The Oregon Nonprofit Handbook

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CHAPTER 10

FISCAL SPONSORSHIP

Cindy Cumfer & Kay Sohl

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This publication is a reprint of a chapter of *The Oregon Nonprofit Corporation Handbook* by Cynthia Cumfer and Kay Sohl. The reprint may contain minor corrections to the Handbook. We have left the page numbering as it is in the Handbook. This allows you to use the cross-references to find additional material in this and any other chapter in the Handbook.

The Handbook is four books in one—it contains information on legal, tax exemption, management and accounting aspects of setting up, running and restructuring or dissolving an Oregon nonprofit corporation. Some chapters are geared primarily for Oregon nonprofit corporations, others apply to nonprofit organizations anywhere in the United States and some chapters contain both general and Oregon-specific information. This chapter contains information that largely applies to nonprofit organizations anywhere in the United States.

You can get Chapter 1 ("Should Your Organization Be a Nonprofit Corporation?"), Chapter 2 ("The Structure and Types of Oregon Nonprofit Corporations") and Chapter 23 ("Understanding Financial Management") and all Appendices and Forms referred to in your chapter for free at our website at **www.nonprofitpublications.net**. If you want other chapters or sections or the entire Handbook, you can purchase these on our website at **www.nonprofitpublications.net**. You can find websites for the authors at **www.cumfer.net** and **www.kaysohlconsulting.net**.

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FISCAL SPONSORSHIP

THIS CHAPTER COVERS

- Proper Uses of Fiscal Sponsorships
- Fiscal Sponsorship Alternatives
- Misuses of Fiscal Sponsorships
- Issues in the Fiscal Sponsor Relationship
- How to Structure a Fiscal Sponsorship

There are occasionally situations in which a group that doesn't have §501(c)(3) recognition from the Internal Revenue Service, needs the assistance of a group that has received its §501(c)(3) recognition of exemption. This commonly occurs when a group is told by a donor or funder that it would like to give the group money but that it will only give to a group that has §501(c)(3) status. The group may not be planning to apply for its own §501(c)(3) status or it may be willing to apply for (c)(3) status but needs or wants to get the money before it will get its notice of exemption from the Internal Revenue Service. In many cases, the group will look for a §501(c)(3) group that will "sponsor" it by letting the new group use the existing §501(c)(3) tax exemption number and by receiving the money in its name and then passing the money on to the nonexempt group.

This relationship is often referred to as a fiscal sponsorship and it can be done if it is carefully structured. Many of the groups that enter into this relationship are unaware that there are serious implications for the sponsor, the project, donors to the project, and foundations that make grants to the project if the relationship is not properly set up. If you are considering entering into this type of relationship or are already in such a relationship, either as the sponsor or as the project, or if your group is thinking about giving money to such a project, you should read this chapter. You will need a basic understanding of Chapter 5 to follow some of the material in this Chapter.

A note on terminology:

In the past, fiscal sponsor relationships have been referred to as "pass throughs" or "umbrella" relationships and the sponsoring organization was called the "fiscal agent." These terms are misleading and can result in serious problems with the IRS.

Currently, the relationship is generally called a "fiscal sponsorship" and the sponsoring organization is the "fiscal sponsor" or "sponsor." We use these terms in this book. The sponsored group is the "project."

Proper Uses of Fiscal Sponsorships

A fiscal sponsorship, as we are using the term, is a relationship between a sponsoring organization that is exempt under §501(c)(3) and an independently-run project which may or may not be incorporated and that is not tax-exempt under §501(c)(3). In this relationship, the sponsor has determined that the project operates for (c)(3) purposes and is in compliance with (c)(3) rules. The sponsor agrees to fund the project by collecting grants, donations, and other revenues intended for the project and distributing them to the project under a carefully structured relationship that ensures that the funds are used for (c)(3) purposes.

Most of the legal rules discussed in this chapter assume that the mission of the sponsor is advanced by its sponsorship of the project.

A good fiscal sponsor relationship can have many positive advantages for all the parties and for the community. The most successful sponsor relationships are generally those in which the project complements the mission of the sponsor. For example, the sponsor may provide education about AIDS and support to people with AIDS and the project may provide financial assistance for those who are HIV positive and who have used up their resources. Most of the legal rules discussed in this chapter assume that the mission of the sponsor is advanced by its sponsorship of the project. We believe that these are the only types of fiscal sponsorship that an exempt organization should consider. So, for example, if your (c)(3) arts organization is approached by a project that wants to provide care for the pets of homeless people, this sponsorship would not be a good fit for your organization.

Fiscal sponsorship may allow a new organization to get off the ground and can give birth to a worthwhile project or service that would otherwise not exist. If the service provided by the project

is a needed one, sponsorship can enhance the sponsor's reputation and relationships in the community as well.

