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**Fiscal Sponsorship – Doing It Right!**

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“Fiscal sponsorship” is not a term that is found in the Internal Revenue Code or in the corporate or other laws of the various states. It is, instead, a term of art that describes a practical construct, a tool, offered by community foundations and other public charities to provide a functional framework for charitable projects that cannot, or choose not to, function as stand-alone legal entities managing their own affairs.

The practice of fiscal sponsorship was given shape, and weight, and credibility, and was distinguished from the more dubious practice known as “fiscal agency,” in a book authored by my law partner Gregory L. Colvin (*Fiscal Sponsorship: 6 Ways To Do It Right*, Study Center Press (1993)).

Mr. Colvin is in the process of updating that book, and what follow are his current thoughts on “Fiscal Sponsorship in the 21st Century.”

# **FISCAL SPONSORSHIP IN THE 21ST CENTURY**

by

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## INTRODUCTION

Eleven years ago, in 1993, the book *Fiscal Sponsorship: 6 Ways To Do It Right*,<sup>1</sup> was published after a period of controversy in the nonprofit world about an arrangement often called “fiscal agency.” This term actually referred to several different constructs, but the common theme was that some enterprising person or group wished to conduct a charitable program (and attract tax-deductible contributions), but without incorporating or obtaining Internal Revenue Service (IRS) recognition of the project’s Internal Revenue Code (IRC) Section 501(c)(3) tax exemption. An existing 501(c)(3) “fiscal agent” would be recruited to receive grants and donations to support the project, which would then be disbursed in the form of payments to employees, vendors, contractors, or grantees.

These arrangements, if not handled carefully, were vulnerable to the criticism that they were mere conduits for the transmission of deductible donations to entities not qualified to receive them.

Since the publication of the book, the term “fiscal sponsorship” has developed as a more appropriate label for these arrangements. In the last decade, the phenomenon of fiscal sponsorship has become common, widespread, and quite reputable. It has become a popular ancillary activity for public charities involved in human service, environmental, and artistic endeavors. Nonprofit institutions solely devoted to fiscal sponsorship have sprung up across the country, ranging from documentary film sponsors to public health research groups to separate corporations spun off by community foundations.

To review the basics of fiscal sponsorship and highlight recent developments, this presentation contains the following elements:

- I. Fiscal Agency v. Fiscal Sponsorship
- II. Summary of the Models
- III. Model A – The Direct Project
- IV. Model B – The Independent Contractor Project
- V. Model C – The Pre-Approved Grant Relationship
- VI. Table Comparing the Models
- VII. Diagrams Illustrating the Models
- VIII. Lessons Learned Since 1993

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<sup>1</sup> Gregory L. Colvin, *Fiscal Sponsorship: 6 Ways To Do It Right*, Study Center Press, 1095 Market Street, Suite 602, San Francisco, California 94103, telephone 415-626-1650, fax 415-626-7276 (1993).

## I. FISCAL AGENCY V. FISCAL SPONSORSHIP

In the early 1990's, a series of discussions occurred among private foundations and public charities concerned about how to maximize the ability of the philanthropic community to support a wide variety of important activities ranging from arts to international aid, from environmental activism to individual health needs, and a host of other human services.

The discussions centered on the future of that funding practice widely (and unfortunately) known as **fiscal agency**.

That practice was criticized and rightfully so.<sup>2</sup> Some organizations considered abandoning the practice. Most continued it, however, for the compelling reason that the charitable sector would be crippled without a way to harness the creativity and respond to the needs of a vast array of groups and individuals that lack the tax status required to receive grants from many private foundations, government agencies, and other funders.

Taking a positive approach to the problem, it is possible to describe six different models by which a public charity, tax-exempt under IRC Section 501(c)(3), can conduct a program of support to individuals and to nonexempt organizations that is legal and proper.

First of all, a change in terminology is needed to reflect the proper relationships. This arrangement should *not* be called "fiscal agency," because the charity is not, and should not be, the legal agent of the nonexempt project. Under the law of agency, an agent acts on behalf of another (the principal) who has the right to direct and control the activities of the agent. Calling a charity a "fiscal agent" implies that the project controls the charity. To comply with tax-exempt law, the relationship must be the reverse; the charity must be in the controlling position, and the nonexempt project must act so as to further the charity's exempt purposes.

**Fiscal sponsorship** is now considered to be the more accurate and acceptable term. It implies, correctly, that the charity has made a choice to support the nonexempt project financially.

Fiscal sponsorship arrangements typically arise when a person or group (a **project**) wants to get support from a private foundation or a government agency, or tax-deductible donations from individual or corporate donors. By law or preference, the funding source will only make payments to organizations with 501(c)(3) tax status. So the project looks for a 501(c)(3) **sponsor** to receive the funds and pass them on to the project.

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<sup>2</sup> See, for example, *Use of Fiscal Agents: A Trap for the Unwary*, by John A. Edie, Council on Foundations (1989).

