

**Internal Revenue Service**

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Legend

Academy =  
EIN =  
State =  
State Law =  
City =  
State Constitution =  
State University A =  
State University B =  
Company =  
Year 1 =  
Year 2 =  
X =

Dear

This is in response to a letter dated July 29, 2003, and subsequent correspondence requesting a ruling that the income of Academy is excludable from gross income under section 115 of the Internal Revenue Code.

Facts

The Academy is organized under State Law and the State Nonprofit Corporation Act to provide free K-12 public education in City. The articles of incorporation of the Academy provide that the Academy is organized and operated exclusively for public educational purposes and no part of its net earnings may inure to the benefit of any private person. The articles of incorporation of Academy further provide that in the

event of dissolution of the Academy and after payment of all liabilities of the Academy, the Academy's assets shall be distributed to the Board of Trustees of State University B, the Academy's authorizing body, or at the direction of the Academy's authorizing body shall be forwarded to the State school aid fund established under the State Constitution. The Academy is recognized under State Law as a body corporate and governmental agency. State Law provides that the Academy is recognized as a public school under the State Constitution.

Under State Law, an academy may be authorized and created by the board of a school district, an intermediate school board, the board of a community college, or the governing body of a State public university. Academy initially was authorized by the Board of Trustees of State University A. The Academy currently is authorized by the Board of Trustees of State University B.

The Academy obtained a contract (also known as a charter) from its authorizing body. The authorizing body of the Academy was required to review the application for a charter in light of the resources available for the proposed academy, the population to be served, and the educational goals to be achieved by it. The contract establishes the Academy as public school under State Law and governs the relationship between the authorizing body and the Academy. The contract may be revoked by the authorizing body, if the Academy fails to comply with contract and all applicable laws, fails to meet generally accepted public sector accounting principles or satisfies one of grounds for revocation set forth in the contract.

The authorizing body serves as the Academy's fiscal agent for purposes of receiving and transmitting State school aid, and it has the responsibility of overseeing the Academy's compliance with the contract and applicable federal and State laws. Operating revenue for the Academy is derived primarily from State school aid payments received pursuant to State law. A small portion of revenues is from federal funds, donations, and fees permitted to be charged by academies. State Law prohibits the charging of tuition by academies.

Academy currently has an enrollment of about X students in grades K-12. Academy was organized in Year 1 for the purposes of: (1) improving pupil achievement of all pupils, including, but not limited to educationally disadvantaged pupils, by improving the learning environment; (2) stimulating innovative teaching methods; (3) creating new and professional opportunities for teachers in a new type of public school; (4) achieving school accountability outcomes by placing full responsibility for performance at the school site level; and (5) providing parents and pupils with greater choices among public schools both within and without their existing school districts.

The Academy entered into a management contract with Company, a for-profit entity, to provide the management and administrative services necessary to implement and operate its educational program. Under this contract, the Company supplied the

curriculum materials (textbooks, etc.) and training in its instructional methods. All personnel working at Academy, except the business service manager, were employees of Academy. The Company paid the costs of salaries, fringe benefits and employment taxes of the employees of the Academy on behalf of the Academy. The Company established with the approval of the Academy's Board the personnel policies of the Academy.

As of Year 2, the Academy has put into effect its intent to be self-managed. The Academy, acting through the employees of its Board of Directors, processes its own payroll, performs its own hiring and other personnel matters, does its own student recruiting and contracts for non-instructional services to the Academy. Arrangements for the formal termination of the management contract between Academy and Company are under active negotiation. Neither party has performed under the contract since Year 2.

### Law and Analysis

Section 115(1) of the Code provides that gross income does not include income derived from the exercise of any essential governmental function and accruing to a State or any political subdivision thereof.

Rev. Rul. 77-261, 1977-2 C.B. 45, income from an investment fund, established under a written declaration of trust by a state, for the temporary investment of cash balances of the state and its participating political subdivisions, is excludable from gross income for federal income tax purposes under § 115(1). The ruling indicates that the statutory exclusion was intended to extend not to the income of a state or municipality resulting from its own participation in activities, but rather to the income of a corporation or other entity engaged in the operation of public utilities or the performance of some governmental function that accrued to either a state or municipality. The ruling points out that it may be assumed that Congress did not desire in any way to restrict a state's participation in enterprises that might be useful in carrying out projects that are desirable from the standpoint of a state government and which are within the ambit of a sovereign to properly conduct.

Rev. Rul. 90-74, 1990-2 C.B. 34, states that the income of an organization formed, funded and operated by political subdivisions to pool various risks (casualty, public liability, workers' compensation, and employees' health) is excludable from gross income under § 115. In Rev. Rul. 90-74, private interests neither materially participate in the organization nor benefit more than incidentally from the organization.

By providing free public education to students in the State, the Academy will perform an essential governmental function.

The articles of incorporation of the Academy provide that no part of the net earnings of the Academy may accrue to the benefit of any private person. In the event of dissolution of the Academy, the articles of incorporation provide that after making provision for payment of all liabilities of the Academy, the Academy's assets shall be distributed to the Board of Trustees of State University B, the Academy's authorizing body, or at the direction of the Academy's authorizing body shall be forwarded to the State school aid fund established under the State Constitution.

The income of the Academy is derived from an essential governmental function and accrues to political subdivisions of the State or to entities the income of which is excludable from gross income under § 115(1). Accordingly, based on the information submitted, representations made and authorities cited, we conclude that the Academy's income is excludible from gross income for federal income tax purposes under § 115(1) of the Internal Revenue Code.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

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

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your representative.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer 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 rulings, it is subject to verification on examination.

Sincerely,

James L. Brokaw  
Acting Chief, EO Branch 2  
Office of Division Counsel/Associate Chief  
Counsel  
(Tax Exempt and Government Entities)

Enclosures (2)