Fiscal sponsorship relationships can be properly set up in a variety of situations. We describe four of the most common below. In all cases, the project has not been recognized as tax-exempt. In all of these situations, you must set your relationship up very carefully, so don't try these at home until you have read this entire chapter.

Fiscal sponsorship relationships can be properly set up in a variety of situations. You must set your relationship up very carefully.

New and Small Projects

A sponsor may support a project, often new or small in scope, that would itself qualify to be tax-exempt but it hasn't received an exemption letter. This is the most common use of fiscal sponsorships. The project may be in the process of applying for its own exemption or it may have decided that it doesn't want to get its own exemption but prefers to focus its energies on the project and not on setting up or administering a nonprofit. The project needs sponsorship because there are donors or foundations that want to give it money but who will only give to a §501(c)(3) organizations. *In a carefully constructed arrangement*, this can be done. For example, a drug prevention program has begun its work and has an interested funder but has not yet received its own tax exemption.

Projects of Limited Duration

Most nonprofits are established to last indefinitely but some nonprofits have a specific goal and will cease operations after achieving it. If this type of nonprofit wants to forego the work and expense of setting up a new nonprofit and obtaining tax-exempt status for it, a fiscal sponsorship could be a solution. An example would be a group organized to raise support for and build a memorial to a hometown service member killed in action.

Ongoing Project with a Major Donor/Funder

Occasionally, a project may be ongoing and have one or a few primary funders whose support is substantial. If the project were to obtain its own §501(c)(3) exemption, it would not qualify as a public charity because its funding does not meet the criteria described in Chapter 7. Instead, it would be classified as a private foundation with more regulation by the IRS and with lower charitable contribution limits that may discourage contributions by wealthier donors. A fiscal sponsor with a broader support base may be able to handle the project without jeopardizing its own public charity classification. If the donors are willing to relinquish some of the control over the project to a fiscal sponsor, a fiscal sponsorship could work. For example, several wealthy private donors

who want to entirely fund a program to offer music opportunities to low income young people may look for a fiscal sponsor.

Assistance to Qualified Individuals

A donor may be interested in giving money to a particular individual but cannot take a charitable deduction if she or he does this. If that individual is within a category of individuals to whom an existing §501(c)(3) organizations can make grants (for example, the poor, artists, or students), *in a carefully constructed arrangement* the donor can give the money to a sponsor who makes grants to that type of individual.

The sponsor cannot accept monies to be passed to specific recipients, but it can pre-qualify the specific individuals that the donor is interested in, as long as any person meeting the criteria could apply for and have the same chance of receiving funds as that individual. The sponsor has to have objective criteria for providing assistance to individuals that would meet the requirements of §501(c)(3). For example, friends of a child with leukemia want to establish a fund to help with her medical expenses. These types of arrangements require legal help to arrange.

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Fiscal Sponsorship Alternatives

There are a number of situations that are sometimes called fiscal sponsorships but are not. We describe two of the most common here. If one of these will work for you, you may want to consider it instead of a fiscal sponsorship.

Programs of the Sponsor

A new project contemplating a fiscal sponsorship arrangement in order to carry out its program ideas might consider whether the project can be run by and be part of the organization it is considering as a sponsor. If the potential sponsor took over the project, it would become one of the sponsor's program. The project would need to fit within the sponsor's mission, the sponsor would maintain control of the project and the ultimate use of the funds, and the project should be the type of activity that the sponsor described as one of its activities to the IRS on its own §501(c)(3) application.

The advantage for the project is that it does not have to set up a new corporation or deal with a fiscal sponsorship agreement. The individuals who seek to run the project would be volunteers or employees of the potential sponsor. The disadvantage is that the founders of the project would not be in control of the project, although it may have a board of advisors that makes recommendations to the sponsor. However, the potential sponsor controls the project, is responsible for any liabilities, and owns any property of the project.

Administrative Assistance for Another §501(c)(3) Organization

In a some cases, the project that has itself been recognized as exempt under §501(c)(3) wants a sponsor to handle its bookkeeping or other administrative matters in order to provide credibility and assurance of experienced management to funders. These arrangements are sometimes called fiscal sponsorships but are actually a contract between the two organizations for fiscal management or other services, not really fiscal sponsor services as we are using the term. The "sponsor" doesn't take on the obligations of oversight that a fiscal sponsor assumes when it is the only (c)(3) entity involved (described below). The sponsor doesn't account for the funds it handles as its own income and expenses in its financial statements, although the funds do show up on the sponsor's balance sheet. Among other issues, sponsors contemplating these types of contractual arrangements do need to consider whether providing bookkeeping or other services is related to the sponsor's mission and whether income received by the sponsor is unrelated business income. See Chapter 9.