However, the IRS has a strict policy against “conduit” arrangements. When a donation is made by A to B, earmarked for C, it is in reality a donation from A to C, and if C is not exempt under Section 501(c)(3), the gift is not a tax-deductible contribution. To be deductible, the IRS requires that B (the sponsor) have *complete discretion and control* over the funds, and holds B legally responsible to see that its payments to C (the project) are made to further B’s tax-exempt purposes.<sup>3</sup>

As the models demonstrate, fiscal sponsorship advantages are not limited to situations where the project lacks, or never will have, 501(c)(3) status. Fiscal sponsorship is often used for that temporary period before a new organization obtains its own tax exemption. Other variations occur when a small 501(c)(3) group needs the help of a larger 501(c)(3) organization to manage its financial affairs or seeks IRS classification as a public charity based on the relationship with the sponsor.

The six models are not etched in stone. They are simply devices for understanding the possibilities. Each model is really a paradigm with certain unique characteristics. In practice, they may be used in combinations, blended, subdivided, and they may serve as springboards for developing new models.

## II. SUMMARY OF THE MODELS

The models summarized in the table below are all legal ways in which a project can derive some benefit from a relationship with a sponsor.

The table places the model with the *least* financial independence for the project at the top (Model A, Direct Project) and the model with the *most* financial independence for the project at the bottom (Model F, Technical Assistance).

Models A (Direct Project) and B (Independent Contractor Project) are arrangements where the project is an integral part of the sponsor’s program activities. They differ on the issue of whether the people conducting the project may be legally classified as independent contractors or whether they must be classified as employees.

Model C (Pre-Approved Grant) is a grantor-grantee relationship between the sponsor and the project. This includes the one-time arrangement enabling a project to obtain the proceeds of a grant from a private foundation via a sponsor, as well as the ongoing arrangement where a sponsor receives and transfers funds to a project as funds are raised.

The next two (Model D, Group Exemption, and Model E, Supporting Organization) are advanced models which result in the project having its own 501(c)(3) tax status, able to receive

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<sup>3</sup> *S.E. Thomason v. Commissioner*, 2 T.C. 441 (1943); Rev.Rul. 54-580, 1954-2 C.B. 97; Rev.Rul. 63-252, 1963-2 C.B. 101; Rev.Rul. 66-79, 1966-1 C.B. 48; *National Foundation v. U.S.*, 13 Cl.Ct. 486, 87-2 USTC ¶9602 (1987).

deductible donations directly from donors, but still with a tax benefit derived from the sponsor. The main tax difference between them is this: with the Group Exemption, the project gets 501(c)(3) status by being included in the group ruling issued by the IRS to the sponsor, but the project must meet a public support test. Conversely, the Supporting Organization applies for its own 501(c)(3) status, but does not need to show public support since its public charity status is derived from its relationship to the sponsor under Section 509(a)(3).

In Model F (Technical Assistance), the project has its own 501(c)(3) status and all funds are handled in the name of the project, but financial management assistance is provided by the sponsor whose employees are skilled in payroll, bookkeeping, tax returns, and other administrative details.

The choice of model does not depend on the type of charitable endeavor, whether the project involves the arts, health, or the environment, but upon making a good match between a specific administrative system and the sponsor's and project's long-term goals.

This discussion will now focus on the three primary models, Models A, B and C.

### **III. MODEL A – THE DIRECT PROJECT**

In Model A, the sponsor takes the project in-house. The project has no separate legal existence. The originators of the project may have approached the sponsor with a program idea that had not been part of the sponsor's activities in the past, but once the sponsor adopts it as a staff project, it belongs completely to the sponsor.

Model A is probably the most common form of institutionalized fiscal sponsorship. These fiscal sponsors see themselves often as “incubators” for new charities, or “umbrella” organizations permitting several related projects to exist in one tax-exempt corporation. Model A provides the most control over the project, and so it is the best training ground for start-up projects and is the least exposed to IRS challenge. Some legal problems do occur, however, when the project decides to go off on its own, if the sponsor and project do not have a clear understanding, at the outset, of what the terms of eventual separation will be.

The people conducting the project become employees or volunteers of the sponsor for the duration of the project. The project's expenses are paid directly by the sponsor to the vendor or supplier. This is so even if a separate bank account is set up for the project.

The project personnel may take the lead in writing grant requests and soliciting donations. In this fundraising role, even before they become employees, they are making representations on behalf of the sponsor. They may be regarded as agents of the sponsor with the result that commitments made by them may be binding on the sponsor. All funds raised are the property of the sponsor. Depending on the commitments made to grantors and donors, the sponsor may be required to treat money designated for the project as a restricted fund on its financial

records. If so, charitable trust law and contract law hold that the funds may not be diverted to another purpose.

The sponsor may decide that a certain percentage of the funds raised shall not be passed on to the project, but shall be kept for the sponsor's general administration and overhead, so long as this does not contravene any agreements made with grantors or donors.

