Fiscal Sponsorship: An Alternative to Forming a Nonprofit 501(c)(3) Corporation

This publication discusses common questions that arise with regard to fiscal sponsorship. Fiscal sponsorship is an alternative to forming a new nonprofit corporation when a proposed charitable program is relatively small in scope or when a business plan is in its beginning stages.

For groups that operate on a smaller scale, incorporating a new entity and filing for tax-exemption, in addition to the ongoing obligations that come with it, may take more time and resources than are necessary to operate the proposed programs. The fiscal sponsorship model can permit a group to carry out charitable programs and test a new idea with fewer administrative burdens by receiving support from an existing nonprofit corporation.

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This alert should not be construed as legal advice. This alert is designed as a highlight and it will not be updated. There are numerous laws and reporting requirements to which California nonprofit organizations are subject that are not included in this alert. Please contact an attorney if you need legal advice about the formation of a nonprofit or otherwise.

Public Counsel's Community Development Project provides free legal assistance to qualifying nonprofit organizations that share our mission of serving low-income communities and addressing issues of poverty within Los Angeles County. If your organization is in need of legal assistance, call (213) 385-2977, extension 200 or visit http://www.publiccounsel.org/pages/?id=0024.

Fiscal Sponsorship: An Alternative to Forming a Nonprofit 501(c)(3) Corporation

What is Fiscal Sponsorship?

Fiscal sponsorship is an alternative to forming a nonprofit 501(c)(3) corporation that allows individuals or groups to perform charitable services and give donors the ability to take a charitable contribution deduction, without spending the time and resources to incorporate, apply for tax-exempt status, and comply with the extensive obligations associated with incorporation and tax exemption. Fiscal sponsorship typically involves an arrangement under which an existing 501(c)(3) tax-exempt public charity (commonly referred to in this context as a "Sponsor") assists an individual or organization with a charitable program (commonly referred to as a "Project") by permitting the Project to solicit tax-deductible contributions or grants through the Sponsor that the Project is not eligible to receive on its own. Through such an arrangement, funds intended for the Project are deposited with and held by the Sponsor, which then disburses them to pay the Project's expenses. The Sponsor usually charges an administrative fee for this service, which is typically set as a percentage of total funds raised for the Project through the Sponsor.

In the most common form of fiscal sponsorship, the Project is not a separate entity, but instead is a charitable program that is legally part of the Sponsor. For example, the employees and volunteers of the Project are the employees and volunteers of the Sponsor. Similarly, the Sponsor would be the contracting party on all contracts relating to the Project's charitable programs (e.g., leases, vendor agreements, consultants, etc.) and the Sponsor would pay the Project's expenses (payroll, rent, supplies, etc.) directly.

When is Fiscal Sponsorship Appropriate?

Fiscal sponsorship may be appropriate when the proposed charitable program is relatively small in scope or temporary in nature or when the business plan is in its beginning stages. For example, consider a group of volunteers who collect toys for needy children during the holidays. A group like this does not require separate office space and is run by volunteers. Incorporating a new entity and filing for tax-exemption, plus the ongoing obligations that come with it, would probably take more time and resources than are necessary to operate the proposed programs.

Fiscal sponsorship may also be appropriate even for larger projects where the leaders intend to hire employees, rent space, or have other substantial expenses. The project leaders may have expertise in performing social services or other charitable programs, but less expertise in corporate, financial, or tax matters. Because of this, they may need time to get their programs started before they can attract the support of additional volunteers or staff who are able to conduct or oversee these compliance activities. The fiscal sponsorship model can permit the idea to be tested in a supportive environment with fewer administrative burdens.

After a few years of operating with the support of a Sponsor, some groups are in a position to form a separate charitable entity and terminate the fiscal sponsorship relationship. However, fiscal sponsorship is not necessarily suitable only for new programs or new ideas. Many established programs decline to incorporate and obtain separate tax-exemption because the fiscal sponsorship is more advantageous for their work.

What are the Administrative and Legal Requirements of Incorporation that Fiscal Sponsorship Can Mitigate?

The administrative and financial burdens associated with forming a new nonprofit incorporation include ongoing corporate and tax filing requirements with the Internal Revenue Service (IRS), California Franchise Tax Board (FTB), California Secretary of State, and California Attorney General; maintaining a board of directors and observing corporate formalities; tracking and reporting lobbying activities; complying with myriad employment laws; and paying insurance premiums. Fiscal sponsorship mitigates these burdens and costs. However, a Project with substantial funding may ultimately determine that the administrative fee paid to the Sponsor exceeds the costs associated with incorporation and maintaining corporate and tax status. At that point, the Project may decide to incorporate and end the fiscal sponsorship.

What are Some Advantages of Fiscal Sponsorship?

