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Strengthening Communities Through Legal Services

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A GUIDE TO BEING A FISCAL SPONSOR: IS IT A GOOD FIT FOR YOUR ORGANIZATION?

I. Introduction

Your organization may be asked from time to time to act as a fiscal sponsor for another organization or even an individual, and you may be wondering what that means. A fiscal sponsorship typically involves an organization (the sponsor) providing financial or other support to a project that does not have its own 501(c) (3) status (the project).¹ Done correctly, acting as a fiscal sponsor can help your organization achieve its mission in a unique and creative manner. Done incorrectly, it can jeopardize your organization's relationship with its donors, its reputation, and even its own 501(c) (3) status. This Booklet identifies certain key points and best practices organizations should consider before agreeing to serve as a fiscal sponsor.

II. Fiscal Sponsorship Overview

One of the most common goals of a fiscal sponsorship is to enable a new project, through its fiscal sponsor, to apply for grants and solicit tax-deductible contributions. To achieve this result, the sponsorship must be structured such that the fiscal sponsor, and not the sponsored project, is considered the true recipient of the funds raised. This generally means that the following requirements must be met:

1. the project must further the sponsor's charitable, educational, religious, scientific, or other tax-exempt purpose; and
2. the sponsor must retain sufficient discretion and control over the funds raised for the project.

If the fiscal sponsorship arrangement is not structured and administered properly, it will be vulnerable to challenge based on a theory that the sponsor is a mere conduit or agent (see Section VI) for transferring tax-deductible contributions to an entity that is not eligible to receive them. The IRS can disregard such an arrangement and treat all contributions and grants made to the sponsor in support of the project as having been made directly to the non-501(c) (3) project. Such conduit treatment would result in non-deductibility of contributions from individual donors and penalties for certain private foundations that did not comply with special requirements with respect to their grants. It also could damage the sponsor's relationship with its donors, impede future fundraising efforts for the sponsor's own programs, and potentially threaten the sponsor's own 501(c) (3) status if the IRS concludes that the sponsor improperly used its 501(c) (3) status for non-charitable purposes.

¹ This Booklet pertains only to public charities that wish to serve as fiscal sponsors. It does not address many of the considerations that would apply to a sponsor that is a private foundation.

III. Considerations and Best Practices

An organization contemplating serving as a fiscal sponsor should evaluate at least each of the following before agreeing to do so:

A. Tax-Exempt Purposes. The prospective sponsor should determine whether and to what extent the project's activities would further the prospective sponsor's charitable and other section 501(c)(3) purposes. If the project does not further the sponsor's exempt purposes, the sponsor should not proceed.

B. Form 990 and Audit Considerations. The prospective sponsor should consider whether it can properly handle the increased reporting and audit requirements that flow from serving as a fiscal sponsor. For example, increased donations to the sponsor for the project could mean that the sponsor has a new audit requirement. Similarly, the fiscal sponsor will need to provide (or have provided on its behalf) the requisite donation acknowledgments for donors.

C. Responsibility for Project Execution. It is important to consider which party is ultimately responsible for executing the project. If the project is going to function as an internal program of the sponsor, the board of directors of the sponsor should have ultimate authority over and responsibility for the project, including making required reports to funders. More commonly, however, the fiscal sponsor makes a grant to the project (often from funds raised from outside sources in support of the project), and the project is responsible for execution.

D. Project Personnel. The prospective sponsor should consider whether and to what extent it will be responsible for the staff and volunteers who work on the project. The personnel working on the project may be employees of the sponsor, or the sponsor may contract out the execution of the project to the unrelated individual or entity as an independent contractor. However, in the latter case, the parties must be sure that the unrelated person or entity does in fact qualify as an independent contractor and will not be reclassified as an employee of the sponsor. If project personnel are employees of the sponsor, the sponsor generally will be responsible for the administrative obligations and costs associated with such employees (e.g., payroll, benefits packages, employment taxes, and insurance). More commonly, however, the sponsor will not want any project personnel to be its employees or contractors, and it will require the project to arrange for staffing independent of the sponsor.