Misuses of Fiscal Sponsorships

Fiscal sponsorship relationships are misused in a variety of circumstances.

The IRS treats the pass-through arrangement as a gift directly from the donor to the new nonexempt group. The donor cannot take a deduction for the donation.

Pass-Through Donations and Grants

A donor cannot take a charitable deduction for a contribution to an organization that is not recognized as exempt and most foundations cannot give money to an organization that is not recognized as exempt unless the foundation follows certain accountability procedures. Frequently, an organization that has not been recognized as exempt (often a new organization) has an interested donor and will ask a §501(c)(3) group to act as an umbrella or a pass-through organization. The donor or funder writes the check to the (c)(3), which has agreed to and does pass the money through to the new group without exercising any control over the money or requiring the specific

accountability mandated by the IRS rules. The IRS treats the pass-through arrangement as a gift or grant directly from the donor or funder to the new nonexempt group. This is an improper use of a fiscal sponsorship. The donor cannot legally take a deduction for the donation, the funder may have jeopardized its own (c)(3) status, and the (c)(3) umbrella may have made an improper grant.

Conduit for Gifts or Grants to Individuals

IRS rules forbid donors from making tax deductible contributions to specifically named individuals. Fiscal sponsorships are sometimes used by a donor who gives money to an exempt organizations with instructions to pass it on to a specific individual who is not properly qualified to receive the money. The donor then takes a tax deduction. Since the donor could not get a tax deduction had she or he given this money directly to the individual, this type of fiscal sponsorship is a misuse of the fiscal sponsorship arrangement. The donor cannot take a deduction for the donation and the (c)(3) has violated IRS rules that require certain procedures before making gifts to individuals.

Conduit to Nonexempt Organizations

Occasionally an organization that would not qualify for exemption under §501(c)(3) asks a §501(c)(3) organization to act as its sponsor. Funders and donors who could not give to the non-§501(c)(3) organization then give to the (c)(3) organization. The (c)(3) organization is supposed to pass the money through to the nonexempt organization. This is a misuse of the fiscal sponsorship arrangement. The donors cannot legally take a deduction and the (c)(3) has jeopardized its own exemption by giving money to a group that does not meet the (c)(3) criteria.

Avoidance of the Public Support Test

The IRS classifies all §501(c)(3) organizations as either private foundations or public charities. Private foundations generally are groups that get much of their income from one person or family or another private foundation. There are significant constraints and legal and accounting rules that private foundations must meet. Most groups prefer to avoid this classification if possible. (See pages 99-101 for a more detailed discussion of private foundations.)

The private foundation classification is commonly avoided by showing that an organization receives support from a variety of public sources. Chapter 7 discusses the tests that establish this in considerable detail. Sometimes a private donor wants to give a small organization a large sum of money that will tip the organization out of the publicly supported category and into the private foundation category. Occasionally the donor will donate that money to another §501(c)(3) organization (in this book, we call this a PSO—see Chapter 7). If the PSO is large enough, the donation does not tip it into the private foundation category. The donor **requires** that the PSO pass the money on to the smaller organization. PSOs do not tip public charities into the private foundation category. Because the PSO and not the donor is giving the money to the ultimate recipient, the recipient does not appear to be tipped into the private foundation category. However, the IRS will characterize this gift as having been made by the original donor to the intended recipient organization, since the original donor has controlled its direction. The IRS will classify the smaller organization as a private foundation.

Avoidance of the Lobbying Excise Tax by Private Foundations

Private foundations are restricted from using money to lobby and must pay excise taxes when they do. In order to avoid this tax, some foundations will attempt to give the money to a §501(c)(3) group that is not a private foundation and which can do limited lobbying without paying a tax. When the gift is to be disbursed for lobbying purposes, the fiscal sponsorship arrangement does not prevent the IRS from characterizing this as lobbying by the private foundation.

Consequences of the Misuse of Fiscal Sponsorships

All the parties involved in the misuse of a fiscal sponsorship may face consequences. The sponsor may lose its own tax exemption for its involvement in activities that are improper for (c)(3) organizations. The project may be classified as a private foundation based on the reclassification of the source of funds by a large private donor. If the donor is a private foundation, it may have to pay a penalty tax. If the donor is a private individual looking for a charitable tax deduction, the donor can lose the tax deduction.

The organizations and the officers and Directors face some additional potential liabilities. The IRS may impose excise taxes or other penalties on the officers and Directors of the exempt organization for misuse of funds. Donors who have lost an expected tax deduction may have sufficient losses to consider legal action against the organization and its officers and Directors. The future Directors of the sponsor may bring suit against the former officers and Directors whose negligent conduct caused the organization's loss of tax-exempt status. Bottom line: you want to do fiscal sponsorships right!

