances. Reg. 1.513-1(d)(2).

[18] Reg. 1.501(c)(3)-1(e)(1).

[19] The doctrine traces back to *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578, 4 AFTR 3802 (1924).

[20] *Am. Inst. for Econ. Research*,302 F.2d 934, 938, 9 AFTR2d 1426 (Ct. Cl. 1962).

[21] Kelley, *supra* note 11 at 2475 (citing the research in Pena and Reid, "A Call for Reform of the Operational Test for Unrelated Commercial Activitiy in Charities," 76 N.Y.U. L. Rev. 1885 (2001)).

[22] *B.S.W. Group, Inc.*, 70 TC 352, 356-57 (1978).

[23] *IHC Health Plans, Inc.*,325 F.3d 1188, 1198, 91 AFTR 2d 2003-1767 (10th Cir. 2003). While in some instances it might be easy to draw a distinction between the nature of an activity and the manner in which it is carried out, that distinction often becomes conflated. The result: the nature of activities does not control the analysis, except when it does.

[24] See, e.g., Ltr. Rul. 201233017.

[25] A recent search in a popular electronic database revealed 97 private letter rulings using the term "inherently charitable" but only nine using "inherently commercial."

[26] Reg. 1.501(c)(3)-1(e).

[27] See, e.g., *B.S.W.*, *supra* note 22, pages 358-360; *Asmark Inst., Inc.*, TCM 2011-20, at 103.

[28] Rev. Rul. 72-369, 1972-2 CB 245.

[29] Compare the public support tests under Section 170(b)(1)(a)(vi) and Section 509(a)(2).

ization, but an organization that brings developed technologies to market in these countries is no longer pursuing scientific purposes and will likely face additional barriers in obtaining exemption on other grounds.[15]

In any event, the regulations contemplate that a Section 501(c)(3) organization may conduct a wide range of activities, including the operation of a trade or business, if doing so furthers its exempt purposes.[16] If an organization operates an unrelated trade or business, the income therefrom (minus applicable deductions) will be taxed,[17] but in no event can an organization qualify for exemption under Section 501(c)(3) if carrying on an unrelated trade or business constitutes a primary purpose.[18]

Given this framework, the Section 501(c)(3) status of most social enterprises will hinge on demonstrating that their activities primarily further exempt purposes and that no substantial part of their activities further a commercial purpose. Unfortunately, this can quickly become a perilous journey into the foggy and fickle seas of the commerciality doctrine.

Commerciality doctrine. The commerciality doctrine does not exist in the Code or regulations; it is judge-made law that the courts and the IRS use to revoke or deny tax-exempt status due to an organization's perceived commercial nature.[19] At its core, the commerciality doctrine involves a review of the facts and circumstances to see if an organization's activities indicate a commercial purpose or have a "commercial hue."[20] But depending on the case, the doctrine may be used to establish that activities do not further a charitable purpose but instead indicate a commercial purpose, or the IRS or a court may simply jump to a conclusory determination that an organization is simply per se commercial.[21]

The commerciality doctrine is troubled at its most fundamental level. From the outset, in determining whether activities indicate a commercial purpose, one is instructed to look at "the purpose towards which an organization's activities are directed, and not the nature of the activities themselves...."[22] This guidance sensibly recognizes that a single activity may be deployed to achieve many purposes. The IRS and the courts can, however, turn this analysis on its head. As one court said, "[B]ecause of the inherent difficulties in determining a corporate entity's subjective purpose, we necessarily rely on objective indicia in conducting our analysis. In determining an organization's purpose, we primarily consider the manner in which the entity carries on its activities."[23]

This circularity is amplified when the IRS or courts are confronted with activities not seen as "inherently charitable."[24] Curiously, the phrase is often invoked in the negative, that is, when activities are deemed to be *not* inherently charitable, and the phrase "inherently commercial" appears in far fewer instances.[25] The very notion of inherent charitability ignores the reality—embodied in regulations—that activities can be conducted in pursuit of a host of purposes.[26] On a daily basis, charities across the country conduct the following critically important and seemingly commercial activities for charitable purposes: lending, equity investing, owning and operating multi-family housing, constructing mixed-use developments, operating hospitals, charging for educational programs, operating health clubs, and publishing magazines, among many others.