Because the project is an integral part of the sponsor, its activities create the same liabilities for the sponsor as would any other program.

If the project buys equipment, furniture, buildings, land, works of art, or other tangible assets, they belong to the sponsor. Likewise, if the project acquires or its work results in the creation of intangible assets, such as copyrights, options, or trademarks, those also are property of the sponsor.

#### **IV. MODEL B – THE INDEPENDENT CONTRACTOR PROJECT**

In Model B, the project belongs entirely to the sponsor, but the actual operation of the project is contracted out to a separate legal entity, which could be a person, a business firm, or some other type of organization. This arrangement differs from a grant (Model C), in that the sponsor wishes to maintain control over the ultimate results of the project.

This model may be well-suited for some short-term projects, such as artworks where the project personnel are accustomed to producing a work of art on an independent contract basis.

First, the sponsor must determine whether the people who will conduct the project for the sponsor can legally be classified (individually or collectively) as independent contractors. That person or entity must have its own legal, tax, and accounting existence. It could be a sole proprietorship, a partnership, a business corporation, or even a nonprofit entity. Essentially, to contract independently with the sponsor, the project should be in business for itself, with its own letterhead, bank account, clientele, and other attributes of separate existence.

The relationship between the sponsor and the project should be spelled out in a written contract. The agreement typically covers the work to be performed, the deadline, the amounts to be paid by the sponsor, the ownership of any property to be acquired or created, and the critical matter of who will bear various liabilities that may arise during the course of the project. It also makes plain that the independent contractor is responsible for paying estimated income and self-employment taxes.

#### **V. MODEL C – THE PRE-APPROVED GRANT RELATIONSHIP**

Model C is a very widespread, and widely misunderstood, form of fiscal sponsorship. Often, the sponsor and project are not aware that they have created a *grantor-grantee*



relationship between them. The project may put a lot of energy into a grant request presented to the funding source in the name of the sponsor, to which the grant is then awarded. The sponsor disburses funds to the project, and everybody tends to see that grant as the only one. Actually, there are two levels of grant relationship that occur, which is why some refer to this model as “regranting.” As explained below, it is best if the sponsor and project create their own grantor-grantee relationship *before* the funding source is approached.

If there is a “trap for the unwary” among fiscal sponsorship arrangements, Model C is it. If the control mechanisms are not administered properly, Model C can collapse into a “conduit” or “step transaction” in which the IRS will disregard the role of the sponsor and declare that the funding source has, in effect, made a payment directly to a non-501(c)(3) project. For funding sources, the result will be that the donor cannot take a charitable deduction, or that the private foundation must now observe the strictures of “expenditure responsibility.” The project will find that its funding has disappeared. The sponsor may lose its tax-exempt status for failure to exercise sufficient control over its funds, permitting those funds to be used in a noncharitable manner.

Model C is cousin to another three-party funding arrangement called the “donor-advised fund,” where a donor makes contributions to a public charity, such as a community foundation, with the understanding that the donor may recommend, from time to time, other organizations to receive certain amounts as grants from the donor’s fund. For this arrangement to avoid being declared a conduit by the IRS, the donor’s choice of grantees must be treated as nonbinding advice to the charity.<sup>4</sup>

In Model C, the project does not become a program belonging to the sponsor. Instead, the sponsor chooses to further its exempt purposes *indirectly*, by giving financial support to another entity or person for a specific project that the sponsor has reason to believe will advance the sponsor’s charitable goals. This is a classic grant relationship.<sup>5</sup> Unlike an independent contractor relationship, the sponsor is not seeking ownership of the results of the work, but simply an assurance that the project will use the grant funds in a reasonable effort to accomplish the ends described in the grant proposal.

A properly administered Model C grant relationship proceeds in steps:

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<sup>4</sup> Although it does not deal specifically with donor-advised funds, Treasury Regulation Section 1.507-2(a)(8)(iv)(A)(2) sets forth factors that demonstrate when a donor’s rights are advisory only and nonbinding. Treasury Regulation Section 1.507-2(a)(8)(iv)(A)(3) sets forth contrary factors that indicate when a donor’s rights are more than simply advisory. Although commonly used in the charitable sector, the term “donor-advised fund” is not found in the Internal Revenue Code, Treasury Regulations or IRS rulings. In a few isolated private letter rulings, the IRS has recognized the validity of donor-advised type funds. (See, e.g., Letter Ruling 9250041 (“Advise and Consult Fund Solicitation Program” approved); Letter Ruling 8752031 (donor-advised type fund recognized); Letter Ruling 7825028 (donor-advised type fund recognized)).

<sup>5</sup> Rev.Rul. 68-489, 1968-2 C.B. 210.

*Step 1:* The person or organization that wants to do the project presents a written grant request to the sponsor, describing a specific program to be conducted.

