

CHARTER SCHOOL LEGAL ISSUES:

**“Friends Of” Organizations**

A. “Friends Of” Organizations – School Support and Fundraising Groups

1. A “Friends of XYZ Charter School” 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.
2. Supporting Organization under IRC 509(a)(3) v. a “Public Charity” under 509(a)(1)
  - a. Charter school planners and organizers may form a “Friends Of” organization to fundraise or otherwise provide support to the school in two (2) ways:
    - i. A “Supporting Organization” under IRC §509(a)(3) or
    - ii. A “Public Charity” under §509(a)(1)
  - b. Supporting Organization under IRC §509(a)(3). (SOs) Supporting Organizations under IRC §509(a)(3) carry out their exempt purposes by supporting one or more other tax-exempt organizations, usually other public charities. The SO classification means the organization can avoid classification as a “private foundation”, a status that is subject to a much more restrictive regulatory regime. To qualify as a “supporting organization under IRC §509(a)(3), the organization must be:
    - i. 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);
    - ii. “Operated, supervised, or controlled by or in connection with” a §509(a)(1) or §509(a)(2) public charity;
    - iii. And it is **NOT** controlled, directly or indirectly, by a “disqualified person”.
      1. A “disqualified person” is any person who was in a position to exercise “substantial influence” over the affairs of the tax-exempt organization” IRC §4946

- a. Family members of “disqualified persons” are also disqualified persons;
  - b. Entities controlled by “disqualified persons” are also disqualified persons.
  - c. “Control” is defined as owning more than 35% of the voting power of a corporation, more than 35% of the profit interest in a partnership, or more than 35% of the beneficial interest in a trust.
2. Note: A disqualified person, i.e., a founder or a founder’s spouse, is permitted to serve on the board of the Supporting Organization. The only requirement is they –as disqualified persons—may not control the board.
  3. Disqualified persons may hold a “minority” voting position in the Supporting Organization.
- iv. Gifts are tax-deductible to Supporting Organizations under IRC §509(a)(3) to the same extent as gifts made to 501(c)(3) public charities.
  - v. The “excise tax” imposed on private foundations do not apply to §509(a)(3) Supporting Organizations.
  - vi. Filing Requirements. Supporting Organizations must file information returns (Form 990, etc.) as do 501(c)(3) public charities. The Pension Protection Act of 2006 (“PPA) changed the filing requirements for small §509(a)(3) supporting organizations. The PPA requires:
    1. §509(a)(3) organizations must 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.
    2. §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.
  - vii. A Supporting Organization’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 lose its tax-exempt status.

viii. 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 Supporting Organizations:

1. Type I SO must be operated, supervised or controlled by the organization;
  - a. IRS has analogized Type I control to a “parent-subsidiary relationship, with the “parent” being the supported organization (the charter school)
  - b. According to IRS guidelines, this relationship exists where the charter school elects or appoints a majority of the Supporting Organization's officers or directors.
  - c. 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.)
  - d. Most support organizations for charter schools are Type I supporting organizations.
  - e. 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 organization is not permissible unless a waiver is obtained from the charter authorizer.
    - i. 40% rule: 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.
    - ii. This restriction is based on the “independent and autonomous public school” language in §2853(1)(c) of the CSA and the language in §2853(1)(f) that states that the “board shall have

final authority for policy and operational decisions of the school.”

2. Type II Supporting Organizations must be “supervised or controlled in connection with a public charity”.
  - a. The relationship between a Type II organization 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.
  - b. In addition, Type II supporting organizations must meet two (2) specific operational tests:
    - i. The supporting organization’s 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.
    - ii. Type II supporting organizations must engage “solely in activities that support” the public charity.
  - c. Very likely that the organizations would have to consolidate financial reports.
3. Type III organizations need to be “operated in connection with the supported organization.”
  - a. With Type III organizations, the supported organization need not be given any power to appoint any member of the board of the supporting organization.
  - b. Nor need the supporting organization and its supported organization have any common board members (However, it may be advisable to have one common board member to meet the “responsiveness” test referred to below).
  - c. Since Type III relationships are less formal, Type III supporting organizations must meet a responsiveness test and an integral part test. See §1.509(a)-4(i)(2) and (3) of the Income Tax Regulations. These tests are designed to ensure

that the supported organization oversees the operations of the supporting organization –in particular since the Type III organization doesn't require control of the board.

- d. Note, as of September 24, 2007, the IRS has suspended the issuance of determination letters for Type III organizations that seek “functionally integrated Type III organization” status. The Pension Protection Act of 2006, Pub. L. No. 109-208 (“PPA”) effectively created a new category of Type III organizations, the “functionally integrated Type III organization” which is not subject to some of the more restrictive PPA requirements. Until final guidance is issued that defines “functionally integrated Type III supporting organizations”, the IRS is generally suspending the issuance of determination letters to this category of Type III organizations other than organizations that choose to meet the advance notice of proposed rule-making requirements. For more information, see IRS Memorandum, dated September 24, 2007, regarding Supporting Organizations IRC §509(a)(3), available at <http://www.irs.gov/pub/irs-tege/509a3guidesheetchoimemo.pdf>
- c. “Public Charity” under IRC §509(a)(1)
  - i. As an alternative to forming a §509(a)(3) supporting organization, charter school planners or founders could set up, a stand-alone independent 501(c)(3) organization.
  - ii. This is the only option available for charter school planners and founders that want to form the support/fundraising organization *prior to the school receiving its charter from the Board of Regents* because under IRC §509(a)(3) the supporting organization must be in support of an organization *already in existence and already has a 501(c)(3) designation*.
  - iii. Under §509(a)(3), the organization must prove that it is a public supported charity.
    - 1. To meet the definition of “public charity” the “friends of” must demonstrate that a “substantial portion” of its financial support is from the “public” (this includes private individual and corporate contributions, as well

as government grants). The organization must also show multiple sources of funding.

2. Although there is no mechanical test, generally, the “friends of” must derive at least 1/3 of its total revenues from “public” contributions and grants.
  - iv. The tax-exempt status of the stand-alone “Friends Of” Organization is not tied to the tax-exempt status of the charter school.
  - v. If the charter is revoked or renewed, the stand-alone “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).
3. Forming a “Friends Of” Organization Before the Charter has been Issued
  - a. 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 also 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.
  - b. Forming a support organization before the school is formed allows school planners and organizers to complete the preparatory work to be done such as:
    - i. Open a bank account,
    - ii. Disburse monies,
    - iii. Solicit donations under an existing 501(c)(3) tax-exempt entity,
    - iv. Find facilities space, i.e. enter into a lease or real estate purchase agreement.
  - c. Purpose Clause. 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.
    - i. 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.
    - ii. 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.

- iii. 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*. Some examples of possible appropriate purposes include:
  - 1. “To provide financial and technical assistance in the development of charter schools in low-income neighborhoods in New York City” or
  - 2. “To support public education and educational opportunities through the support of the development of charter schools” or
  - 3. “To provide assistance to charter schools and other forms of alternative education, including, but not limited to XYZ Charter School.
- 1. Also, drafting a purpose clause that is sufficiently broad enough to provide alternative beneficiaries (other charter schools) in the event that the charter school that is the primary focus of the support organization ceases to exist, permits the “friends of” organization to continue to exist independent of the charter school (even post-dissolution).