In any event, depending on the nature of the organization, the IRS or a court can focus on different factors when analyzing whether activities are commercial or indicate a commercial purpose. Factors often include such things as how an organization prices its goods or services, how they are marketed, whether they are intended to benefit the broader public or a distinct charitable class, the accumulation of a surplus, and whether decisions are made on an economic basis.[27] Critical for social enterprise organizations, key factors often include the existence of commercial competition and the extent to which the organization depends on revenue from fees or sales as opposed to donations. Often, the IRS will find commercial purposes where the organization did not heavily subsidize the delivery of its services. Even providing services at cost is insufficient since doing so "lacks the donative element necessary to establish this activity as charitable."[28] The cutting room floor of exempt organizations is littered with organizations denied in part because they did not provide their goods or services to the public substantially below cost.

There can be good reasons for weighing these factors in certain circumstances, and oftentimes the outcome is right. Yet nothing in Section 501(c)(3) prohibits charging fees or recovering costs, and exempt organizations—even publicly supported charities—are not required to be financed through a certain percentage of donative support.[29] Nor does the law prohibit exempt organizations from operating in the same space as for-profit entities. Otherwise, a host of organiza-

There is a fundamental tension in Section 501(c)(3) between traditional definitions of charity and our modern understanding of the role and purpose of charitable organizations.

tions would not be exempt: health care organizations, colleges and universities, community economic development organizations, research and development institutes, and many more. The sector would be gutted.

The dangers posed by the commerciality doctrine to the tax exemption of social enterprises are obvious. By its nature, the typical social enterprise likely will coexist with for-profit enterprises and generate a substantial portion of its budget from fees for services or sales of products. It may also be tackling issues (e.g., climate change) or operating in contexts (e.g., the Internet) not historically contemplated by traditional notions of charity. From the outset, these factors may portend a struggle for exemption, and the presence of additional commercial indicia or the absence of a strong tie to charitable purposes may spell doom.

The commerciality doctrine is troubled at its most fundamental level.

Integral part doctrine. Despite their perceived commercial nature, some social enterprises may be able to obtain exemption under the integral part doctrine. Under this doctrine, an organization may qualify as exempt if (1) it performs essential services for one or more tax-exempt organizations (provided that such services, if performed by the exempt organizations themselves, would not constitute an unrelated trade or business), and (2) the organization stands in one way or another in a parent-subsidiary relationship to the exempt organizations.[30] A technical parent-subsidiary relationship is not required,[31] and it can flow in either direction. For instance, an organization could be controlled by a family of exempt organizations[32] or be the parent of a family of exempt organizations, which is a common in complex health care systems.[33] The relationship between or among the organizations is determined by the facts and circumstances, but it must permit an exempt organization to exercise control and close supervision over the organization seeking exemption under the integral part doctrine. At least in the health care context, the IRS has permitted this control to be manifested by contractual arrangements.[34]

A note on public charity status. or a nonprofit social enterprise, public charity status can be of almost equal importance to tax-exempt status. Generally, by default, each Section 501(c)(3) organization is classified as a private foundation unless it can meet a test to be described as a public charity in Section 509(a)(1), (a)(2), (a)(3), or (a)(4). The distinction can be crucial, as private foundations are subject to a more restrictive regulatory regime that can increase costs and reduce flexibility.[35] Public charities are also tax favored for the purposes of receiving charitable contributions as well as grants from private foundations and donor advised funds.[36] Generally, most social enterprises will need to pass one of two public support tests that are designed to ensure that the charity is receiving significant support (at least one-third) from the broader general public: one measures the breadth of donative support,[37] and the other gauges the diversity of funding for organizations that have significant percentages of support from gross receipts from related activities.[38] However, an organization can also be a public charity by qualifying as a "supporting organization" that carries out the purposes of one or more related public charities.[39]

The rules that govern public charity classification can be confusing and deceptively complex, and a fair treatment of them is beyond the

[30] See Reg. 1.502-1(b).