*Step 2:* The sponsor evaluates the grant proposal to determine whether the project is charitable and carries out the sponsor's tax-exempt purposes.

*Step 3:* The sponsor's board of directors reviews and approves the project as furthering the sponsor's exempt purposes. Thus, before funds are solicited from donors, foundations, or government agencies, the sponsor has *pre-approved* the project as its grantee.

*Step 4:* The sponsor and the project sign a written grant agreement setting forth all the terms and conditions that apply to the project's use of the grant and relations with funding sources. The specific work to be performed by the project using grant funds should be spelled out in the grant agreement or in a cover letter.

*Step 5:* The project, the sponsor, or some combination of the two solicits funds for the specific grant to be made by the sponsor to the project. The sponsor's bylaws provide that such solicitations shall be made only on the condition that the sponsor retains complete control and discretion over the use of all contributions it receives. That element of sponsor discretion and control should be made known, in writing, to the funding sources.

*Step 6:* As the sponsor receives donations and grants for the specific project, the money is taken into income by the sponsor and then disbursed as a grant to the person or organization conducting the project, subject to the terms of the grant agreement.

*Step 7:* The project makes periodic written reports to the sponsor, in accordance with the grant agreement, showing its actual expenditures of grant funds and its progress toward accomplishing the purposes of the grant.

It is important to understand that, like the independent contractor, a project under Model C has its own legal, tax, and accounting identity. The project could belong to an individual (as a sole proprietor) or to a nonprofit organization of some kind other than a 501(c)(3). It could also be a partnership or a business corporation.

The project should not lull itself into a false sense of security because it has a sponsor. *The project, not the sponsor, is responsible for the project's tax returns, employment taxes, insurance, debts, liabilities, and other legal obligations.*

Where the funds are granted to a non-501(c)(3) project, the IRS requires that the sponsor maintain full discretion and control over the funds received for the project. Donors fully relinquish control over the funds once they are given to the sponsor. The sponsor is not legally obligated to fund the project, and the sponsor has the right to withdraw financial support from the

project and redirect the funds to another purpose, in which case the donor has no legal recourse against the sponsor.<sup>6</sup>

Ordinarily, however, the funds for a pre-approved grant are solicited for a particular purpose. Funders would naturally expect the sponsor of a pre-approved project to fund the project so long as the project follows its grant agreement. For instance, the terms of a government grant to a sponsor might provide that the funds are to be spent for a specific work of art to be created or film to be produced, with the funds to be returned to the government agency if the project fails. Similarly, if a project has been adhering to its grant agreement with a sponsor and the sponsor is holding back funds for the project, the project should be able to enforce the grant agreement as a contractual obligation of the sponsor to pay. Also, the state attorney general may insist that charitable funds raised for a particular purpose be held in trust for that purpose, and not allow the sponsor to divert them to another project.

So there is a certain contradiction between federal tax law, which emphasizes the discretion of the sponsor, and state charitable trust law, which emphasizes commitments made to donors. There are two solutions:

1. *The Unrestricted Fund.* Under this option, great care is taken not to make or imply any commitments to funding sources. The solicitation materials and grant agreement with the project make plain that the sponsor, in its sole discretion, may withdraw support from the project and spend funds for some other purpose within its overall charitable purposes. If these steps are taken, federal tax law requirements are easily met and the charitable trust problem is avoided.

2. *The Restricted Fund.* The act of pre-approval, plus a carefully drafted grant agreement creating a restricted fund, should satisfy the IRS,<sup>7</sup> the funder, the project, and the attorney general. Pre-approval means that the sponsor has already exercised, at the outset, discretion and control over the funds to be raised by declaring that financial support of the project will further its exempt purposes. What remains to be spelled out in the grant agreement are (1) performance requirements for the project, (2) the right of the sponsor to withhold, withdraw, and demand return of the grant funds if the performance requirements (or other conditions affecting the sponsor) are not met, and, in that circumstance, (3) the right of the sponsor to redirect grant funds to some other person or entity who can complete the project.<sup>8</sup> The restricted fund, even though it is committed to a particular project, should pass muster with the IRS because the sponsor retains the right to choose other people to do the project if the individuals originally involved with the project do not perform.

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<sup>6</sup> This is the fact pattern in the *National Foundation* case, *supra*, footnote 3.

<sup>7</sup> This process has been confirmed by the IRS as an appropriate mechanism for fiscal sponsorship arrangements in the context of U.S. charities soliciting donations that will then be used for grants to foreign organizations. Rev.Rul. 66-79, 1966-1 C.B. 48.

<sup>8</sup> If no one else can finish the project, the law of *cy pres* requires the sponsor to use the funds in a manner that will accomplish the donor's intentions as nearly as possible. If the funds originally came from a government agency or private foundation grant, that contract or grant agreement may dictate the final disposition of funds.