Issues in the Fiscal Sponsor Relationship

Four different participants may have an involvement in the fiscal sponsor relationship: the sponsor, the project, the donor, and the grantor. All of these parties have an interest in ensuring that the relationship is properly established. A number of issues come up in the fiscal sponsor relationship that will impact each of the participants differently. Before you set about structuring your sponsorship agreement, you need clarity about how you want to handle these issues.

Characterizing the Use of Project Funds

The parties have two choices about how to characterize the relationship in which the sponsor will handle funds raised for the project: the funds can be solicited as unrestricted or restricted funds.

Unrestricted Funds

If the parties agree that the sponsor has complete discretion over the use of any funds raised for the project, the funds are unrestricted. The parties will be aware that the sponsor plans to fund the project with the funds, but all contributors and funders understand when they provide the funds that the sponsor has the right to use the funds in any manner that it wants. Most sponsors will not be willing to antagonize potential funding sources and community relations by exercising their power to use the funds for other purposes without a good reason, but the sponsor has this right under this arrangement.

The parties have two choices about how to characterize the relationship in which the sponsor will handle funds raised for the project: the funds can be solicited as unrestricted or restricted funds

When funds are taken in as unrestricted funds, the funds are being held by the organization in a manner that is akin to Board-designated funds. An accountant would not classify the funds as restricted, since the Board has the right to change how the funds are used. Nonetheless, the Board may want its financial statements that show these funds set aside for the project. One consequence of this arrangement is that, if the project fails, the Board can use the funds in any manner that it wants.

From the sponsor's point of view, this is generally the simplest and preferred manner of handling funds and this probably is the most common form of sponsorship relationship. Occasionally, contributors, as well as many projects, may want more assurance that the funds contributed for the project will go to the project or, at least, for activities similar to those envisioned by the project.

Restricted Fund

The alternative is for the sponsor to collect funds that can only be used for the project. In order to avoid classification as a pass-through relationship, the sponsor must pre-approve the project **before** the funds are received and retain some control over the use of the funds. Because the funds have been solicited for a particular purpose, the sponsor will hold the funds in a restricted account. The power to exercise control to refuse to give the funds to the project is sometimes called a variance power.

One central issue in the sponsorship arrangement concerns the circumstances under which the sponsor may refuse to give the restricted funds to the project. In order to define the situations that could trigger the sponsor to vary from using the restricted funds for the project, the parties need to consider several potential factors:

- what the parties need to do to ensure that the relationship is not treated by the IRS as a pass-through relationship
- what commitments the sponsor made to the grantor;

- what representations the sponsor or donor made to individual contributors in soliciting funds;
- under what circumstances the sponsor itself may want to refuse to fund the project; and
- what happens to the funds if the parties terminate their relationship before the funds are distributed.

avoiding the irs pass-through designation

In order to avoid the IRS classification as a pass-through transaction, the sponsor needs to exercise the right to control the funds. One control the IRS requires is that the funds will be used in compliance with the rules for organizations exempt under §501(c)(3). The IRS relies on the (c)(3) sponsor to ensure this. At a minimum, the sponsor must exercise the expenditure responsibility described on pages 234-35. This means that if the project acts in any way to jeopardize the sponsors (c)(3) status, the sponsor must have the right to stop payments to the project and to recoup any monies that were not properly used. All grantors and contributors must be aware that the sponsor has the right to exercise this power.

Commitments made to the grantor

The foundation or governmental entity that makes a grant to the sponsor to be used for the project acts on the basis of a grant application and grant agreement that sets out the terms of the relationship. Although the funder anticipates that the funds will be used for the project, the monies are actually given to the sponsor. In almost all cases, the sponsor will sign a grant agreement with the funder which commonly includes agreements to spend the funds in certain ways and anticipates designated outcomes. In these circumstances, the sponsor will want the power to terminate its relationship with the project if the project is failing to comply with the grant terms.

representations to individual donors or the public

Many projects raise money from individual and sometimes corporate contributions. In the course of raising money, the project persuades the public to donate based on claims about what it will do. Because the contributions actually go to the sponsor to hold in a restricted fund, the sponsor must hold the money for the purposes for which it was solicited. Consequently, the sponsor needs to be sure that the project is correctly representing what it will do and that it in fact does it. To do this, the sponsor should review and approve all solicitations by the project before the project approaches donors or the public. The sponsor also needs to have the right to refuse to disperse funds from its restricted account to the project if the project is not using the funds as promised. The sponsor will want to be sure that the solicitation and any other descriptions about the project make clear to the public and contributors the sponsor's right to exercise these controls.

sponsor's decision to discontinue funding the project

The sponsor needs to consider whether circumstances might arise, in addition to those described above, that would cause the sponsor to terminate the sponsorship. One such circumstance might

be if the project was operating in such a way that might negatively affect the sponsor's reputation in the community—for example, if the project director was being disrespectful to clients or community members important to the sponsor.