E. Resources. The prospective sponsor should determine whether it will provide the project with any resources, such as office space, furniture, or equipment.

F. Administrative Matters. The prospective sponsor should consider whether and to what extent it is willing to undertake certain administrative obligations associated with the project (e.g., accounting, payroll support).

G. Fee. The prospective sponsor should determine whether it will charge a fee for acting as a fiscal sponsor. Such a fee may be structured in a variety of ways. In one common fee structure, the sponsor retains a percentage of the funds raised for the project (e.g., 3-5%). Another common way to structure the fee is for the sponsor to charge a flat dollar amount. Often, the project must pay the fee in addition to reimbursing the sponsor for expenses incurred by the sponsor in connection with the fiscal sponsorship.

H. Reputation. The prospective sponsor should evaluate any potential reputational risk that accompanies the project or acting as its sponsor.

I. Legal Obligations and Liabilities. Typically, where the fiscal sponsor is merely funding a project housed in a separate entity, that entity will be responsible for its own tax return, employment taxes, insurance, debts, liabilities, and other legal obligations. To the extent that this is not the case, however, the sponsor may require the project to indemnify it for any liabilities assumed or costs incurred by the sponsor in connection with the project. Additionally, the fiscal sponsor may assume some or all of these responsibilities and liabilities in exchange for a fee from the project.

IV. Structural Options

The prospective sponsor needs to determine how the fiscal sponsorship will be structured. Such a relationship may be structured in a variety of ways, each with its own benefits and drawbacks. The most common structures are as follows:

1. *Direct Model*. Under this model, the project becomes an internal program of the sponsor and does not have a legal identity separate from the sponsor. The sponsor receives funding (*e.g.*, grants and donations) for the project and reports the receipt and use of such funds on its own tax filings. It also controls the day-to-day affairs of the project. Anyone who volunteers on behalf of the project is considered an agent of the sponsor, and anyone who is paid for rendering services in connection with the operation of the project is considered an employee or independent contractor of the sponsor. The sponsor's potential liability for the project's activities is unlimited because the project's activities are considered those of the sponsor. Accordingly, proper risk management is extremely important under the Direct Model. A prospective sponsor generally should refrain from sponsoring a project under the Direct Model if (a) the project's activities carry high liability risks; or (b) the prospective sponsor does not have the organizational capacity to undertake the various administrative obligations associated with the Direct Model.

2. *Grant Model*. Under this model, the project is an entity distinct from the sponsor. The project and sponsor have a grantor/grantee relationship in which the sponsor receives funding to support the project, grants such funds to the project, and generally maintains oversight (*e.g.*, requires the project to provide certain reports) to ensure that the funds are used in furtherance of tax-exempt purposes and in accordance with the grant agreement. The sponsor must know the project's legal status (*e.g.*, corporation, limited liability company, individual, etc.) for purposes of fulfilling certain reporting obligations. Under the Grant Model, the sponsor's potential liability is limited to that of a typical grantor, so there is less liability exposure to the sponsor under the Grant Model, as compared to the Direct Model. Because the project is a separate legal entity, the sponsor will not be responsible for fulfilling filing and reporting requirements associated with the project, managing the project's day-to-day affairs, or maintaining the project's payroll. Structured properly, the Grant Model requires fairly detailed reporting and oversight between the sponsor and the project, including that the sponsor may withhold the funds raised for the project. To emphasize its discretion and control over the funds raised for the project and minimize the risk of the IRS characterizing the fiscal sponsorship as an impermissible conduit, the sponsor should inform those who contribute funds for the project that the sponsor retains full discretion and control over the use of the funds,

including the right to distribute the funds to a different recipient that can achieve or further the purposes of the project.