As in Models A and B, the sponsor may establish a charge for general administration, overhead, and fundraising, so long as this does not contravene any agreements made with grantors or donors. This could be a fixed dollar amount, but more commonly the charge is set at a certain percentage of the funds raised for the project. In actuality, the sponsor is not charging the project a fee; the sponsor is simply retaining a certain portion of funds which are the sponsor's property anyway. The administrative charge should be specified in the grant agreement. There is no normal or customary percentage, and so far there is no federal tax law declaring any type or amount of charge to be improper.<sup>9</sup> The amount of the charge is a matter of negotiation between sponsor and project.

The liabilities of the grantor are generally quite limited in a grantor-grantee relationship. The grantee does not act as the agent of the grantor legally, and so any obligations incurred, damages or injuries caused, or misconduct committed by the grantee, should not be the responsibility of the sponsor. The main liabilities of the sponsor flow from the grantor's obligations under tax law to maintain discretion and control over use of the grant funds, and from the terms of any grant agreement between the sponsor and the private foundation or government agency that originally provided the funds. Basically, the sponsor is liable only for properly selecting and paying the grantee, and for reasonably monitoring the grant to make sure the funds are spent in accordance with the grant agreement.

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<sup>9</sup> In the *National Foundation* case, *supra*, footnote 3, the IRS argued that a 2½% charge for administrative costs indicated that the organization was really a commercial enterprise serving a collection of clients. The court rejected this argument, noting that "every organization bears some operating expense" and that the amount of any contribution available for the intended charitable project would not be diminished by more than 2½%. The implication is that the lower the charge, the less likely it is to be controversial. (National Foundation also charged 8½% of the first \$500 contribution for administrative and fundraising costs.)

## VI. Table Comparing the Models

MODELS FOR FISCAL SPONSORSHIP ARRANGEMENTS	Basic Characteristics	Is project a separate legal entity?	Relationship is	Charitable donations belong to	Liability of sponsor to 3rd parties	Ownership of result	Payments shown on IRS returns filed by:		Comments
							Sponsor	Project	
A. DIRECT PROJECT	Project belongs to sponsor and is implemented by its employees and volunteers.	No	Employer-Employee	Sponsor	Total liabilities for acts of employees.	Sponsor	990, payroll tax returns	Individual 1040's	Legally, the project is no different than any other activity carried on by the sponsor directly.
B. INDEPENDENT CONTRACTOR PROJECT	Project belongs to sponsor but is conducted by separate entity under contract.	Yes	Project Contract	Sponsor	Varies, may be partial or total.	Sponsor usually	990, 1099 if person	Depends on legal status.	Appropriate where a project is an integral part of the sponsor's work, but may be legally performed by an independent contractor.
C. PRE-APPROVED GRANT RELATIONSHIP	Project applies to sponsor for one or a series of grants, sponsor funds the project only to the extent that money is received from donors.	Yes	Grantor-Grantee	Sponsor	Selection and payment of grantee, plus terms set by funding source.	Project usually	990	Depends on legal status.	Used by a non-501(c)(3) project, in order to raise tax-deductible support from donors, private foundation or government grants.
D. GROUP EXEMPTION	Sponsor obtains federal group tax exemption, confers 501(c)(3) status on subordinate projects.	Yes	Subordinate Affiliate	Project	Only as provided in affiliation agreement.	Project	Annual listing of organizations, no financial information.	990, separate or group return	Project gets 501(c)(3) status without separate application to IRS; must be subject to general supervision or control of sponsor.
E. SUPPORTING ORGANIZATION	Project gets its own 501(c)(3) exemption, but public charity status is based on support of sponsor's purposes.	Yes	Degree of connection varies	Project	None	Project	None	990	Project must apply to IRS for 501(c)(3) status, but can be a public charity even with only one donor.
F. TECHNICAL ASSISTANCE	Project has its own 501(c)(3) exemption but needs help with bookkeeping, tax returns, payroll, management, etc.	Yes	Management Contract	Project	Only as provided in the contract.	Project	990, if fee charged	990, if fee paid	Sponsor provides financial management to project, but all funds are raised and spent in the name of the project.

## VIII. Lessons Learned since 1993

1. Original Text of *Fiscal Sponsorship: 6 Ways To Do It Right*. Fortunately, no significant changes in the aspects of tax-exempt or nonprofit law that bear upon fiscal sponsorship have occurred since the book was first published in 1993, so readers can continue to rely on it as a valid expression of the legal principles underlying fiscal sponsorship.

2. Terminology. Usage of the phrase “fiscal sponsorship” is growing. In March 2003, a Google.com search of the term yielded 40,600 hits, as compared with 6,160 hits for “fiscal agency.” The phrase “fiscal sponsor” yielded 4,760 hits; however, the term “fiscal agent” produced 72,900 hits. The situations in which something called a “fiscal agent” appears are so varied and far-ranging as to defy any coherent definition. Just in the first 10 Google.com hits, one finds the Bank of Lithuania, Medicare and Medicaid claims processing, California state educational agency contracts, and the National Endowment for the Arts. The website [www.investorwords.com](http://www.investorwords.com) defines a fiscal agent as follows: “A bank or trust company which handles fiscal matters for a corporation, including disbursement of dividend payment funds, redeeming bonds and coupons at maturity, and handling taxes related to the issuance of bonds.” That obviously has nothing to do with projects sponsored by 501(c)(3) organizations, which is all the more reason to avoid use of the term “fiscal agent.”