Termination of the Relationship

If the sponsor becomes concerned with how the project is operating, it is generally in everyone's best interest for the sponsor and project to talk and attempt to resolve the difficulty. If after that the sponsor determines that it must exercise its control over the funds to refuse to continue its funding of the project, the sponsor then needs to decide how to handle any funds that remain in its restricted account. In some cases, the sponsor may also need to attempt to recoup misspent monies from the project and add those funds to the restricted account.

In determining how to handle the restricted funds upon the termination of the project, the sponsor should first consult the funding agreements for any provisions requiring that foundation or government monies be returned. If the grant agreement requires a return, then of course the sponsor must return the funds that have not been spent.

The sponsor's next step is to consider what to do with the remainder of its funds. Because it collected funds as restricted funds, it has to spend the funds for the purpose for which they were collected. For example, if your nonprofit educates the public about children with cancer and the project you sponsored raised money to grant wishes for young cancer patients, you will need to spend monies restricted to the project to grant children's wishes. You may do this by establishing your own program or by finding another (c)(3) that can honor the terms of your restriction.

If the sponsor determines that it can comply with the terms of the restriction, it may want to consider having conversations with its funders and donors before it continues. The sponsor will want to do what it can to maintain good relationships with the funding community. The sponsor may want to explain to the grantor or donor why it is redirecting the funds and its plan for the use of the monies. Some grantors who did not retain a right in their grant agreement may want the funds returned to them and, though the sponsor is not obligated to do this, it may want to consider it as long as the grantor is a governmental entity or exempt under §501(c)(3).

If the sponsor is considering whether to return funds to an individual donor, both the sponsor and donor may want to get professional advice. The sponsor will need to be sure that the restriction supports a return to the donor, since normally a (c)(3) sponsor can't give money to individuals except those who are its charitable beneficiaries. The donor will want to consider the tax impact on the donor of accepting the return of a failed gift which it has already deducted.

If the sponsor is not in a position to spend the funds in accordance with the restriction without giving them to the project, it needs to consider what it will do in those circumstances. It may need to get the approval of the Department of Justice or a court to keep or dispose of the funds.

Control

As described above, the sponsor must exercise control in certain important areas in order to protect its §501(c)(3) status and the commitments it made to funders and donors. At a minimum, the spon-

sor should collect all pertinent financial information and records; it should approve all financial expenditures, hiring and firing, and all significant decisions in running the project; and it should have the power to terminate the relationship if the project engages in any activity that jeopardizes the sponsor's tax-exempt status or funder or donor commitments. To the extent that the sponsor maintains control, it may also find itself taking on responsibility for the liabilities of the project.

Control is a central issue for both the sponsor and project. In order to protect its §501(c)(3) status, the sponsor must exercise some control over any money that it gives to the project.

The project typically wants to exercise as much control as possible over policy and administration. It can set policy about the project, subject to the sponsor's right to veto its decisions if these decisions threaten the sponsor's tax-exempt status. It may want to hire employees and run the day-to-day activities of the project. In some cases the project may want the sponsor to provide bookkeeping, hire employees, and handle other administrative matters.

Internal Accounting of the Project Funds

How the funds are recorded in your books depends on the how you decided to characterize your arrangement as described above. If you are treating the funds as unrestricted, you will record the funds in your operating budget. If you accepted the funds as restricted, the funds will be kept in and classified as a restricted fund. Because the project has not been recognized as exempt, the sponsor under either classification has the right to exercise some control over the funds received for the project. The accounting implication of this is that the revenue and expenses of the project will be reported on the sponsoring organization's books.

Be sure to avoid the use of terms like pass-through or acting as an agent. These terms have specific meanings to the accounting profession as well as the IRS. If the sponsor has an independent audit and presents the relationship to its auditor as a pass-through or an agency relationship, the auditor will not include the amounts received and expended as revenues and expenses. Instead, only the balance of funds remaining at year end will show up on the sponsor's audited financial statements—and it will be classified as a liability. This will mean that the independent audit does not support the donor's claim to have made a contribution to the organization. The proper treatment of a fiscal sponsorship project involving a sponsored project which is does not have §501(c)(3) status will be reflected in the audit in both revenues and expenses. Thus the audit report will agree with the Form 990 and the tax returns filed by the donors.

An important implication of showing the project's figures as revenues and expenses on the sponsor's books is that if the sums are large, this may distort the sponsor's true financial picture and may create problems with the sponsor's own funders or donors. Sponsors need to consider this before they agree to become sponsors.

Ownership of Property

In many cases, the project will generate or acquire property. It may generate property by producing a work of art, a book, or some other marketable item. It may acquire property, such as office furniture. The sponsor and project need to decide who will own this property upon the termination of the sponsorship. The decision may be influenced, in part, on how the parties structure their relationship, as described above.