- **Ability to Receive Tax-Deductible Donations.** A donor that contributes to a Project through a Sponsor with 501(c)(3) status may normally deduct the contribution as a charitable contribution deduction. Those funds will then be directed to the Project to assist with running its programs.

- **Ability to Get Off the Ground Faster.** Typically, a Sponsor permits a new project to test its new ideas more quickly than it otherwise could by providing administrative and capacity building support and permitting charitable fundraising without the delays associated with incorporating and filing for tax-exemption.

- **Wider Base of Support.** If the organization that acts as a Sponsor has a solid track record with foundations and other funders, this may benefit a Project of that organization. Projects that do not already have pre-existing relationships with funders may be in a better position to secure some grants or charitable donations if they have a fiscal sponsorship relationship with a reputable charity.

- **Technical Support / Administrative Support.** Many Sponsors may also provide Projects with additional support such as insurance, payroll and accounting services, office space, publicity, capacity building, or fundraising assistance, making it possible for Projects to focus more time and energy on their missions and less on administrative persons. Moreover, due to economies of scale, the administrative costs and services may be cheaper when obtained and provided by the Sponsor rather than by a separately incorporated Project.

- **Potentially Lower Insurance Costs.** Often, Sponsors will be able to obtain lower insurance rates than would be available to a small start-up nonprofit corporation, and these savings can be passed along to the Project.

What are the Disadvantages of Fiscal Sponsorship?

- **Surrender of Control to the Sponsor.** The Sponsor will receive and administer any grant funds in connection with the Project. The Sponsor will then disburse those funds to the Project (after subtracting an administrative fee), unless the Project is not engaging in the charitable purposes for which the grant was received. If the Sponsor finds that the Project is not engaging in those charitable programs, the Sponsor retains the right to spend the funds in accordance with the charitable intent for which such funds were given. To ensure that grant funds are spent properly, the Sponsor must sign all contracts to which the Project is a party. Given the amount of control that is typically surrendered in such cases, it makes sense for Projects to seek reputable and trustworthy Sponsors.

- **Administrative Fee.** The Sponsor usually deducts a fee in connection with receiving and administering grant funds on behalf of a Project. Although fees can vary, they are usually associated with the level of services provided to the Project. For example, if a Sponsor also provides payroll and accounting services to the Project, the fee may be higher. Typically, Sponsors charge an administrative fee of 5-15% of the funds collected on the Project's behalf. You should compare this fee to the likely costs your organization would incur as a separate corporation for the administrative services and other benefits that will be provided by the Sponsor.

Our Potential Sponsor Has Asked Us to Incorporate First. Is That Okay?

It is highly recommended to not incorporate if you are entering into a fiscal sponsorship agreement. Incorporation may eliminate or diminish many of the advantages of fiscal sponsorship. For example, if you were to incorporate and not apply for tax-exempt status, your corporation would be subject to income tax on income it earns. Note that in California, even corporations with no income are subject to a minimum franchise tax of $800 per year (unless tax-exempt). In order to avoid the tax burden, you would need to apply for tax-exempt status and submit annual filings, defeating the purpose of fiscal sponsorship.

Moreover, if a fiscally sponsored Project incorporates, rather than pay the Project's expenses directly (as is standard when the Project is not incorporated), the Sponsor will likely transfer any money raised on behalf of the Project to the incorporated entity, which will then have to pay administrative expenses itself. Similarly, contracts will likely be in the name of the Project, rather than the Sponsor. As a result, the incorporated Project will be responsible for ensuring compliance with various laws, including employment law protections and workers' compensation. Simply put, a fiscal sponsorship that requires a Project to incorporate poses very little benefit to a charitable project. Should a fiscal sponsor require you to incorporate, we recommend finding a new Sponsor or, if not possible, incorporating and applying for tax-exempt status as a separate nonprofit.

However, one situation where incorporation may be appropriate is when a Project intends and is capable of applying for tax-exempt status in the immediate future (and no later than 27 months after incorporation so that retroactive tax-exempt status is available). This allows a Project to begin collecting tax-deductible donations in order to fund charitable activities while preparing its tax-exemption application and waiting for a recognition letter from the IRS and Franchise Tax Board. A nonprofit corporation that has already received tax-exempt status may choose to contract with another nonprofit for technical assistance, such as payroll processing, bookkeeping, preparation of tax returns, or advertising. This arrangement is sometimes referred to as a fiscal sponsorship, although it differs from the arrangement discussed in this FAQ since both parties are nonprofit corporations with tax-exempt status.