3. *LLC Model.* The project is a limited liability company (LLC) that is wholly owned by the sponsor, and the sponsor is the sole member of such LLC (SMLLC). Unless an SMLLC project elects otherwise, it is considered part of the sponsor for federal income tax purposes but is a separate and distinct entity for most other purposes. Because the project and sponsor are considered the same entity for federal income tax purposes, individual donors may claim a charitable deduction for direct contributions to the project, private foundations may make grants directly to the project without being required to maintain significant oversight over such grants, and the sponsor may make grants to the project without requiring reports and extensive oversight. For federal income tax purposes, the SMLLC's activities are attributable to the sponsor; therefore, if the project engages in activities that the sponsor is prohibited from conducting itself, the sponsor might incur certain tax penalties and the sponsor's federal income tax exemption could be in jeopardy. Thus, a prospective sponsor considering use of the LLC Model should, prior to agreeing to serve as a fiscal sponsor, assess whether it could directly engage in the activities conducted by the project without incurring penalties or jeopardizing its tax-exempt status. If the answer to that question is no, then the LLC Model likely is not the best approach for the prospective sponsor.

If the sponsorship is structured properly under the LLC Model, the sponsor is shielded from many of the potential liabilities associated with the project because the project is a separate and distinct entity for state tort liability purposes. Accordingly, if the organization wishes to serve as a fiscal sponsor to a project that engages in activities, which, although charitable, carry a high liability risk (e.g., operating a summer camp), the LLC Model might be a more appealing option than, for example, the Direct Model. To properly structure an LLC Model fiscal sponsorship for liability protection, the sponsor must maintain enough control over the project to ensure that the project's activities further the sponsor's tax-exempt purposes and do not result in penalties to the sponsor but must not exert so much control that the project would be deemed a mere alter ego of the sponsor. To achieve the requisite balance of control, the sponsor generally should indirectly control the project by retaining the power to appoint and remove the manager of the SMLLC, but the sponsor should not otherwise manage the SMLLC's day-to-day affairs.

V. Fiscal Sponsorship Agreement

An organization should not agree to serve as a fiscal sponsor without entering into a comprehensive written agreement that clearly establishes the relationship between the sponsor and the project and sets forth all of their respective rights, responsibilities, and liabilities. The agreement should be entered into by the sponsor and another person or entity with the authority to bind the operator(s) of the project to the terms of the agreement. The fiscal sponsorship agreement generally should include, among other things, language that:

- (1) describes the project and requires that the project act, and that funds be expended, exclusively in furtherance of section 501(c)(3) purposes that are consistent with the purposes of the sponsor;
- (2) forbids the project from engaging in activities prohibited under section 501(c)(3), such as participation or intervention in political campaigns;

- (3) outlines sponsorship policies, procedures, and fees, if any;
- (4) explains who will be responsible for executing the project, including the delivery of appropriate donation acknowledgements to donors;
- (5) specifies which party will have ownership rights in the work product or results of the sponsored project, as well as in the tangible and intangible property created or purchased during the course of the sponsorship;
- (6) emphasizes the sponsor's control and discretion regarding the use of the funds raised for the project, including the sponsor's right to redirect the funds to another qualified recipient;
- (7) requires contributions and grants received for the benefit of the project to be deposited into a restricted fund and separately tracked on the sponsor's books;
- (8) highlights the independence between the project and sponsor for liability and certain other purposes (if the fiscal sponsorship is structured such that the project is housed in an entity separate from the sponsor); and
- (9) sets forth the term and procedures for termination of the fiscal sponsorship.

VI. A Note about Fiscal Agency

The term "fiscal agency" is often used interchangeably with the term "fiscal sponsorship". Though used interchangeably, the terms have different meanings and a 501(c) (3) organization generally should agree to serve as a "fiscal agent" only in rare circumstances. A fiscal agent is a mere conduit of funds. Thus, all of the risks of an improperly structured fiscal sponsorship are inherent in a fiscal agency.

Acting as a fiscal agent for an individual or non-501(c) (3) organization poses a serious threat to the agent's 501(c) (3) status.

VII. Conclusion

Fiscal sponsorships offer a significant degree of flexibility and opportunity for organizations, but they must be structured appropriately and carefully to achieve the goals of the parties and safeguard the tax-exempt status of the sponsor.

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