Unless it is the rare case of a true “fiscal agent” (also known as a “custodial fund,” see point 6 below), a transparent financial relationship where one party holds and transmits funds that truly belong to another, the term fiscal agency is absolutely not equivalent to or interchangeable with fiscal sponsorship. Still, there are government agencies and other funding sources that persist in telling projects that don’t have their own 501(c)(3) exemption to find a “fiscal agent.” This misleading and legally improper usage ought to be stamped out at every opportunity. Those who are conversant in the proper terminology should be vigilant in calling upon those who draft application forms, instructions, and other documents to stop using “fiscal agent.” If the correct terms and legal concepts are not understood and used at the outset of a fiscal sponsor relationship, it is very possible that the parties will find out much later, in an IRS audit or in a lawsuit, that they did not structure the relationship in a manner that protects the interests of the funding source, the sponsor, and the project.

Quite a few terms have emerged in the lexicon of fiscal sponsorship; some fit well into best practices, others seem to give the wrong signals. For example:

<u>Inaccurate/Confusing/Improper</u>	<u>Relatively Safe</u>
Fiscal agency	Fiscal sponsorship
Fiscal agent	Fiscal sponsor
Earmarked for the X project	In support of the purposes of the X project
Acting as a conduit	Exercising discretion and control
Pass-through	Re-grant
Intermediary	Umbrella
Partnership	Collaborative
Cooperative	Consortium, coalition
Autonomous	Accountable
Laundering	Incubation

3. Relative Popularity of the Models. By far, Model A (direct project) is the most popular, followed by Model C (pre-approved grant relationship). More will be said about those below.

Pure Model B (independent contractor project) is not as common as one might imagine, although many Model A direct projects rely heavily on the use of consultants and other independent contractors to do their work.

Model D (group exemption) has not become a popular fiscal sponsorship vehicle, despite its potential, and continues to be most typical of parent-affiliate groups organized geographically.

Model E (supporting organization) is a popular vehicle for donors as an alternative to a private foundation, but from an operational standpoint, few projects seek to incorporate and obtain tax status as supporting organizations to their sponsors.

Model F (technical assistance) is a very common phenomenon, but due to the low profile of the service provided, it is hard to measure. The most prominent examples probably are community foundations that offer financial administration to private foundations in their areas.

Model X (payments “for the use of” sponsor) was a theoretically intriguing trust arrangement that emerged from litigation over the funding of Mormon missionaries, but it has not been imitated outside of that context.

4. Model A Direct Project. This Model has proved to be very popular because the project has none of the responsibilities of maintaining separate, functioning legal existence. The project has no board of directors, no tax return to file, and usually has no bank account of its own to worry about (except perhaps a small petty cash account). The sponsor handles the complete financial administration for the project, from payroll to health plan to tax filings to insurance, and can achieve great efficiencies by issuing checks from one central bank account for dozens of projects, posted to separate accounts for each of them. The project just needs to submit timely check requests and make sure it raises enough revenue to keep its project account in positive territory.

The main downside of Model A is, of course, the complete liability borne by the sponsor for everything the project does.

For those who have fiscal sponsorship arrangements, but are unsure which Model they are using, the first question to ask is this: “Are the people running the project organized as a separate legal entity?” If they are not, the arrangement is most likely Model A.

A number of fascinating issues have arisen in connection with Model A projects, as follows:

a. Advisory Committee. Some Model A sponsors require that a project have an advisory committee overseeing its work. This promotes a collective sense of responsibility for the project, and a means of holding the project director accountable. By requiring an advisory committee, the sponsor can screen out projects that are little more than a personal enterprise of the project director. Typically, such committees include funders, professional colleagues, and senior project staff. They serve as a sounding board for the project director’s plans, ideas, and problems, and often have authority delegated to them, by the sponsor’s board of directors, to supervise the operation of the project. The advisory committee should not be called a “board of directors,” because that suggests that the project is its own legal entity and that the board has independent power to control the affairs of the project.

b. Unincorporated Association. It is often advisable to form the project’s advisory committee as an unincorporated association. This involves little more than signing a form of bylaws called “articles of association” to govern the committee’s decision-making process and filing a simple notice with the secretary of state in the state where the project is located. Thus acquiring the capacity to “sue and be sued” in that state, the advisory committee has the legal power to enter into a fiscal sponsorship agreement with the sponsor, and it thereby acquires certain contractual rights under the agreement which it could enforce in court. This could be critical at the time the project decides to “leave the nest” of the sponsor. If the advisory committee has the right to terminate the sponsorship and transfer all assets and liabilities associated with the project to another sponsor, it has real “portability.”

