Fiscal Sponsorship: Leveraging Your Organization's Creativity & Energy

Jason Z. Qu

D.C. Bar Pro Bono Center

DC BAR PRO BONO CENTER

D.C. Bar Pro Bono Center

- We match nonprofit organizations with pro bono legal counsel
  - Pro bono attorneys help with many different types of legal issues including corporate governance, IRS compliance, employment law, or real estate matters.
- We host legal clinics to assist with specific issues such as governance policies, risk management, and intellectual property needs.
- We sponsor trainings, webinars, and podcasts on important legal issues and provide written resources/archived sessions on our website: www.lawhelp.org/dc/ced

Today's Webinar

- What is fiscal sponsorship? Why is it used?

- Key issues when creating fiscal sponsorship arrangements
  A. Mission alignment
  B. Variance power
  C. Fundraising responsibilities
  D. Financial & programmatic oversight
  E. Written fiscal sponsorship agreements

What is Fiscal Sponsorship?

- A funding practice where 501(c)(3) nonprofit organizations (“Sponsors”) provide support—including receipt and management of tax-deductible contributions—to charitable groups or initiatives (“Projects”) lacking their own 501(c)(3) status
  - Sometimes referred to as “fiscal agency”, but this term is not preferred
  - Other arrangements (e.g., both entities are 501(c)(3)) are possible, but are not the focus of today’s presentation

Benefits of Fiscal Sponsorship

For Projects

- Receive tax-deductible donations without the costs & burdens of creating an independent 501(c)(3)
  - e.g., application process; board formation and governance; periodic reporting
- Avoid other state and federal registration and reporting requirements, including registration under charitable solicitation laws, by operating through the Sponsor
- Sponsor can provide additional administrative and technical support
  - e.g., payroll, HR, benefits, accounting support, insurance, tax filings, office space, furniture/equipment/computers/IT
- Room for growth - Project can operate exclusively as a sponsored project, or can apply for 501(c)(3) at an appropriate time

Benefits of Fiscal Sponsorship

For Sponsors

- Opportunity to advance mission by supporting allied organizations & initiatives
- Support, test, and accelerate innovative or creative projects without developing full in-house capabilities
- Costs of fiscal sponsorship can be offset by charging Projects an administrative fee

Fiscally Sponsored Project Examples

- Incubation-Stage: newly formed, start-ups; proof-of-concept projects; 501(c)(3) pending

TIDES

- Time-Limited: one-time projects (e.g. renovation initiatives, special events) or short-term projects (“XYZ Initiative 2017”)
- Emergency Purpose: e.g. disaster relief, disaster response

HAND IN HAND
A BENEFIT FOR HURRICANE RELIEF

Fiscally Sponsored Project Examples

- Coalitions, Joint Ventures, and Consortiums: members are already operating entities, making standalone organization unnecessary
- International Projects: support for projects located abroad which may not be eligible to become domestic 501(c)(3)s

GlobalGiving

- Individual or Small-Scale: e.g. filmmakers, artists, activist groups

WMM WOMEN MAKE MOVIES

Sponsor-Project Relationship

- Operationally, structure of the Sponsor-Project relationship can vary – 2 common forms are:
    - <u>Direct Project Model</u> – Project has no separate legal entity whatsoever; project personnel are employees of the Sponsor; project itself is a program of the Sponsor
        - high degree of Sponsor operational involvement and support; Sponsor bears all liability
    - <u>Grant/Regrant Model</u> – project is a separate legal entity, but lacks 501(c)(3) status; Sponsor's main role is to solicit and disburse third-party funding; Sponsor "regrants" outside funding to the Project
        - Essentially a grantor-grantee relationship; Sponsor may provide other support services as needed
        - From IRS perspective, higher risk of abuse – could become a conduit for contributions that benefit noncharitable projects
            - Sponsor must still exercise oversight and control to ensure IRS compliance
- Considerations in this presentation apply to <u>both</u> models

Fiscal Sponsorship Considerations

Compliance with IRS Requirements is Key

A. Mission Alignment

- The sponsored project operates under the Sponsor's 501(c)(3) status
- Therefore, the sponsored project must operate in a manner (i) consistent with the Sponsor's governance documents and (ii) consistent with the Sponsor's tax-exempt status generally.
  - For example, if your organization was incorporated for the purpose of feeding the hungry, it cannot fiscally sponsor an organization that:
    - Operates a school, because the organization's governing documents do not authorize such activities; or
    - Operate a commercial grocery store, because it is not consistent with the work of a tax-exempt charitable organization.

A. Mission Alignment (cont.)

- You can avoid the corporate purposes problem if the articles of incorporation provide that the nonprofit organization can carry on any activity which an organization exempt under Section 501(c)(3) of the Internal Revenue Code can engage in

- If the sponsored project is not consistent with the Form 1023 that the Sponsor filed with the IRS and has not already been disclosed, nonprofit will have to disclose the new activity on its next Form 990

A. Mission Alignment (cont.)

- Sponsor's board should review and approve each project to ensure it is consistent with its corporate purposes and tax-exempt status
  - Decision to support should be made via board resolution

- Particularly important for grant/regrant arrangements, where the Sponsor is less involved in day-to-day management of the Project
  - If engaged in multiple grant/regrant relationships, consider defining eligibility criteria ahead of time or creating a standard application process that will help to identify/screen mission-aligned projects