Payments to the Sponsor

The parties need to decide what fee, if any, will be paid to the sponsor for its administrative services. The amount of the fee will vary depending on the sponsor and what is involved. In order to exercise the control needed to protect its own tax-exempt status, the sponsor will need to provide, at a minimum, some bookkeeping services and some supervision of the project. It needs to decide how much time and energy the fiscal sponsorship will take. Factors it may want to examine are whether the project has employees; what the sources of the project's income are; how much control the sponsor is exercising; and how much bookkeeping and compliance reporting on the sponsor's part is required.

Many sponsors charge for their services. Often they charge a percentage of the funds that they handle for the project. If you are considering a percentage charge, both parties need to be sure that this will not violate the terms of any grants that are being given to the project. In some fiscal sponsorship relationships, the sponsor takes a hefty percentage of the funds that it is handling. Although there are no hard and fast rules about usual percentages, projects can expect to pay up to about 15% for the service. Percentages over 30% are probably excessive. 15-30% is somewhat negotiable.

In addition to a fee for acting as a sponsor, some sponsors charge for other costs. Many grants permit adding overhead costs on top of the amount granted for the program. Some institutions add the cost of employee fringe benefit to their sponsorship fee. If you want to work with one of these large institutions, explore whether this add-on method would be acceptable to your funder. You will also want to have an explicit agreement about what costs the institution covers as part of its fee.

If the sponsor's charges for its services are more than just a reimbursement for expenses, its fee in excess of the expense reimbursement may be classified as unrelated business income (see Chapter 9). If so, the sponsor may need to file the Form 990-T and to pay the UBIT tax.

Liabilities

Typically, the sponsor will prefer not to assume the liabilities of the project, but the law may impose liabilities, depending on how much control the sponsor exercises over the project. The sponsor needs to identify the aspects of the project's operations that may create the greatest exposure to risk. It may be helpful for the sponsor and the project to review the description of common risks and insurance and other strategies to address them on pages 566-68. The parties should plan for this and discuss insurance and the payment of insurance premiums.

Public Relations

To some extent, the project will be perceived as associated with the sponsor. Each party needs to evaluate the reputation of the other to determine whether this association will help or hurt it with funders and with the community it serves. Many sponsors require that any publicity by the project must identify the sponsorship and the sponsor and that the sponsor pre-approve any publicity materials.

Protecting the Sponsor's Funding Sources

Sponsor organizations recognize that many foundations are unwilling to make multiple grants to the same organization during a specific time period. A funder that funds a grant to the sponsor that is solicited by the project may then refuse to award other grants to the sponsor for its own work. Most sponsors will want to protect their own funding sources. Typically, sponsors prioritize submission of proposals on behalf of the sponsor's core activities and limit the funders to which projects may apply. The sponsor may require that the project have the sponsor's explicit permission to seek contributions or grants which will be handled through the sponsorship relationship.

Special Issues for the Sponsor

If you are planning to act as sponsor for a project, there are two additional issues you must consider.

Mission and Purpose

The proposed project must fit within your own mission statement and purposes. You should review your Articles of Incorporation, your Bylaws, and any Board resolutions on the subject to see what your mission statement or purposes are. If the mission of the project does not fit within your own mission, you need to decide whether you are the most appropriate sponsor for this project. If you decide to sponsor the project even though it does not fit within your current mission or purposes, you may need to amend your purposes and mission statement so that your governance documents authorize this type of activity.

Activities Disclosed to IRS

When you applied for tax exemption, you submitted an application to the IRS that listed the activities in which you planned to engage. It was on the basis of those activities that the IRS granted you an exemption. The IRS rules provide that if you substantially change those activities, you must notify them.

You need to find your Form 1023 application for tax-exempt status and review what you told the IRS you would be doing. This is found in Part IV of the applications filed in or after October 2004 and Part II of most applications filed before that. If you cannot locate your application, contact the IRS to see if it can supply a copy. If the activities of the project fit the activities in your narrative description to the IRS, you do not need to do anything further. However, if the activities are sub-

stantially different from those you described to the IRS, the funds you are giving to the project are substantial, and your sponsorship is going to extend for a period of time, you may need to notify the IRS that you have substantially changed your activities.

> *Example*: Neighborhood Health Clinic, a §501(c)(3) organization that provides health services to those who cannot afford them, has been approached by an environmental group that wants to advocate for the clean-up of a toxic site in the neighborhood. The group wants the Clinic to act as its sponsor. The Clinic needs to review its IRS application, because it is very likely that this kind of project was not disclosed to the IRS.

You can notify the IRS in your Form 990 (see Chapter 12) that includes a brief paragraph explaining what your new activities are. The IRS can inquire if it wants to know more.

