

# Attachment D

## Fiscal Sponsorship: Six Ways To Do It Right — A Synopsis —

by Gregory L. Colvin  
Silk, Adler & Colvin, San Francisco, Calif.

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*The book-length version of this work will be available later this spring. Address inquiries to San Francisco Study Center, 1095 Market Street, Suite 602, San Francisco, California 94103, telephone (415) 626-1650, fax (415) 626-7276.*

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### Introduction: The Problem

This book is the result of a series of discussions 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 has been criticized in recent articles.<sup>1</sup> In the face of this advice, some organizations have considered abandoning the practice. Most have 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.

The purpose of this book is to take a positive approach to the problem. It describes, in general terms, six different models (plus a seventh, experimental model) by which a public charity, tax-exempt under section 501(c)(3) of the Internal Revenue Code, can conduct a program of support to individuals and to nonexempt organizations that is legal and proper.<sup>2</sup>

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 the more accurate 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 (we will call this 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 section 501(c)(3) tax status. So the project looks for a section 501(c)(3) **sponsor** to receive the funds and pass them on to the project.

<sup>2</sup> This publication is intended to orient a variety of charities to the possibilities for legal, effective fiscal sponsorship programs. It is not intended to provide legal advice directly to any specific organization. Each organization will need professional legal and accounting advice to help it establish, review or modify a fiscal sponsorship program.

<sup>1</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, section 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 section 501(c)(3) group needs the help of a larger section 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 models we present are not etched in stone. Consider them 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.

### The Models

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

The chart 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). The seventh model has had limited use so far, but has the potential for broader applications.

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 (Preapproved 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 section 501(c)(3) tax status, able to receive 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 section 501(c)(3) status by coming under the sponsor’s umbrella, but the project must meet a public support test. Conversely, the Supporting Organization applies for its own section 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.

In Model F (Technical Assistance), the project has its own section 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.

Model X (Payments “For the Use of” Sponsor) is a new, untested concept derived from a recent U.S. Supreme Court decision involving Mormon missionaries. The ruling appears to allow donors to make deductible contributions not directly to a charity sponsor, but to a separate account set up by the project in trust for the sponsor.

### 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 fund-raising 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

<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. United States*, 13 Cl.Ct. 486, 87-2 USTC para. 9602 (1987).

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: Sponsor	Comments
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 1040s	Legally, project is no different than any other activity carried on by 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	Appropriate where project is integral part of sponsor's work, but may be legally performed by independent contractor.
C. PREAPPROVED GRANT RELATIONSHIP	Project applies to sponsor for one or a series of grants, sponsor funds projected only to extend that money is received from donors.	Yes	Grantor-Grantee	Sponsor	Selection and payment of grantee, plus terms set by funding source.	Project usually	990	Used by 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.	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	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 contract.	Project	990, if fee charged	Sponsor provides financial management to project, but all funds are raised and spent in the name of project.
X. PAYMENTS "FOR THE USE OF" SPONSOR	Project approved by sponsor, trust account is set up for project separate from sponsor's assets, donors pay directly to trust account.	May or may not be	Sponsor must control project	Project, in trust for sponsor.	Varies, may be partial or total.	Project, in trust for sponsor	None	New, untested model based on U.S. Supreme Court decision on acceptable methods for Mormon parents to aid missionary children.

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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.

### 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.

### Model C — The Preapproved 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 people refer to this model as "regranting." As we will show, 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 nonsection 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:

*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,

<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.

foundations, or government agencies, the sponsor has *preapproved* 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, solicit 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 section 501(c)(3). It also could 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 nonsection 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 preapproved grant are solicited for a particular purpose. Funders would naturally expect the sponsor of a preapproved project to fund the project so long as the project follows its grant agreement. For in-

stance, 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 preapproval, 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. Preapproval 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.

As in Models A and B, the sponsor may establish a charge for general administration, overhead, and fund-raising, so

<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 which 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.

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

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.

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.

#### Model D — The Group Exemption

Usually, the main reason that a project seeks a sponsor is because the project does not have its own section 501(c)(3) tax exemption. Applying to the IRS for recognition of section 501(c)(3) tax status can be a lengthy and costly process where the project has to respond to a battery of IRS questions to demonstrate that its purposes, governing structure, operations, and budget all meet IRS requirements. For a small or short-term project, the application process may not be feasible.

