

June 22, 2018

## **Charter School “Friends Of” Organizations FAQ**

In the context of a charter school, a “Friends Of” organization is a separate, not-for-profit 501(c)(3) corporation that is created to raise funds, awareness, and otherwise support a charter school or the charter school movement. This Legal Alert answers common questions that charter school planners and organizers may have about forming such an organization.

### **1. How can I form a “Friends Of” organization?**

Charter school planners and organizers may form a “Friends Of” organization to provide support to the school by forming either a “supporting organization” under Internal Revenue Code (IRC) §509(a)(3) or a standalone entity under IRC §509(a)(1). The process for forming an organization under either IRC §509(a)(3) or §509(a)(1) is the generally the same as forming any 501(c)(3).

### **2. What is a Supporting Organization under IRC §509(a)(3)?**

Supporting organizations under IRC §509(a)(3) (SO) carry out their exempt purposes by supporting one or more other tax-exempt organizations, usually other public charities. For charter schools, the SO would support the charter school. Organizing as an SO allows the organization to avoid being classified as a “private foundation,” which would subject the organization to a much more restrictive regulatory regime. To qualify as an SO, an organization must meet certain organizational, operational, and control tests. Specifically, the SO must be:

1. Organized and operated “exclusively for the benefit of, to perform the functions of, or to carry out the purposes of” an organization qualifying as a public charity under §509(a)(1) or §509(a)(2);
2. “Operated, supervised, or controlled by or in connection with” a §509(a)(1) or §509(a)(2) public charity; and
3. **NOT** controlled, directly or indirectly, by a “disqualified person,” a term that is explicitly defined.<sup>1</sup>

### **3. What are the types of Supporting Organizations?**

The IRS has determined that the “operated, supervised, controlled by or in connection with” results in three (3) distinct types of SOs. The type of SO is determined based on a set of relationship tests.

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<sup>1</sup> See IRC §4946.

### Type I

A Type I SO must be “operated, supervised or controlled by the supported organization.” According to IRS guidelines, “control” in this instance can be thought of as a parent-subsidiary relationship, with the “parent” being the supported organization (the charter school). According to IRS guidelines, this relationship exists where the charter school elects or appoints a majority of the Supporting Organization's officers or directors. The supported organization would have a “majority voting interest” in its supporting organization, and therefore, under applicable accounting guidelines, would be required to consolidate financial reports (Form 990, etc.)

**Note, however**, that charter authorizers in the charter agreement or in the charter application may limit the number of board of trustees from a charter school that may serve on the board of a “Friends Of” organization and thus a Type I SO is not permissible unless a waiver is obtained from the charter authorizer, e.g., per the 40% rule, which says that no more than 40% of the school board may be affiliated with any single entity (regardless of whether the entity is affiliated or otherwise partnered with the school) unless the school has received a waiver from the State University Trustees.

Most support organizations for charter schools are Type I SOs.

### Type II

Type II SOs must be “supervised or controlled in connection with a public charity.” The relationship between a Type II SO and its charter school is described by the IRS guidelines as a “brother-sister relationship”: the same people must control or manage both the supporting organization and the supported organization.

In addition, Type II SOs must meet two (2) specific operational tests: 1) its corporate documents (e.g. certificate of incorporation, bylaws) must limit its purposes to operate “exclusively for the benefit of, to perform the functions of, or to carry out the purposes of” a public charity, and 2) it must engage “solely in activities that support” the public charity. It is also very likely that a Type II SO would have to consolidate financial reports with the charter school.

### Type III

Type III SOs must be “operated in connection with the supported organization.” With Type III SOs, the supported organization need not be given any power to appoint any member of the board of the supporting organization, and the supporting organization and its supported organization are not required to have any common board members. (However, it may be advisable to have one common board member to meet the “responsiveness” test referred to below).

Because Type III relationships are less formal, Type III SOs must also meet a responsiveness test and an integral part test.<sup>2</sup> These additional tests are designed to ensure that the supported organization oversees the operations of the supporting organization – particularly since the Type III organization doesn't require control of the board.

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<sup>2</sup> See §1.509(a)-4(i)(2) and (3) of the Income Tax Regulations.