[31] Rev. Rul. 68-26, 1968-1 CB 272.

[32] *Id.*

[33] See, e.g., Ltr. Rul. 200417035.

[34] See Darling and Friedlander, "Virtual Mergers: Hospital Joint Operating Agreement Affiliations," *Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 1997* (1996), page 131, available at www.irs.gov/pub/irs-tege/eotopicj97.pdf.

[35] See, e.g., Section 4941, relating to self-dealing, and Section 4945, relating to taxable expenditures.

[36] For example, charitable contribution of cash from individuals to public charities are subject to a 50% adjusted gross income limitation, but only a 30% AGI limit if contributed to a private foundation. Sections 170(b)(1)(A); (C).

[37] Section 509(a)(1), 170(b)(1)(A)(vi).

[38] Section 509(a)(2).

[39] Section 509(a)(3).

[40] For an exploration of some of the key issues under the public support tests, see Chaney and Eney, "Getting Public Charity Status Right Before it Goes Wrong," 27 Exempts 3 (Sep/Oct, 2015).

[41] See, e.g., Ltr. Rul. 201221023.

[42] National Center for Educational Statistics, "Fast Facts: Charter Schools," available at http://nces.ed.gov/fastfacts/display.asp?id=30.

[43] Pub. L. 107-110, 115 Stat. 1425 (2002). Schools that chronically do not meet certain standards can be subject to a restructuring by their local educational agency (e.g., the school district), which can include "[r]eopening the school as a public charter school" and "[e]ntering into a contract with an entity, such as a private management company, with a demonstrated record of effectiveness, to operate the public school." *Id.* at § 1116(b)(8)(B)(i), (iii).

[44] Miron and Gulosino, "Profiles of For-Profit and Nonprofit Education Management Organizations" (National Education Policy Center 2011-2012), available at http://nepc.colorado.edu/files/emo-profiles-11-12.pdf.

[45] See, e.g., National Association of Charter School Operators, "Principles and Standards for High Quality Authorizing" (2012), page 24, available at http://www.qualitycharters.org/wp-content/uploads/2015/08/Principles-and-Standards_2012-Edition.pdf.

[46] Miron and Gulosino, *supra* note 44, pages 5-15.

scope of this article.[40] However, a social enterprise would be wise to consider these rules prior to seeking exemption under Section 501(c)(3), particularly if revenue would be derived from only a handful of sources.

The charter school management organization example

Examples of how commerciality can affect tax exemption for nonprofit social enterprise abound in the public record of denied applications.[41] But the CMO presents an interesting case study for a number of reasons, not the least of which is how the commerciality doctrine divided the IRS, and the outcomes therefrom.

CMOs as social enterprise. To understand the connection of CMOs to social enterprise, it is helpful to look at their broader context and history.

CMOs are relatively young creatures. The first charter schools did not exist until 1991, when Minnesota became the first state to authorize their creation, but by 2013, 42 states had authorized 6,100 public charter schools.[42] Charter schools were initially envisioned as learning labs for innovation, but they have become important (and sometimes controversial) components of school reform, spurred in part by the "No Child Left Behind" legislation.[43] Charter schools are tuition-free public schools not directly operated by the school district. Instead, the school district or other chartering authority grants private organizations (usually nonprofit corporations) a charter and funding to operate a public school pursuant to an application process and a contract. Charter schools remain under the general oversight of the chartering authority.

Charter schools can be self-contained single organizations, but by the early 1990s, CMOs sprang up to replicate, operate, and manage multiple charter schools within a network.[44] While contexts can vary, CMOs are often created to spread a successful model, such as a school designed to meet the needs of high poverty and minority communities in urban areas. A charter school network can be a complex family of organizations that may include other types of affiliated entities, such as administrative/back office service providers or real estate holding companies. For the purposes of this article, the term "CMO" does not refer to these ancillary or administrative services; it refers to the entity that is responsible for conducting and overseeing the educational activities and primary school operations of the network.