Although it is not widely known, the IRS has had, for decades, a procedure whereby certain organizations can receive section 501(c)(3) tax status *without* applying to the IRS. The "group exemption" process, set forth in a simple, three-page IRS Revenue Procedure,<sup>10</sup> is designed for "subordinate organizations that are affiliated with and under the general supervision or control of a central organization."

In a nutshell, the central section 501(c)(3) organization applies to the IRS for a group exemption letter covering its subordinates, attesting that each of the subordinates is also

qualified under section 501(c)(3). After the initial group exemption letter is issued, subordinates can be added or deleted to an annual listing that the central organization files with the IRS at least 90 days before the end of its fiscal year.

A central organization is defined as an organization that has one or more subordinates under its general supervision or control. A subordinate is defined as a chapter, local, post, or unit of a central organization.

The group exemption process is mainly used by nonprofits that are geographically organized on a state, regional, or national basis. The Roman Catholic church in the United States is a prime example. However, there is no reason why a sponsor (the central organization) should not be able to obtain a group exemption letter covering a variety of artistic, community, environmental, or other charitable projects (subordinate units) if the arrangement meets the IRS tests for affiliation and supervision or control.

#### Model E — The Supporting Organization

This model does not relieve the project of any of the details of establishing a free-standing section 501(c)(3) nonprofit organization, except one. That one, however, is crucial. The project can obtain IRS classification as a *public charity* — which is a very valuable classification to have — without having to meet the highly technical *public support* test used to divide the world of section 501(c)(3) organizations into private foundations, which are heavily regulated under chapter 42 of the Internal Revenue Code, and public charities, which are free of those regulations.

An organization normally qualifies as a public charity based either on the nature of its activities (a church, school, hospital, etc.) or the broad base of its financial support (the public support test). By contrast, a Model E supporting organization (the project) does not have to concern itself with these issues. Instead, the project achieves public charity status under section 509(a)(3) of the Internal Revenue Code by having a special relationship to a "supported organization" which *does* qualify, independently, as a public charity (the sponsor). The project must meet four tests under section 509(a)(3):

1. The *relationship test* offers three different ways in which the project can be operated by, supervised by, controlled by, or connected to the sponsor. Most Model E projects will want to qualify as "operated in connection with" the sponsor, by having at least one member of the project's board of directors selected by the sponsor, who has a significant voice on the board, and by showing that the project directly engages in activities that perform the functions or carry out the purposes of the sponsor. The project should be able to demonstrate that its program is within the range of activities normally conducted by the sponsor as part of the sponsor's charitable mission.
2. The *organizational test* is met mainly by special provisions in the project's articles of incorporation

<sup>9</sup> In the *National Foundation* case, *supra*, footnote 3, the IRS argued that a 2-1/2-percent 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 2-1/2 percent. The implication is that the lower the charge, the less likely it is to be controversial. (National Foundation also charged 8-1/2 percent of the first \$500 contribution for administrative and fundraising costs.)

<sup>10</sup> Rev. Proc. 80-27, 1980-1 C.B. 677.

which commit the project to a supportive relationship to the sponsor.

3. The *operational test* is met by the fact that the project conducts independent programs which support the mission of the sponsor.

4. The *control test* basically requires that substantial contributors to the project (as well as their families and business enterprises) must have less than 50 percent of the voting power on the project's board of directors.

Model E is best suited to the project that is willing and able to obtain its own section 501(c)(3) tax-exempt status, but expects to get *all* of its funding from *less than five* private foundations, individuals, families, or business companies. Such a project would fail a public support test on its own, but by linking up with a public charity sponsor in the manner prescribed by the IRS, it can avoid classification as a private foundation. If the project has five or more unrelated private donors, or has government funding, or receives a sizable portion of its income from selling goods and services related to its exempt purposes, it can probably meet a public support test on its own.

#### Model F — Technical Assistance

In all the other models, the project relies upon the sponsor for some legal benefit or advantage under federal tax law. In Model F, the project may have complete legal independence, its own section 501(c)(3) status and its own public charity classification. It has no duty to support the purposes or follow the directions of the sponsor. Instead, what the project receives from the sponsor is practical help with the details of administering a nonprofit organization that might otherwise be beyond the skills or capacity of the project.