For more information on applying for tax-exempt status and deadlines you need to be aware of, see Public Counsel's *Guide to Forming A Charitable, Tax-Exempt Nonprofit Organization.*

How to Establish a Fiscal Sponsorship

(1) Find a Sponsor or Potential Sponsors

Some organizations specialize in providing fiscal sponsorship to Projects. These groups have, as their charitable purpose, the mission of assisting and "incubating" emerging projects and groups. A Project wishing to engage in a fiscal sponsorship arrangement may also seek out tax-exempt public charities that are willing to serve as Sponsors and whose charitable purpose is consistent with the type of work the Project intends to perform. For example, groups seeking to do health care work might seek out charities that are engaged in such work (such as hospitals or health care clinics). It is very important to ensure, in these cases, that the Sponsor understands its responsibilities to oversee all Project activities. If the Project's activities are or become inconsistent with a Sponsor's charitable purpose, the Sponsor may lose its tax-exempt status and contributors to the Project may not be able to take a charitable deduction.

For a partial list of organizations that serve as fiscal sponsors, visit the Fiscal Sponsor Directory, a tool created by the San Francisco Study Center, at *www.fiscalsponsordirectory.org*.

(2) Submit a Proposal to the Sponsor

The Project should submit to the Sponsor a written sponsorship request or "proposal" describing each activity it proposes to conduct that will further the Sponsor's tax-exempt purpose. Organizations specializing in providing fiscal sponsorships may have a formalized application process as well.

(3) Execute a Fiscal Sponsorship Agreement

Next, the Sponsor and the Project should complete an agreement in writing that details the terms and conditions of the sponsorship, including the specific work to be performed in furtherance of the Project using funds obtained through the Sponsor. The agreement is typically between the Sponsor and the Project leaders as individuals because the Project is not a separate entity and cannot be a party to a contract. This agreement must state clearly that the Sponsor retains complete discretion and control over the use of the contributions it receives on behalf of the Project. Topics covered by the agreement may include reporting requirements imposed on the Project leaders, the mechanism for requesting payment of Project expenses, limitations on the permissible activities of the Project, and the administrative responsibilities of the Sponsor. The agreement should also include a mechanism explaining how to terminate the relationship and how the Project's activities and assets will be separated from the Sponsor in case of termination. It is very important to have a written agreement or memorandum of understanding signed by both the Sponsor and the Project leader(s) before beginning to operate under a fiscal sponsorship to make sure that both the Sponsor's and the Project's rights and responsibilities are clear and to avoid any misunderstandings.

(4) Operate the Project in Accordance with the Terms of the Fiscal Sponsorship Agreement

Written notice should be given to all funding sources that the Sponsor retains complete discretion and control over the use of the contributions it receives on the Project's behalf. Donations should be made to "XYZ" Sponsor, for the benefit of "ABC" Project. Finally, the Project should make periodic written reports to the Sponsor showing its actual expenditures of disbursed funds and its progress towards accomplishing its charitable purposes.

Projects interested in pursuing a fiscal sponsorship relationship should consult an attorney familiar with nonprofit laws for more information specific to their circumstances.

If We Choose Fiscal Sponsorship Now, Could We Still Incorporate A Nonprofit Later?

Depending on the terms of the fiscal sponsorship agreement, the decision to contract with a Sponsor is not final. A Project may normally terminate the fiscal sponsorship relationship at any time and for any reason as long as it gives the Sponsor a reasonable amount of notice. Upon termination, the assets connected with the charitable programs of the Sponsor are either transferred to another corporation exempt under section 501(c)(3) (for example, a corporation created by the founders of the Project) or remain with the Sponsor, depending on the circumstances. Some Projects never terminate the fiscal sponsorship relationship. Others, after a few years of operating under a Sponsor, are ready to form a separate charitable entity, obtain tax-exemption for that entity, and terminate the fiscal sponsorship relationship.

A Project should pay close attention to the termination provisions of the fiscal sponsorship agreement to ensure that it has the right to terminate the agreement for any reason with a reasonable amount of notice to the Sponsor.

I Don't Want to Incorporate But I'm Not Sure Fiscal Sponsorship is Right Either. Are There Any Other Alternatives?

There are many alternatives to incorporation for individuals or groups wishing to implement a charitable idea. For example, an individual or group might start out by volunteering, providing resources to, or partnering with an existing charity that conducts similar programs and is willing to expand its programs to encompass the new idea. Volunteering with an existing charity can be beneficial because it may help the individual to gain the expertise required to run a particular program or to make connections to the local nonprofit funding community. Also, if an individual volunteers with and maintains a good relationship with an existing charity, he or she may in time be able to work with that charity to apply for funds to operate a new charitable program as an employee of that charity. Many groups exist that connect volunteers with existing charities, such as Idealist (*www.idealist.org*) and VolunteerMatch (*www.volunteermatch.org*).

Depending on the proposed program, an individual or group may instead decide to create a for-profit business that is committed to social justice objectives. For example, a business may decide to dedicate a portion of its profits to charitable causes, operate in an environmentally friendly way, or commit to hiring disadvantaged populations.