CMOs can vary in structure, informed in no small part by a couple of key aspects in state law. First, in many states, each charter school must be a separately incorporated nonprofit corporation, and one organization cannot directly operate multiple schools under one corporate umbrella. Second, and in accordance with best practices in the field, some states require significant or complete governance independence between a charter school and its management entity.[45] As a result, to replicate a successful charter school model in these jurisdictions, a CMO has little choice but to form each school as an independent organization and then contract with it.

Nothing in Section 501(c)(3) prohibits charging fees or recovering costs.

In this way, CMOs develop a network of schools that share common purposes, curriculum, culture, and systems, all coordinated and managed, to the extent permitted by state law, by the CMO. The board of each school, however, maintains ultimate responsibility over the performance of its school and staff, including oversight over the operational functions delegated to the CMO. The relationship between a school and a CMO is typically memorialized in a management services agreement, and a CMO typically recovers costs by charging a fee based on the percentage of the allocated funds the charter school receives from the chartering authority.

CMOs and for-profit companies performing similar functions (sometimes referred to as education management organizations, or EMOs) have coexisted from the outset of charter schools, but historical trends tell an important story about the differences between them. In 1998, there were nearly 40% more CMOs (46) than EMOs (33), but the EMOs managed 68% more schools (193 compared to only 92 schools managed by the nonprofit CMOs).[46] By 2012, CMOs still significantly outnumbered EMOs (201 compared to 97), but CMOs then managed appreciably more schools than their for-profit counterparts (1,206 to 840). During this time, however, EMOs always managed a greater percentage of the overall students. In 2001, EMOs accounted for 70,743 students compared to only 20,133 for nonprofit CMOs. By 2012, the numbers had evened out somewhat to 462,926 and 445,052, but by this point, there were twice as many CMOs as EMOs. Ac-

cordingly, the average EMO-managed school size in 2012 contained 551 students compared to 369 for their CMO-managed counterparts.

These trends and data indicate how the profit motive manifests for EMOs. Because (1) the revenue for operating charter schools is generally tied to the per capita student population of the school, and (2) each separate school is going to have a certain amount of fixed costs to operate that cannot be ameliorated by scale, operating a smaller number of larger schools should increase revenue and decrease costs. On the other hand, mission-driven CMOs tend to open a larger number of small schools that are chosen because they further the educational purposes of the organization, such as reaching particular geographic and demographic communities.[47] Operating in this manner trades economic efficiency for social impact.

Even publicly supported charities are not required to be financed through a certain percentage of donative support.

All of this leads to why CMOs should be seen as a form of social enterprise. By rationale and characteristics, CMOs are nestled in the center of the social enterprise middle space. CMOs respond to the partial government failure in providing high-quality public education. In many instances, government fulfills this traditional function very well, but where it fails, the costs to society are very high generally, and particularly for those communities directly experiencing the failure. In this way, CMOs offer the government a way to reduce social costs without increasing the burden to the taxpayer, which gives them a dimension akin to social impact bonds.[48] Moreover, governments are experimenting with charter schools in part to see how public/private partnerships might increase both educational outcomes and economic efficiencies, and these partnerships involve both nonprofit and for-profit organizations. In sum, these factors combine to create fertile ground for mission-oriented social enterprises that can create sustainable solutions through revenue-based models.

CMO exemption struggles. Tax exemption in the charter school context has always been fraught with issues, even for the charter school itself. It took quite some time for the IRS to get comfortable with the notion that a charter school could be managed by a for-profit enterprise without resulting in excessive private benefit. While no longer a fundamental bar to exemption, it remains a critical issue for exemption, and the extent of private benefit remains a source of concern.[49]

An appropriately structured and governed CMO does not implicate private benefit in the same way, but CMOs still struggle with obtaining exemption because of the commerciality doctrine. But the case of the CMO is particularly interesting in this regard, because for at least the past decade, the IRS has been split between those who consider the activities of a CMO to be educational and those who believe a CMO simply to be a management consulting organization and therefore inherently commercial.