This practical help is recognized by the IRS as "technical assistance." The theory is that one nonprofit organization can fulfill its exempt purposes by providing below-cost services to aid another nonprofit to achieve its charitable work in the community. Here is a partial list of some of the services that could qualify as technical assistance.

- \* Preparation of tax exemption applications
- \* Bookkeeping and accounting
- \* Payroll
- \* Preparation of tax returns
- \* Fund-raising
- \* Advertising
- \* Office management
- \* Legal services
- \* Insurance

Notice that none of these services are charitable *per se*. There are for-profit businesses that provide these services in most communities. The key distinction is that technical assistance rendered by charity A to charity B must generally be priced *below charity A's cost of providing the service*.<sup>11</sup> Often, the service is provided free of charge. If the sponsor does charge the project for the service, the sponsor should be able to show that the rate of charge is less than the sponsor's cost, including both direct expenses as well as a portion of indirect staff and overhead costs. Alternatively, the sponsor could demonstrate that the services are priced below cost because grants and donations are required to balance the sponsor's budget by subsidizing the technical assistance services.

#### Model X — Payments "For the Use of" Sponsor

This model is experimental and untested, but it offers the possibility of a new form of fiscal sponsorship with a much lower level of accounting and tax reporting, at least for the sponsor. As you will see, Model X should be undertaken only with specialized legal advice, and perhaps a private letter ruling should be sought from the IRS before proceeding.

Model X is suggested in a U.S. Supreme Court opinion written by Justice Sandra Day O'Connor for a unanimous court in *Davis v. United States*.<sup>12</sup> In this case, the IRS challenged the method by which most Mormon missionaries receive financial aid from their parents. The young missionaries, who receive no salary from the Mormon Church, typically pay their own living and travel expenses out of their own savings or out of funds sent directly to them by their parents. The parents claim the payments as tax-deductible charitable contributions, even though the money does not pass through the Church, relying on language in Internal Revenue Code section 170 which permits deductions for donations to *or for the use of* religious and other charitable organizations.

The Supreme Court ruled in favor of the IRS, but it did not require that donations, to be deductible, only be made to the immediate possession and control of the Mormon Church. It interpreted the phrase "for the use of" to refer to donations made to a legally enforceable trust or similar legal arrangement, separate from the charity but established for the benefit of the charity.

Justice O'Connor's opinion seems to prescribe four requirements for a new and intriguing fiscal sponsorship

<sup>11</sup> Some of the leading IRS authorities on the subject of below-cost technical assistance are Rev. Rul. 69-528, 1969-2 C.B. 127 (investment services); Rev. Rul. 69-572, 1969-2 C.B. 119 (community chest office building); Rev. Rul. 71-529, 1971-2 C.B. 234 (management of endowment funds, for a nominal fee less than 15 percent of operating costs); Rev. Rul. 72-369, 1972-2 C.B. 245 (managerial and consulting services); *B.S.W. Group, Inc. v. Commissioner*, 70 T.C. 352 (1978) (consulting services); IRS General Counsel Memorandum ("G.C.M.") 38447 (July 17, 1980) and G.C.M. 39003 (June 24, 1983) (insurance services).

<sup>12</sup> 495 U.S. 472, 110 S. Ct. 2014, 109 L.Ed.2d 457, 90-1 USTC para. 50270 (1990).

method where the funds to support a project do not have to pass through the sponsoring charity:

1. Take the steps normally associated with creating a trust or similar legal arrangement (e.g., execute a written trust document) for the benefit of the sponsor.
2. To handle donations, set up a bank account for the trust or similar arrangement, upon which the individuals conducting the project are not the sole signatories.
3. Have the individuals involved with the project sign a legally binding agreement with the sponsor, obligating them to use the funds in the trust or similar arrangement according to the sponsor's guidelines.
4. In the written document creating the trust or similar arrangement, provide for the sponsor to be legally entitled to take possession of the money (at any time,

or upon certain conditions); *OR* give the sponsor a civil cause of action against the individuals conducting the project if they use the money for purposes not approved by the sponsor.

### **Conclusion**

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.

We expect that publication of this book will stimulate others to comment and elaborate upon, criticize, and refine the ideas presented here. It is our hope that this definition of alternative models for fiscal sponsorship will help to develop a common language, so that charitable organizations and their legal advisors can understand and describe more clearly the structures and relationships they have created.