c. Transfers of Projects, In and Out. Sometimes, a Model A project comes into being with one sponsor and stays with it until its work is done, its funding runs out, or its people give up and move on. More often, projects transfer from one 501(c)(3) sponsor to another, and this may occur once, twice, or many times. When a new project applies to a 501(c)(3) organization for sponsorship, it may turn out that the project had a former sponsor, in which case the two sponsors need to sign an agreement transferring the project assets and liabilities from the old one to the new one. Since the advisory committee will also be a party to the new sponsorship, these become 3-party agreements. A similar transfer agreement is required when the project moves on, including in the circumstance where the project has incorporated and obtained IRS recognition of its 501(c)(3) status. In this “exit” situation, a transfer agreement is needed to move the project assets and liabilities from the sponsor to the project’s own new corporation.



d. Common Uses. Some of the popular uses of Model A sponsorships are:

1) Incubation. In the early stages of its life cycle, a project develops its programs under the wing of a fiscal sponsor that handles all financial administration; the project determines whether it is likely to succeed, then spins off into its own 501(c)(3) nonprofit corporation when it is financially viable. These can range from small mental health projects to multi-million dollar civic facility construction projects.

2) Clusters of Similar Projects. Some projects would never be large enough to succeed on their own, but by sharing financial administration, as well as legal and tax status, with similar educational programs, environmental projects, artistic endeavors, or policy initiatives, they can thrive.

3) Short-term Projects. Model A is perfect for events such as conferences and programs that just need a fund for temporary employees, contractors, and vendors, rather than a new, separate legal organization.

4) Sudden Needs. A disaster or other immediate need for charitable work in a community often results in creation of a Model A project because there is simply no time to go through the legal and tax formalities of organizing a new entity. For example, when 12-year-old Polly Klaas was kidnapped in Petaluma, California, in 1993, a fund was established within the local Petaluma Junior High School PTA to support the search effort. Several weeks later, when the IRS recognized the Polly Klaas Foundation as tax-exempt, the assets and liabilities of the search fund were transferred from the PTA to the new Foundation.

5) Joint Funding Collaboratives. Often, a consortium of private and community foundations will come together in a state or region to accomplish joint work in public education, preschool, criminal justice, neighborhood rehabilitation or other priority areas. One of the community foundations, or a stand-alone fiscal sponsor, may act as the Model A sponsor for the collaborative, aggregating all the foundations' grants, paying the staff and vendors, and reporting the project on its tax return.

6) Coalitions. A coalition of operating charities may gather together to pursue a common goal, such as lobbying for funding for breast cancer treatment for low-income women or for school reform or to expand wilderness areas in a specific state or national forest. Like the joint funding collaborative, one of the members of the coalition may act as a Model A sponsor of the effort, handling all receipts and disbursements.

e. Staying Solvent. Without fairly strict financial discipline, projects running a deficit can bring down a Model A sponsor, depleting the sponsor's administrative funds and potentially invading funds held for other sponsored projects. Some Model A sponsors do not allow a project to continue without a sufficient balance to cover at least a month of payroll and expenses, and do not allow external or internal borrowing. Since the sponsor has full legal liability for each project, it must be prepared to lay off employees, notify vendors, and terminate a project if future funding is in doubt.

f. Employees. Realizing that all of the project employees are employees of the Model A sponsor, it must be understood that they all come under the same personnel policies, same health plan or plans, same retirement options, and other benefits and rules. Projects cannot depart from these standards without potentially causing the Model A sponsor to violate nondiscrimination rules and other labor laws. The sponsor's board of directors is ultimately responsible for the supervision of all project employees, even though authority to hire, fire, and supervise employees on a daily basis may be delegated to project directors and/or advisory committees. When a project transfers from one sponsor to another, there needs to be a clean cutoff of employment, with no assurance of employment at the new sponsor, and accrued leave must be paid to the employee or assumed by the new sponsor to the extent it hires the same employees.

g. Insurance. Model A fiscal sponsors must become expert in insurance matters. One large community fiscal sponsor has a motto of buying insurance "by the truckload." With so many disparate endeavors under one roof, insurers may raise questions about (and decline to cover) certain types of activity; e.g., events where alcoholic beverages are provided, programs involving care of children, adoption services, operation of vehicles and machinery, and sports or outdoor activities. Model A sponsors go back and forth with projects and insurance companies over exclusions, special policies and limits, additional insureds, etc., often passing on any added premiums to the projects responsible for exposure to risks.