B. Variance Power

- Remember – donors' tax deductions for contributions to the sponsored project are a product of Sponsor's 501(c)(3) status – Sponsor is ultimately accountable for use of donated funds
- IRS requires that Sponsor maintain "discretion and control" over Project funds – prevents Sponsor from becoming passive conduit for donations.
  - Ensures that Sponsor bears the legal responsibility for ensuring such funds are used for an exempt purpose, and do not benefit private individuals
- Key element of "discretion and control" is "variance power" – Sponsor's power to divert funds that were originally intended to support the sponsored Project to a different beneficiary
  - e.g. if the Sponsor discovers that funds are being spent improperly by the sponsored project – Sponsor must have ability to course-correct, and must have power to cut off support
  - Sponsor must also be able to deal with situations where it becomes impracticable to spend the donations in a manner consistent with the donor's wishes, such as when the sponsored project ceases operations

B. Variance Power (cont.)

- Scope of Sponsor's variance power:
  - The Board must have the unconditional right to use the funds only in a manner consistent with its exempt purpose
  - The Board cannot use the funds in a manner inconsistent with the donor's restrictions
  - If the Board cannot reconcile those two requirements, it can do one of three things:
    1. Return the donation to the donor;
    2. Get the donor's permission to redirect the donation to another purpose or organization; or
    3. If this is not possible because the donor cannot be located, or is no longer available, seek permission of the court to redirect the donation
- Best practice is to inform the donor at the time of the donation of the Sponsor's variance power

B. Variance Power (cont.)

- "As XYZ Program's fiscal sponsor, XYZ Sponsor retains full discretion and control over the use of funds donated with the intention of supporting XYZ Program, including the unilateral right to redirect funds to a different beneficiary if XYZ Program cannot accomplish its charitable mission for any reason."

- "Habitat for Humanity International shall make every effort to use funds as designated; nevertheless, under the direction of the board of Directors, Habitat for Humanity International retains complete control over the use and distribution of donated funds in furtherance of its mission."

C. Fundraising Responsibilities

- Because Sponsor is ultimately responsible for donated funds, fundraising responsibilities also fall primarily on Sponsor
  - Sponsor also holds the state-level charitable solicitation registrations, must monitor where solicitations are being made

C. Fundraising Responsibilities (cont.)

- Sponsor should:
  - fundraise in the Sponsor's own name for the benefit of the sponsored project, or note on all fundraising materials that the sponsored project is fiscally sponsored by Sponsor;
  - review and approve potential fundraising sources;
  - review and approve all fundraising materials;
  - require all checks to be made payable to the Sponsor;
  - acknowledge contributions in Sponsor's name;
  - execute grant agreements and other funding commitments;
  - take responsibility for grant compliance and reporting, with assistance from sponsored project as needed;
  - ensure that fundraising by the sponsored project complies with the law, including the various charitable solicitation statutes.

D. Financial & Programmatic Oversight

- Even if funds are intended for the sponsored project, Sponsor is liable for financial misconduct involving donated funds, including:
  - expenditures for non-charitable/nonexempt purposes;
  - excess benefit transactions/private inurement;
  - political intervention & other prohibited activities

- Unless the sponsored project is a separate legal entity, the Sponsor may also be responsible for Project's financial liabilities

- Ongoing monitoring and oversight is therefore necessary

D. Financial & Programmatic Oversight (cont.)

<u>Financial Controls</u>

- Categorically prohibited expenditures and activities should be defined in the fiscal sponsorship agreement
- Extent of other financial controls will be context-specific
  - For directly sponsored projects, all bank accounts should belong to the Sponsor
    - Sponsor exercises ongoing oversight and control over these accounts
    - However, project staff can be signatories on project-specific accounts; project may also be allotted petty cash
  - For grant/regrant arrangements, project will often have a separate bank account in its own name – however, additional financial controls should be implemented, e.g.:
    - Preapproval of expenditures
    - Disbursements on demand
  - In all events, there should be financial reporting to Sponsor of how assets are used, and the Sponsor should have the right to review and audit project activities

D. Financial & Programmatic Oversight (cont.)

<u>Programmatic Oversight</u>

Sponsor should also review the sponsored project's programs and activities to ensure mission alignment and to verify charitable purpose

- *Periodic reports:* Fiscal sponsorship agreements can require periodic reports by the project to the Sponsor
- *Advisory committee*: Sponsors can require projects to create advisory committees which oversee operations
  - can include Sponsor representatives and other stakeholders; decentralizes oversight function

E. Written Fiscal Sponsorship Agreements

- Sponsors and projects should execute a written fiscal sponsorship agreement to address the questions outlined above

- The agreement should also address basic operational considerations and obligations of the parties – these may be fact-specific, but may include:

E. Written Fiscal Sponsorship Agreements (cont.)

- Administrative charge: generally calculated as a % of gross receipts intended for the Project (5-15% is common); may also consider minimum flat rate
  - Ensure that administrative charge is consistent with donor restrictions. For example, a grant request should include the fee in its budget, or the sponsored project should use other, unrestricted donations to pay the fee for the grant funds

- Fund balance requirements: Sponsor should require that a sponsored project maintain a minimum level of operating funds to ensure that the sponsorship doesn't linger in name only. This could subject the Sponsor to liability

- Hiring of personnel: should be subject to Sponsor approval

E. Written Fiscal Sponsorship Agreements (cont.)

- <u>New intellectual property and other created property</u>: who is the owner of new IP or other property created during the course of the sponsorship? Who has a right to use the new property?
  - Sponsored project usually owns the end product of a sponsored initiative, if any

- <u>Use of existing IP</u>: license to use marks and other IP for specified purposes

- <u>Risk management</u>: requirements to carry insurance, or agreement to cover sponsored project under Sponsor's insurance; if separate legal entities, "no agent" clauses; indemnification provisions

- <u>Exit provisions</u>: define conditions when fiscal sponsorship will end, e.g.: grant of 501(c)(3) status; financial or other growth thresholds; upon notice; specified date

Questions?

Jason Qu
D.C. Bar Pro Bono Center
1101 K Street, NW
Washington, D.C.
jqu@dcbar.org