To some extent, this division has been memorialized in writing. In late 2006, the IRS released the Charter School Guide Sheet and accompanying Charter School Reference Guide (together, the "Guide Sheet"). The IRS drafted the Guide Sheet to assist its reviewers in processing charter school-related exemption applications and, for the most part, it applies to cases where the applicant is the school itself. However, section 14 of the Guide Sheet is devoted to CMOs, and it stakes out a very unfavorable position:

> 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.[50]

However, the Guide Sheet leaves open the possibility for qualifying under the integral part doctrine.

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[47] National Resource Center on Charter School Finance and Government, "Mapping the Landscape of Charter Management Organizations: Issues to Consider in Supporting Replication," page 6, available at www.usc.edu/dept/education/cegov/focus/charter-schools/publications/policy/MappingTheLandscape-SupportingReplication.pdf.

[48] This might explain why charter schools have a greater percentage of high poverty schools (36%) than their public school counterparts (23%). National Center for Educational Statistics, "Fast Facts: Charter Schools," available at http://nces.ed.gov/fastfacts/display.asp?id=30.

[49] See, e.g., Kelley, "N.C. Charter Schools' (Non?) Compliance with State and Federal Nonprofit Law," 93 N.C. L. Rev. 1757 (2015).

[50] Charter School Reference Guide, Internal Revenue Manual, dated 7/20/10, Exhibit 7.20.4-13 10 (12/5/06), Q&A 14.a, available at www.irs.gov/pub/irs-tege/irm7_20_4_13_charterschoolguidesheet.pdf.

[51] *Id.*, Q&A 14.b.

[52] *Id.*, Q&A 14.d.

[53] PMTA 2007-00925 (7/9/07), available at www.irs.gov/pub/lanoa/pmta00925_7313.pdf.

[54] *Id.*, pages 1-2.

[55] *Id.*, page 5.

[56] *Id.*, page 6.

[57] *Id.*, page 8.

[58] See, e.g., Ind. Code § 20-24-4-2.

[59] See, e.g., D.C. Code § § 38-1802.01, 38-1802.02.

> 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).[51]

In sum, according to the Guide Sheet, a CMO is performing activities that are not inherently charitable and can only qualify if it either provides its services substantially below cost or can be considered an integral part of its schools. The Guide Sheet goes on to address the more complex scenario in which a CMO may both directly operate a school and manage other schools within its network. The IRS states that exemption will depend on "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,"[52] noting that a substantial purpose of managing network schools would disqualify the entity from exemption.

Shortly after the Guide Sheet was released, in program manager technical assistance (a PMTA), the IRS Office of General Counsel repudiated this position and effectively reversed a determination that a CMO did not qualify for exemption.[53] In that particular case, a CMO managed three separate charter schools "located in economically disadvantaged, inner city communities." As is typical, the CMO remained "subject to the direction, oversight and policies" of the boards of each school, and the CMO provided a comprehensive management program, including:

> [T]he development of specialized curriculum for inner city children, as well as providing curriculum materials; recruiting students; recruiting, hiring, supervising, and compensating faculty and staff; providing food service for the students; cleaning and maintaining school facilities; and preparing the annual budget.[54]

The relationship between the CMO and the schools was memorialized in a contract for which the CMO would receive fees for its management services. The CMOs fees were intended to cover its full costs.

Consistent with the Guide Sheet, EO Determinations argued that the organization's activities were not directly educational and did not advance education, but rather were commercial in nature. EO's argument rested on the fact that the boards of each school retained ultimate control over the school operations. As a result, EO argued, the CMO was a mere management services provider contracted by the schools for their own purposes. Moreover, EO argued that the CMO was inherently commercial because it competed with for-profit organizations conducting similar activities.

The Office of Chief Counsel, however, saw things differently. In rejecting EO's position, it stated that, "EO is giving more significance than it should to the fact that [the CMO] is providing services under contract to organizations directly responsible for running the charter schools, rather than conducting the educational activities under its own authority."[55] It found no authority for disregarding the purposes for which the CMO conducted its activities and stated that doing so would be counterintuitive.

