NONPROFIT ORGANIZATIONS NEWSLETTER

March 2019

FISCAL SPONSORSHIPS: A TIME TO BE WARY

The Latin phrase "caveat emptor" is a contract law principle that is commonly used in transactions involving the sale of goods. The phrase roughly translates to "let the buyer beware." The phrase also appropriately describes how nonprofits should approach fiscal sponsorship arrangements.

Fiscal sponsorships have become commonplace in the nonprofit sector. However, the sponsoring nonprofit organizations often approach these relationships without the proper care and diligence that is required. Many nonprofit organizations simply do not understand the scope of their duties when they become fiscal sponsors of non-exempt organizations. Oftentimes, nonprofit organizations view these relationships as opportunities to raise additional revenue, but do not take into account the responsibilities that are placed upon their organization or the risks to their own tax exempt status if the applicable rules and regulations are not followed.

The term "fiscal sponsorship" generally describes an established relationship in which a tax-exempt organization agrees to receive funds and use those funds for the benefit of an organization that is not tax-exempt. The tax exempt organization in such a relationship is called the "fiscal sponsor" and the non-exempt organization is the "sponsored entity."

Fiscal sponsorships are often initiated at the behest of the sponsored entity. The entity may approach a tax exempt organization with which it has a relationship and request that the tax exempt organization act as a fiscal sponsor. The typical request includes an arrangement in which the sponsored entity will locate donors for its cause and instruct the donors to contribute funds to the fiscal sponsor. The fiscal sponsor then agrees to subsequently provide the donations to the sponsored entity. In some situations the fiscal sponsor takes a percentage of the donations as an administrative fee.

Sponsored entities may request such a relationship for a variety of reasons. Examples include the following: the sponsored entity has applied for tax exempt status but is waiting to get a response from the IRS, or the sponsored entity believes that its activities are too small to warrant the creation of a nonprofit corporation or the filing of an application seeking its own separate exemption.

Although fiscal sponsorships are used in the nonprofit community, they have no official recognized status or common definition in the legal community or with the IRS. Whether or not a particular fiscal sponsorship arrangement is appropriate is largely determined by the specific factual circumstances at issue. The arrangement described above is not appropriate as described, but a similar relationship may be appropriate if it is structured to comply with the appropriate rules and regulations. The organization being asked to serve as the fiscal sponsor must be careful to comply with all applicable rules and regulations. The fiscal sponsor has the most to lose, including revocation of its tax exempt status, if the IRS determines that the relationship is inappropriate.

One of the primary issues for the fiscal sponsor is that it must ensure that any funds it distributes are used in furtherance of its charitable or other tax exempt purpose. This requirement is derived from a set of six separate tests that must be met by all entities recognized as exempt under Internal Code Section 501(c)(3). One of these tests is the "operational test." The operational test requires that the organization be operated exclusively for one or more exempt purposes. Among other things, in order to meet the operational test, an organization's activities, including the distribution of funds, must be reasonably related to the accomplishment of the organization's exempt purpose.

Addressing the distribution of funds to an entity which has not received exemption, in Revenue Ruling 68-489 the IRS ruled that an organization will not jeopardize its exemption by making grants to a non-exempt organization if the following conditions are met: (1) the distributions are made in furtherance of the exempt organization's own purposes, (2) the exempt organization retains control and discretion as to the use of the funds, and (3) the exempt organization keeps records showing that the funds are actually used for that purpose.

Revenue Ruling 68-489 illustrates the general rule that distributions from exempt entities are appropriate so long as the distribution furthers the exempt organization's purpose. For example, if the mission of the sponsoring entity is to provide, promote and facilitate educational programs, it may be appropriate for it to support the activities of a separate school providing similar services.

As set forth in Revenue Ruling 68-489, fiscal sponsors must also retain control and discretion over the use of the funds, and keep records showing that the funds are actually used for that purpose. In order to meet this requirement, the fiscal sponsor must own the funds and be free to distribute them, or not, as it sees fit. For this reason, donors may not earmark or otherwise restrict funds donated to the fiscal sponsor. If the funds are earmarked or otherwise restricted for distribution to the sponsored entity, the IRS will likely take the position that the funds were, in actuality, intended to benefit a non-exempt entity and, therefore, do not constitute a charitable contribution by the donor to the fiscal sponsor. This issue is one of the reasons that the fiscal sponsorship described above is inappropriate (in that example the fiscal sponsor agreed to funnel all earmarked donations to the sponsored entity).

Furthermore, exempt entities that distribute funds to non-exempt entities have legal and fiduciary duties to ensure that any funds distributed to the non-exempt entity were actually used for appropriate exempt functions. This obligation can be met through appropriate monitoring of the use of funds and the maintenance of proper reports, books, and records.