5. Model C Pre-approved Grant Relationship. For some fiscal sponsors, such as 501(c)(3) funds attached to 501(c)(4) advocacy groups, Model C is the only arrangement made, because the sponsors do not operate any programs directly. The sponsor may have a primary relationship with a single grantee, with highly evolved systems of joint fundraising, and sponsor supervision and control over grants made to the 501(c)(4) project. Other sponsors use Model C as a better alternative than Model A for certain kinds of projects, especially those with inherently risky activities. The project needs to be able to manage its own financial affairs, maintain its own payroll, carry appropriate levels of insurance, and file its own tax returns. In addition, the project is required to identify one or more specific charitable projects eligible for grants from the sponsor, and file timely reports on its progress toward achieving the sponsor's charitable purposes.

Some of the interesting issues that can arise with Model C projects are as follows:

a. Array of Projects. A broader range of projects can benefit from Model C fiscal sponsorship as compared with Model A. They may include individual authors, artists, musicians, documentary filmmakers, or web-based enthusiasts. They may be located in the United States or abroad. They may be sole proprietors, partnerships, for-profit corporations, or nonprofit social welfare groups, trade unions, business associations, or social clubs, so long as they are conducting specific charitable projects.

b. Accounting Issues. In addition to the IRS requirement that the sponsor maintain "discretion and control" over funds received and granted to Model C projects, GAAP (generally-accepted accounting principles) may call for additional steps to be taken to

establish clearly that the sponsor is not simply acting as an intermediary for a transfer of assets to a specific ultimate recipient. The sponsor must retain “variance power” over funds earmarked to support the purposes of the project. The best practice is for the Model C sponsor to inform donors in writing along the following lines:

For legal and accounting purposes, we need to notify you of our “variance power” over funds donated to us in support of this program. Under our fiscal sponsorship agreement with ABC project, we retain full discretion and control over the use of such funds to accomplish the charitable purposes of the approved program. This power includes the unilateral right to redirect funds to a different beneficiary who can accomplish the purposes of this program if for some reason ABC cannot. (See Interpretation No. 42 of the Financial Accounting Standards Board’s Statement No. 116.)

c. Incubation. Model C can provide a good way to incubate a new nonprofit charitable organization. For the first few months while the new entity is awaiting IRS recognition of its exemption, the sponsor can receive grants and donations, provide charitable gift acknowledgements and receipts to donors, and regrant funds to the new corporation so it can commence operations immediately. However, some new 501(c)(3) entities actually prefer Model A fiscal sponsorship while they are waiting for their IRS letter, so they can postpone having to manage their own bank account, payroll, and vendor bills until the letter comes.

6. Other Models: True Fiscal Agents. Occasionally, true “fiscal agency” arrangements are created. Suppose five charities co-sponsor a fundraising event, and one agrees to collect the revenue, deposit it in its bank account, and split it five ways afterwards. The donor gets a receipt showing the names of all five charities. While the lead charity temporarily possessed all the funds, it never legally owned more than one-fifth of the revenue, and would only report the one-fifth on its Form 990 tax return. These arrangements are also called “custodial funds” or “common paymasters,” where the lead charity is truly acting as an agent for itself and the others.

7. Intellectual Property. Increasingly, intellectual property matters are important in all types of fiscal sponsorship and they are frequently overlooked. Sponsors and projects are most aware of the cash fund balance maintained by the sponsor for the project, and are usually aware of unpaid bills and other known liabilities associated with the project. They are often much less conscious of intangible assets such as trademarks, copyrights, licenses, mailing lists, and valuable assets created with computers and disseminated via Internet websites. Sponsors and projects need to be deliberate in handling the identification, enumeration, ownership, usage, and transfer of such assets. Often, the inquiry begins with the question “who created this?” Depending on whether a name or logo, an article or a software program, a mural or photograph was created by project employees, independent contractors, volunteers, outsiders, or perhaps the project staff, but long before the sponsorship commenced, the intellectual property issues can be complicated and solutions evasive. The sponsor may need to wrestle with questions such as: Did the project create or acquire this work or did it infringe someone’s copyright? Is this a “work made for hire”? Did the independent contractor assign all rights to

their work product to the sponsor? Do we have an oral license that should be reduced to writing? How can we compile a full inventory of this project's intellectual property so that it can be transferred, along with its tangible assets and liabilities, to another sponsor or to the project's new 501(c)(3) entity?

These questions are most acute with Model A projects; Model C project agreements generally provide for the project to retain all tangible or intangible obtained or created as part of the project. A Model A sponsor needs experienced intellectual property legal counsel, along with a good insurance broker, and lawyers specializing in tax-exempt nonprofit law and labor law.

8. Administrative Fees. Anecdotal evidence indicates a very wide range of fees charged for fiscal sponsorship, and a fair degree of price competition in some areas. There are sponsors who charge nothing to take on a project, and there are universities who reputedly charge 40 percent of the total budget for grant-funded public health research projects. Even the interest that may accrue on funds held by a sponsor for a project can be the subject of bargaining; some sponsors keep all the interest, some allocate all of it to the project, and some split the interest between them.