The Office of Chief Counsel also used the word "counterintuitive" to dispatch EO's position that the CMO was inherently commercial because it competed against for-profit counterparts. It asked rhetorically:

> Does the fact that commercial firms are venturing into this area due to the apparent failure of some local governments to provide an adequate education to all children (to children in certain urban areas, for example) mean that currently exempt schools and educational organizations now face disqualification on the basis of competition from these commercial firms?[56]

The Office of Chief Counsel then conducted a point-by-point analysis on the factors typically necessary to invoke the commerciality doctrine, noting that what matters is not the nature of the activities, but the purpose for which they are conducted. It concluded:

> From its funding and plans for funding to its structure and operation, [the CMO] can be distinguished from a typical commercial enterprise. For example, [it] does not work to maximize shareholder value, to achieve economy of scale (by opening many schools), or to build a brand name (with [its name] appearing in the name of each school). It does not pay dividends to shareholders ... provide incentive compensation to officers or teachers for financial performance, or include non-competition provisions in its employment contracts. In fact, as a commercial operation, [it] would be judged a failure.[57]

The Office of Chief Counsel did acknowledge that the presence of commercial actors in the same space with exempt organizations could make for challenging determinations in certain circumstances, but not where the facts show that the CMO is organized and operated for exempt purposes and without profit motive. Because the organization was educational, the

Despite their perceived commercial nature, some social enterprises may be able to obtain exemption under the integral part doctrine.

Chief Counsel did not need to address whether the organization could qualify on the bases discussed in the Guide Sheet.

The Office of Chief Counsel has the far better argument, and nowhere is this better illustrated than in comparing CMOs across jurisdictions. As previously noted, some states permit one entity to hold charters for and directly operate multiple schools.[58] Other states require that each school be operated by a distinct nonprofit pursuant to a single charter.[59] So imagine an organization with the purpose of replicating a particular charter school model that serves low-income and minority students in districts that have chronically failed this population. According to the Service's position, this organization would be alternatively: (1) exempt if established in a state that permitted it to operate all of the schools under one corporate umbrella; (2) a commercial entity if established in a state that required separate entities for each school; or (3) subject to a weighted analysis if it operated in both of these states simultaneously. Nothing in Section 501(c)(3) supports these disparate and arbitrary outcomes, and they would not come to pass under the position of the Office of Chief Counsel.

By rationale and characteristics, CMOs are nestled in the center of the social enterprise middle space.

One would think that EO Determinations would heed the advice of the Office of Chief Counsel and change its view of CMOs going forward. To the contrary, the opposing view in EO Determinations did not go away. The Guide Sheet remains incorporated in the Internal Revenue Manual in its 2006 form,[60] and its position and language have been mirrored in other subsequent documents without mention of the PMTA or any related analysis.[61]

Nonetheless, it seems at least some officials in EO Determinations began changing their practice, because CMO applications for exemption began experiencing disparate results. The application of one CMO might sail through the process while another from a similarly situated organization might face an adverse determination.[62] Similarly, some organizations were being approved on the basis that they were educational and charitable in nature, while others were being instructed to take steps to qualify under the integral part doctrine.[63] Anecdotally, the commerciality camp seemed to becoming more entrenched, even narrowing the integral part doctrine to an extent that very few, if any, CMOs would fit through.[64] It seemed that a CMO's exemption did not hinge on any consistent application of the principles under Section 501(c)(3), but rather on the views of the particular EO Determinations employee that a CMO applicant happened to draw.

This went on for several years, but the issue came to head when the IRS held a number of CMO applications for an extended review period (lasting several years) before proposing adverse determinations.[65] As one might expect, news of this hardline approach began creating unsettling uncertainty for the charter school field, which in turn started affecting collateral issues such as tax-exempt bond financing. The National Alliance for Public Charter Schools (NAPCS), the preeminent nonprofit devoted to advancing the charter school sector, gathered a working group of tax professionals on the issue. That group submitted a memorandum to Treasury seeking clarity on the integral part test.[66] Around the same time, the IRS undertook a restructuring of its EO division, and new leadership ascended to the head of EO Determinations. Shortly thereafter, in the course of responding to the protest of a proposed adverse determination of an organization very similar in nature to the subject of the Chief Counsel PTMA, that new leadership evaluated how CMO applications were being reviewed and the resulting inconsistencies.[67] It informed this article's author that the Chief Counsel PTMA would be recognized as the principal piece of guidance going forward, and the protest was subsequently resolved in favor of the CMO. Later, EO Determinations confirmed its position as to the Chief Counsel's PTMA with the NAPCS working group, though as of yet, the Service has not updated any charter school-related guidance, including the erroneous Guide Sheet. So it appears that the issue has quietly been resolved.