Due to the legal and fiduciary responsibilities placed upon the sponsoring entity and the various issues that may arise during the term of a fiscal sponsorship, a written agreement should be prepared. The agreement should not contain any obligation on the part of the fiscal sponsor to send distributions to the sponsored entity. The fiscal sponsor must maintain control and discretion over any and all funds that it receives. The agreement should at least address the following issues: the services to be provided by the parties, how payments will be made, whether funds will be invested, documentation for accounting purposes, monitoring the use of funds, availability of books and records for inspection, necessary reports, indemnification of the fiscal sponsor, and the rights of the parties to terminate the arrangement.

In addition to the issues discussed above, fiscal sponsors should be aware that by acting as fiscal sponsor there is a risk that they may be legally liable for the activities of the sponsored entity. This may include a determination, by one or more governmental entities, that the fiscal sponsor and not the sponsored entity is, for example, the de facto employer of the sponsored entity's staff. If an entity intends to enter into a fiscal sponsorship, it should conduct proper due diligence to determine, among other things, the sponsored entity's current obligations, the existence of appropriate insurance, and compliance with all applicable regulations and laws. In addition, the fiscal sponsor should consider additional coverage from its existing insurer.

If your organization is considering entering into a fiscal sponsorship arrangement and would like assistance, please contact us.

UBTI UPDATES

As a follow up to our January 2019 article titled "IRS Issues Guidance For Determining Nondeductible Amount of Parking Fringe Benefits and UBTI; Provides Penalty Relief to Tax-

Exempt Organizations," we offer a copy of a slide presentation recently presented by Jon Grissom, Chair of our Nonprofit Organizations Practice Group, at the University of San Diego's 15th Annual Nonprofit Governance Symposium.

The presentation is titled "Updates Regarding Tax Law and IRS Regulations - The 2017 Tax Cuts and Jobs Act - What You Should Know." The 2017 Tax Cuts and Jobs Act made significant changes affecting all types of nonprofits, including private foundations, public charities, trade associations, and colleges and universities. The presentation outlines changes made by the Act, including qualified transportation fringe benefits, executive compensation, unrelated business income, and endowment earnings.

If you have questions regarding UBTI and your organization, please contact us.

ATTORNEY GENERAL ANNUAL REGISTRATION RENEWAL

Every charitable nonprofit corporation, unincorporated association or trustee holding assets for charitable purposes that is required to register with the California Attorney General's Office is also required to file an Annual Registration Renewal Fee Report (RRF-1). The purpose of the Form RRF-1, as stated on the form itself, is "to assist the Attorney General's office with early detection of charity fiscal mismanagement and unlawful diversion of charitable assets." **The Form RRF-1 must be filed four months and fifteen days after the close of the organization's calendar or fiscal year.** Thus, for an organization on a calendar year, the Form RRF-1 is due by May 15, unless on extension (discussed below).

An entity whose registration is delinquent or has been suspended or revoked is not in good standing with the Registry and is prohibited from engaging in conduct for which registration is required, including solicitation for charitable purposes. Failure to file the Form RRF-1 could result in the loss of California tax-exempt status. Charities previously registered and in good standing with the Attorney General's office may now use the Attorney General's registration online renewal system.

Extensions of time for filing the RRF-1 will be allowed if an organization has received an extension from the IRS for filing the IRS Form 990, 990-PF, or 990-EZ. An organization shall file both forms (RRF-1 and IRS Form 990, 990-PF, or 990-EZ) with the Registry of Charitable Trusts at the same time, along with copies of all requests to the IRS for an extension and, where approval of the extension is not automatic, a copy of each approved extension request. The Form 990-N due date cannot be extended.

IRS NATIONWIDE TAX FORUMS

The IRS recently announced the dates and locations of its 2019 Nationwide Tax Forums. A Forum will be held in San Diego, California on September 17-19 at the Town & Country Resort and Convention Center.

The Tax Forums offer three days of seminars with the latest on tax law, compliance and ethics, as well as networking opportunities. Registration for the 2019 IRS Nationwide Tax Forums begins March 1. For registration details and additional locations, see the IRS website.

The IRS also provides links to webinars and virtual workshops for exempt organizations on its website to help these organizations better understand tax responsibilities.

FRANCHISE TAX BOARD -
EDUCATIONAL MATERIAL FOR EXEMPT ORGANIZATIONS

As part of its education and outreach programs, the California Franchise Tax Board provides a copy of its program materials used in their public seminars. The Exempt Organizations Filing and Compliance - General Information (FTB 932) gives an overview of:

- Application process
- Information disclosure/privacy
- Franchise Tax Board and Secretary of State suspensions
- State and federal differences
- Filing requirements
- Dissolving an exempt organization
- FTB exempt forms and publications
- Contact information

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