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

Fiscal sponsorship may be an appropriate alternative to forming a new nonprofit corporation when your proposed charitable program is relatively small in scope or when your business plan is in its beginning stages.

For groups that operate on a smaller scale, incorporating a new entity and filing for tax-exemption, plus 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 an idea to be tested in a supportive environment with fewer administrative burdens.

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***This alert should not be construed as legal advice.*** This alert is designed as a highlight, and 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.

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

### **I have a great idea for a new charitable program. Is it necessary to form a new nonprofit corporation right away?**

**No.** When you develop your new idea, you will likely want to get started on the programs right away. Unfortunately, many people believe that the required first step in implementing a new charitable idea is to incorporate and file for recognition of tax-exemption under Section 501(c)(3) of the Internal Revenue Code (the "Code"). On the contrary, when developing a new idea it is more important to take the time up front to design the proposed programs thoroughly, determine what resources (such as money, and staff or volunteer time) will be required to carry out the programs, and determine what types of funding sources a new nonprofit could feasibly tap to conduct the programs. These steps should be undertaken **before** you form a new entity to operate your charitable programs.

Nonprofit corporations recognized as tax-exempt under Section 501(c)(3) are subject to a wide array of filing and regulatory requirements under local, state and federal law, and must continue to operate tax-exempt programs to maintain exemption from tax. Countless examples exist of nonprofits that have neither the time nor the resources to comply with these various requirements. There are innumerable other examples of nonprofits that waited until after obtaining recognition of tax-exempt status to test their programs, found that the programs were not feasible, and never began to operate the charitable programs. In either case, the consequences of noncompliance can be dire. Failure to comply with applicable laws may result in taxes and fees that can grow to thousands of dollars if left unpaid. Organizations that fail to operate charitable programs can lose their tax exemptions and become subject to income taxes. Directors and officers can be held personally liable if they do not take due care to cause their organizations to comply with the law. Individuals who form a new nonprofit corporation often find themselves spending a lot of time and energy on corporate and tax compliance instead of focusing on the important work of developing and starting up their charitable programs.

### **Are There Alternatives to Forming a New Nonprofit Corporation?**

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*).

Another alternative, fiscal sponsorship, is discussed below as an alternative that may be appropriate for individuals or groups starting their charitable programs and wishing to test the feasibility of their ideas before forming a new corporation or wishing to focus their attention on the delivery of program services rather than on corporate and tax compliance.

## What is Fiscal Sponsorship?

Fiscal sponsorship is an alternative available to individuals or groups performing charitable services and wishing to give their donors the ability to take a charitable contribution deduction, but not wanting to spend a great amount of time and resources to comply with the extensive filing requirements, tax compliance, and other legal 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 the Sponsor, which then disburses them to the Project.

## When is Fiscal Sponsorship Appropriate?

Fiscal sponsorship may be appropriate when the proposed charitable program is relatively small in scope, 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. Or, consider an association of persons who propose to provide small amounts of assistance to a few needy children per year. Neither group requires separate office space and both are run almost entirely by volunteers. For groups like these, that operate on a smaller scale, 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. Similarly, many groups who have expertise in performing social services or other charitable programs do not have expertise in corporate, financial or tax matters, and 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 an 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 projects have existed for years and years under Sponsors, declining to incorporate and obtain separate tax-exemption after realizing the advantages of 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 the Project 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 don't 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. This support not only makes it possible for Projects to focus more time and energy on their missions and less on administrative matters, but, due to economies of scale, may also be provided at lower cost to a Project than the Project might have to pay if it incorporated on its own.

- **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 Some 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 almost always 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 that are provided to the Project. For example, if a Sponsor also provides payroll, accounting and other 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, such as accounting services or insurance.

## What if the Organization is Already Incorporated? Is it Too Late to Choose Fiscal Sponsorship?

**Not necessarily.** It depends on the policy of the Sponsor. Some Sponsors will provide sponsorship to an incorporated entity. In such case, even though it operates under a Sponsor, the corporation must make state filings, and (if it is formed in California) will likely need to obtain California tax exemption to avoid paying franchise taxes. Fiscal sponsorship may still provide benefits and cost savings in this context. You should consult with counsel as to whether fiscal sponsorship is right for the corporation and what ongoing legal obligations the corporation would have as a fiscally sponsored Project.

## 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. 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.

## 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, contributors to the Project may not be able to take a charitable deduction, and/or the Sponsor may lose its tax-exempt status.

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.

### (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. 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. It is very important to have a written agreement or memorandum of understanding signed by both the Sponsor and the Project 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. 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.

### (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.