[60] "Commonly Used Guidesheets," IRM 7.20.3.3.12 (updated 10/2/15).

[61] IRS Exempt Organizations Determinations Unit 2, *Student Guide* (2009), "Miscellaneous Grade 12 Topics and Advanced Procedures," page 9-5, available at www.taxanalysts.com/www/freefiles.nsf/Files/EO%204.pdf/$file/EO%204.pdf.

[62] Memorandum from Charles Cardall to Ruth Madrigal and Vicky Tsilas, re: "Integral Part Status of Charter Management Organizations 2" (10/27/14).

[63] *Id.*

[64] This was likely aided by state laws and policies requiring board independence between a CMO and its network schools.

[65] One of these organizations was represented by the author.

[66] The Cardall memo, *supra* note 62.

[67] The protest was co-written by the author and Fred Gerhart of Dechert, LLP.

The change in the Service's position is both welcome and correct. It recognizes that a CMO's activities can in fact directly further exempt purposes and that these organizations are not commercial entities created to make money to steal business from for-profit competitors. The guidance still leaves open the possibility that CMOs can be denied exemption or must qualify under the integral part test if they stray too far from the educational activities discussed in the Chief Counsel's PTMA, but the default position is now appropriately set.

Implications

The tale of the CMOs' struggles with the IRS over tax exemption could be cautionary or reason for cautious optimism for other social enterprises, depending on their nature and mission. In any event, there are some practical lessons that can be pulled from the story. On the cautionary side, the tale illustrates how middle-space organizations of all types can raise the hackles of the IRS. Once that has happened, things can take a quick turn for the worse for an exemption application with certain unfavorable factors, like the presence of for-profit counterpart organizations or a high percentage of revenue derived from the performance of services. In these types of cases, the IRS can be perfectly willing to completely disregard the purposes of an organization if its activities do not meet some preconceived notions of inherently charitable activities—even where an organization is solely devoted to providing a high-quality education to historically disadvantaged students, which is as charitable as charitable can be. It may not be an overstatement to say that any nonprofit social enterprise is at risk from the reckless imprecision of the commerciality doctrine.

On the other hand, the tale shows how it may be possible—at least in some circumstances—to fight the commerciality doctrine by exploiting its weaknesses. Invoking the doctrine in the CMO context created internal conflict at the IRS and led to disparate results. This is a natural outcome of circular and imprecise doctrine in need of reform. But on a more practical level, CMOs were able to break the doctrine's circularity by convincing the IRS (albeit not all at once) of the direct connection between their activities and their stated purposes. Other contextual factors may have aided in this, such as fully educating the IRS on how charter school structures vary across states and how the typical structure for CMOs is driven by necessity and not commercial motives. Ultimately, the CMOs' case for exemption was simply too strong to be overcome by the inappropriate application of the commerciality doctrine. Obviously, the nature of other social enterprises will vary significantly, and the positive outcome for CMOs will not likely carry over to other contexts. But if a social enterprise faces the commerciality doctrine, its exemption will depend on connecting the dots between its activities and its exempt purposes in as clear and strong a manner as possible.

Conclusion

Nonprofit social enterprise holds great promise for addressing some of our most intractable issues, from chronic failures in our education system to climate change. The commerciality doctrine threatens that potential, and without careful consideration, worthy nonprofit social enterprises may fall victim to its imprecision. However, as was the case with the CMO, that imprecision may also hold the key for keeping the doctrine at bay. ■