How to Structure a Fiscal Sponsorship Agreement

After you have made your decisions about the issues described above, you are ready to structure your fiscal sponsorship agreement. To avoid the improper pass-through arrangement, both parties need to recognize is that there are actually two relationships taking place, and each relationship must follow proper procedures. The donor or funder is making a contribution or grant to the sponsor. This grant may be unrestricted or it may be restricted, as described above. In either case, it must follow the rules discussed below about funding. The second relationship occurs when the sponsor becomes a funder by passing the money to the project, either by re-granting it or by hiring the project as an independent contractor. In any fiscal sponsorship arrangement, the parties should have a contract setting out the terms of their agreement.

Both parties need to recognize is that there are actually two relationships taking place, and each must follow proper procedures.

Phase 1: Handling the Initial Contribution or Grant

Earlier in this chapter we described two arrangements that the sponsor and project might make with reference to how the sponsor classifies project funds—the sponsor could make no binding commitment about how it spends the funds or it could receive the funds as a restricted gift to be used for the project. The choice you make is central to how you structure your fiscal sponsorship agreement.

Unrestricted Funds

Where there is no binding commitment to the funders to use the funds for the project, your agreement will reflect that the sponsor retains the right, without approval from any funding source, the project, or anyone else, to redirect the use of the funds away from the project. The sponsor may use the funds for its own purposes or give them to another beneficiary capable of fulfilling the purpose of the project. The sponsor should take the funds with an internal but not legally binding commitment to use the funds for the project as long as this does not threaten the sponsor's exempt status. All donors and funders need to be aware of the Board's right to change the use of the funds.

Restricted Funds

The sponsor and project can agree that the sponsor will restrict the funds for the project's use but this is a tricky arrangement about which there is some legal and accounting uncertainty. You should get legal and accounting advice if you are considering this option. We describe the broad contours of the relationship so that you can see what it entails.

If the sponsor and project agree that the Board will restrict the funds for the project's use, the sponsor needs to pre-approve the project as a project of the sponsor's **before** it receives money for it. Pre-approval means that the sponsor must gather information about the project—what it plans to do, how it fits within the corporation's mission, whether it meets the (c)(3) requirement, and how it plans to fund it—much like the Board or staff would do before adding any new program. It is particularly important that a sponsor considering a restricted funds arrangement be sure that the project advances the sponsor's mission. In most cases, this pre-approval of a new program should be done by the Board. If the Board wants to delegate this task to the Executive Director, it should get legal advice. Upon pre-approval, the Board can collect funds. It is now collecting funds under an agreement that they are restricted for a particular purpose and, like any restricted fund, must be spent for that purpose.

However, unlike a restricted fund (which accountants call a designated fund) used by the sponsor for its own internal programs, the sponsor will have notified the funders and donors of additional conditions on the restricted fund. At a minimum, these restrictions will include the right of the sponsor to terminate funding the project if the project does anything that jeopardizes the sponsor's (c)(3) status. If the sponsor has signed grant agreements with a funder aimed at funding the project, the sponsor will need the ability to terminate funding the project if the project fails to comply with the terms of that grant agreement. The sponsor may also need to terminate supporting the project if the project is misleading the public about the sponsorship relationship or what the project is doing or is in other ways negatively affecting the sponsor. The sponsor should have the right to control the investment of the project's funds and the timing of their distribution.

If the project fails or the Board terminates its relationship with the project because it operated in ways that violated the rules regulating (c)(3)s or funder requirements or donor commitments, the sponsor will need to establish its own program that satisfies the restriction or it can make a grant to another (c)(3) that satisfies the restriction.

All donors and funders must be aware of the limitations of the restricted fund to which they contribute—while the fund is restricted to the use of the project, if the project fails or operates outside the (c)(3) and funder rules or donor commitments, the Board can make an alternate distribution. Some grantors may require that unspent funds be returned to them, which you must do if you accept the grant with those terms. If an individual donor puts such a restriction on his/her gift, the donor should talk with a tax adviser to determine if the restriction means that the gift is not deductible until the funds are spent.

Phase 2: Funding the Project

Once the sponsor has received the funds for the project, it can fund the project in two ways. The most common mechanism is to distribute the funds to the project as a grant. Because the project doesn't have (c)(3) status, the sponsor must follow special expenditure responsibility rules to ensure that the grant is used for (c)(3) purposes. Another option is to hire the project as an independent contractor to carry out the project. In some cases, this option can work but it does have the challenges and limitations described below.

