

LEGAL *ease*

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Fiscal Agents: The Legal View

You've just started a nonprofit, but haven't filed for exempt status with the IRS. Or maybe you've filed but haven't yet gotten your ruling. Can you raise funds while waiting? There are a number of possible answers to this question, including something called a "fiscal agent" or "fiscal sponsor."

Although the fiscal agent is used frequently in the nonprofit sector, it actually has no recognized status or common definition in the legal system or with the IRS. It generally describes a nonprofit, charitable, tax-exempt organization that receives funds from a donor (individual, corporation or foundation) for the benefit of an individual or organization which is *not* tax-exempt. (We'll call this beneficiary "the program.") The donor supports the program's request for funds, but is unable or unwilling to make the grant directly to the program.

The Donor's Concerns

The key issue for a corporate or individual donor is maintaining the contribution as tax deductible. To do so, the donor must give to an entity recognized by the IRS as tax-exempt under section 501(c)(3) of the Internal Revenue Code. A contribution to an individual does not qualify for a tax deduction, nor does a contribution to an organization without tax-exempt status.

If the donor is a private foundation, it will incur substantial excise tax penalties if it contributes to an organization which is not a public charity unless it exercises "expenditure responsibility," which typically it will not want to do. (Expenditure responsibility means that the foundation oversees the spending of the money to ensure its use for charitable purposes.) The foundation can make a grant to an individual only if it is a scholarship, prize or award or if the purpose is to achieve a specific objective, produce a report or similar product or enhance the artistic, scientific, teaching or similar skill of the recipient. But the foundation has to jump through extra legal hoops to give such individual grants.

The issue relates to who truly receives the gift. If it belongs to the fiscal agent, there is no problem with the contribution being considered charitable. However, if the gift is given to the fiscal agent, specifically earmarked for a nonqualifying individual or organization, the IRS will not consider it a

qualifying charitable contribution.

Fiscal Agent's Concerns

The fiscal agent is obliged to assure that any funds it distributes are used for charitable purposes and that all applicable tax reporting is done. Distributions can be anything from grants to contracting for services which further the fiscal agent's exempt purpose.

For this arrangement to work, the fiscal agent must own the funds and be free to disburse them or not, as it sees fit, within the confines of any instructions from the donor. (But remember, as we discussed above, the donor may not identify a specific recipient.)

Sometimes the fiscal agent may receive a fee for handling the funds and for any other services it provides. Such a fee is probably "unrelated income" for the fiscal agent and may be subject to tax, depending on the amount and whether the fiscal agent has other unrelated income.

If your organization is considering using (or being) a fiscal agent, some issues to consider are:

For the program:

- How important it is to seek funds now? Is this worth the effort?
- Identify one or more agencies willing to be a fiscal agent and investigate the corporate and exempt status of each.
- Consider the compatibility of the fiscal agent's mission with your purpose.
- Identify benefits to both parties.

For the protection of both parties, consider a written agreement. There is no such thing as a standard agreement, but generally it should address at least the following:

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Fiscal Agents

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- the services to be provided by both parties;
- whether a separate bank account will be established. (If it is, it should be in the name of the fiscal agent.);
- how payments using the grant funds will be made, i.e., by transferring the funds to the program or by the fiscal agent making payments directly to third parties;
- whether funds will be invested;
- who owns any income and who is responsible for losses;
- documentation for accounting and evaluation purposes;
- availability of books and records for inspection by authorized persons;
- what reports are necessary and who will prepare and submit them;
- whether an audit is required and who will pay for it;
- whether the fiscal agent will be paid a fee, and if so, for what and how much;
- whether the program protects the fiscal agent from liability for the actions of the program;
- how the arrangement can be terminated, and the consequences of termination.

Both parties should be alert to employee vs. independent contractor issues. If individuals associated with the program are paid out of the grant funds for their work, will they be considered employees of the fiscal agent or independent contractors? If the latter, the fiscal agent may need to issue 1099 forms at the end of the year.

There are several models with degrees of ownership and responsibility for each party. Someone may have to give up some control or responsibility or take on some activity or liability. Be sure to determine what is to be accomplished, who will do what and what is the IRS status of each.

This is not an exhaustive list of considerations, but it will get you started. Once the important points are established, you can probably create an agreement that will keep everything legal and reduce the risk of disputes. To do it right, you might want to consider the assistance of an attorney experienced in the issues.

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Why We Don't Make Grants To Fiscal Agents

By Neal Cuthbert
McKnight Foundation

McKnight's policy about making grants to groups without 501(c)(3) status has changed over the last five years.

In the past, the policy was more or less a traditional fiscal agent arrangement. The group lacking 501(c)(3) tax-exempt status would enter into a contract with a related nonprofit that was tax-exempt. Once the grant was made, the money would pass from the nonprofit to the non-exempt group, often subject to an administrative charge. The foundation would simultaneously enter into a contract with the nonprofit designating the terms and use of the granted funds. For the foundation, the nonprofit was assured of some oversight and proper handling of the granted funds, as well as being IRS-certified.

Generally we used this arrangement only when the new group was already in the process of getting its own 501(c)(3) status, and waiting for the status might jeopardize the project. In any case, we were never eager to use this arrangement.

In the course of a normal, periodic review of foundation policies, our lawyers examined the use of fiscal agents. They advised the foundation not to do indirectly what it could not do directly. In other words, if the grant to the fiscal agent designated funds for a group without 501(c)(3) status, the IRS would consider that the foundation had made the grant directly to the non-exempt group and was attempting to "launder" the funds.

As a result, we do not make grants to fiscal agents anymore. Our policy is now that of "expenditure responsibility." The grant is made directly to the non-exempt group, which signs a contract with the foundation indicating the terms, conditions and uses of the funds.

Unfortunately, because such grants represent extra administrative work and invite additional IRS scrutiny, the foundation does not make them readily. When we do, it is generally in urgent cases where the agency is applying for 501(c)(3) status, or its mission or programs are parallel to a 501(c)(3) and foundation support is critical.