#### **4. What are the filing requirements of a Supporting Organization?**

SOs must file information returns (Form 990 or 990-EZ) in the same way that all 501(c)(3) organizations must.

The Pension Protection Act of 2006 (PPA) changed the filing requirements for small §509(a)(3) supporting organizations. The PPA requires §509(a)(3) organizations to file paper or electronic Form 990 or Form 990-EZ for tax periods ending after August 17, 2006, even if the annual gross receipts are normally \$25,000 or less.

§509(a)(3) supporting organizations that support religious organizations are exempted from the above requirement, but most file an annual electronic notice, the Form 990-N (e-postcard), for tax periods beginning after December 31, 2006.

#### **5. Are gifts to Supporting Organizations tax deductible?**

Yes. Gifts are tax-deductible to SOs to the same extent as gifts made to 501(c)(3) public charities. Further, the “excise tax” imposed on private foundations does not apply to §509(a)(3) Supporting Organizations.

However, keep in mind that an SO’s tax-exempt status is tied to the status of the supported organization. If the charter of a school is not renewed or revoked, and the charter school is dissolved, the SO will lose its tax-exempt status. If the charter school loses its tax-exempt status, the SO will also lose its tax-exempt status.

#### **6. What is the alternative to organizing a “Friends of” as a Supporting Organization?**

As an alternative to forming an SO, charter school planners or founders could set up a standalone independent 501(c)(3) organization pursuant IRC §509(a)(3). A “Friends Of” formed as a standalone entity would not need to meet the particular organizational, operational, control, relationship, and other tests that an SO must meet.

A “Friends Of” organized as a standalone entity must meet the criteria of being a “public charity.” Under §509(a)(3), an organization must prove that it is a publicly supported charity by demonstrating that it obtains a “substantial portion” of its financial support from the “public” (this includes private individual and corporate contributions, as well as government grants). The organization must also show multiple sources of funding. Generally, the “Friends Of” must derive at least one-third (1/3) of its total revenues from “public” contributions and grants.

Note that a “Friends Of” organized as an SO is not required to meet the public support test itself, but the supported organization must still qualify as a public charity.

#### **7. Are gifts to a “Friends Of” organized as a standalone entity tax deductible?**

Yes. Further, the tax-exempt status of a “Friends Of” organization organized as a standalone entity is not tied to the tax-exempt status of the charter school. If the school’s charter is revoked or renewed, the standalone “Friends Of” can continue to exist and support other charter schools (provided the purposes clause may need to be amended in the Certificate of Incorporation).

## **8. Can I form a “Friends Of” organization before the charter has been issued?**

Yes. Given the substantial amount of fundraising and organizational activity that must be done before a charter school is actually formed, many groups forming charter schools form the “Friends Of” organization or 501(c)(3) support and fundraising organization before the charter is issued, to aid in the development of the proposed school. Forming a support organization before the school is formed allows school planners and organizers to complete the preparatory work like opening a bank account, disbursing monies, soliciting donations under an existing 501(c)(3) tax-exempt entity, and finding facilities space.

However, because under IRC §509(a)(3) an SO must be in support of an organization *already in existence and already has a 501(c)(3) designation*, the only option available for charter school planners and founders who want to form the support/fundraising organization *prior* to the school receiving its charter from the Board of Regents is to form a standalone entity.

## **9. Are there any particular issues to watch out for when forming a “Friends Of” organization before the charter has been issued?**

If a charter school is going to form a support or fundraising organization before the school is formed, organizers should pay particular attention to the construction of the “Purpose Clause” when drafting the Certificate of Incorporation. A purpose that narrowly focuses on the support of the proposed charter school (e.g., “to support the development of the ABC Charter School”) may prove problematic in the IRS’ evaluation of the organization’s tax-exempt application.

Since the charter school will not be formed until *after* the charter is issued and *after* the support and fundraising organization is established, the IRS may not, and will most likely not, issue 501(c)(3) tax-exemption to a group that claims to support an entity that is not yet in existence. In essence, there is no charitable or educational purpose if the entity does not exist. To avoid this, it might be prudent to draft a purpose clause that contains language that encompasses charitable and educational endeavors or the general charter school movement, but does *not focus specifically on the proposed charter school*.

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