Expenditure Responsibility for the Grant to the Project

As the funder of the second grant (the re-granting arrangement), the (c)(3) sponsor is making a grant to a non-(c)(3) organization. To do this, the sponsor must exercise *expenditure responsibility* by engaging in these steps to correctly complete this type of funding process:

- The project is pre-approved by the sponsor after receiving a written request from the project and before funds are solicited from donors. The pre-approval should be made only if the project fits within and advances the sponsor's mission in its Articles or Bylaws and within the activities for which it received its tax-exemption, all as described above. The sponsor also needs to be sure that the project does not operate in any ways that would prevent if from being tax-exempt—for example, by engaging in political activities or improperly benefiting insiders.

- The sponsor and project must comply with the expenditure responsibility rules by signing a *written grant agreement* setting forth the terms and conditions of the grant from the sponsor to the project, the use of the money by the project, the control by the sponsor, the ability of the sponsor to terminate the grant and demand return of the funds if they are misused, and reporting requirements to the sponsor about the use of the money. This grant agreement needs to be carefully written and may be part of a fiscal sponsorship agreement. Except for very small projects, you should have an attorney with some experience in this area prepare this agreement.

- The sponsor or the project solicits the funds for the specific grant to the project. The funding sources are made aware of the sponsor's control in writing.

- As the sponsor receives funds for the project, the sponsor takes the funds in as contributions or grants income to the sponsor and then disburses the funds as a grant payment to the project, subject to the terms of the grant agreement.

- The project makes periodic written reports to the sponsor, showing its actual expenditures of the funds and its progress toward accomplishing the purposes of the grant.

The project can control the use of the funds after they are re-granted to the project, as long as they are used within the parameters of the grant.

Any property that is acquired in connection with the project is generally owned by the project, although the parties have some room to negotiate about this.

The responsibility for the liabilities of the project is somewhat uncertain. The parties will generally agree that the project is liable, but this is not necessarily binding on third persons who are owed money. The ultimate resolution of liability questions may rest on the amount of control the sponsor retains and on the circumstances giving rise to the liability.

Independent Contractor

In the independent contractor model, the project is really the sponsor's project. However, the founders of the project are not working on the project as volunteers or employees of the sponsor subject to the sponsor's control over how they carry out the details of the project. Rather, the sponsor contracts the project out to the founders of the project who can control the details of how the project is run.

The independent contractor arrangement means that the sponsor and not the project makes the major decisions about what the project does and how it does it. Of course, in a fiscal sponsorship situation, the sponsor will be heavily influenced by the creators of the project in making these decisions. When the sponsor jobs the project out to the founders of the project, it will need to walk a fine line between creating a true independent contractor relationship in which the sponsor has little influence in how the project is carried out but still allow the sponsor the ability to ensure that the founders are carrying out the project in compliance with (c)(3) and grantor rules. To create this relationship, the parties must become familiar with the requirements for establishing independent contractor status (see Chapter 20) and understand how to mesh this with the IRS rules. You will need legal help with this arrangement.

If the parties successfully create an independent contractor relationship, the monies from donors and foundations will belong to the sponsor, as will any property acquired or created by the project. The funders need to be aware of the nature of this relationship. Generally, the independent contractor is responsible for the project's liabilities, but, depending on the factual situation that gives rise to the claim, the sponsor may also be liable.

Drafting an Agreement

Once you have determined the central structure of your agreement, you are ready to draft your agreement. The type of agreement you use will vary depending on whether you are re-granting funds to the project or hiring the project founders as independent contractors.

Fiscal Sponsorship Agreement

If you are re-granting funds to the project, your agreement should consider the following provisions:

- a description of the sponsor's services, including a provision that describes whether the funds are restricted or not (see above), the sponsor's right to control the funds, fund management by the sponsor, and sponsor's compensation;
- a description of the project's rights and obligations; including property rights to property acquired by the project, a commitment to use funds for the purposes stated in the grant agreement from sponsor, any restrictions on grant-seeking by the project, requirements that project provide a budget for sponsor's approval, any requirements concerning project's publicity and use of the sponsor's name, and a requirement that project inform donors about the funding relationship the parties have established;
- reporting requirements so that the parties are informed about what each other are doing;
- a limitation on the project from using any of the sponsor's grant for a political campaign, lobbying, or for improper private benefit or inurement;
- an acknowledgement that the sponsor is not the project's agent;
- an agreement that the project is liable for its actions and a clause indemnifying the sponsor from damages arising from actions of the project; and
- a provision describing the circumstances under which the agreement can be terminated and what happens to the remaining funds on termination, including the right of the sponsor to recover misspent funds from the project.

The agreement should, of course, include any other provisions important to the parties.

Independent Contractor Agreement

Your independent contractor agreement will include many of the elements above but will need to be drafted with the requirements of Chapter 20 in mind. As we noted above, you will need legal help with this agreement.

Consult Appendix 1 if you would like information about source material related to this Chapter. Appendix 1 has references of interest to all readers, not just professionals.