Using LLCs in Fiscal Sponsorship: An Update on "Model L"[1]

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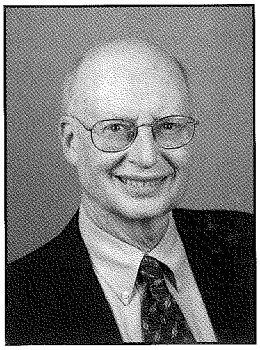

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(The following article is based on a presentation concerning the use of LLCs in fiscal sponsorship given by Steven Chiodini at a joint meeting of the California State Bar Association's Committees on Nonprofit Organizations and Tax-Exempt Organizations on September 5, 2014, in San Francisco.)

Setting up a new charity can be time-consuming and expensive. A new charitable corporation needs to be formed, with its own board of directors and officers and its own bank accounts. Then it needs to prepare an application to the Internal Revenue Service for recognition of its exemption under Internal Revenue Code section 501(c)(3), a process that can take months, if not years.[2] Since there is no guarantee during this time that the charity's bid for tax-exempt status will succeed, it may be difficult for the charity to raise funds. In any event, the ongoing expense and effort of running a charity—maintaining a governance structure, setting up payroll administration if there are employees, complying with federal and state reporting requirements, among a host of other things—can be considerable. As a result, it is sometimes not feasible or desirable to set up a new charity where the intended charitable project is discrete and has a limited timeframe, where financial support is limited, where a novel program idea has not been tested in the charitable "marketplace" yet, or even simply where project leaders do not want the hassle and expense of administering an independent charity.

In these situations, the concept of fiscal sponsorship, where an established section 501(c)(3) public charity brings an outside charitable project under its umbrella, can prove especially useful. In his book *Fiscal Sponsorship: Six Ways To Do It Right*, Greg Colvin explored several possible models of fiscal sponsorship, of which two have become the most common among charities that regularly serve as fiscal sponsors: Model A, where a charity takes in an outside project as a new internal program; and Model C, where the charity enters into a grant relationship with outside personnel, or even an outside entity, to conduct the project with funding received by the charity. While these models are tried and tested and have become quite common, we recently proposed another form of fiscal sponsorship, using a limited liability company (LLC) wholly owned by the fiscal sponsor—a "Model L" sponsorship—to address some of the drawbacks of the existing predominant models. In this present article, we will review the attributes of Model L, which we introduced in an article in 2011,[3] and discuss both some benefits and some difficulties with the model that have become apparent in setting up actual Model L arrangements and in our discussions of the form with other practitioners.

Classic Fiscal Sponsorship: Models A and C

In a Model A sponsorship, outside project leaders approach the public charity that will serve as the fiscal sponsor, which then establishes a restricted fund to receive

contributions and grants itself for the charitable purposes of the project. The sponsoring charity may bring the key project personnel onto its staff; it may also form an advisory committee of project leaders to oversee the project under the ultimate authority of the charity's board of directors. From a tax perspective, Model A is a relatively safe and known quantity, since, for all intents and purposes, the Model A project is essentially an internal program or division of the sponsor: the sponsor takes in all contributions for the project in its own name, operates the project internally, and reports project activities as its own on federal and state returns. Unfortunately, Model A also involves another aspect of an internal program: as a matter of tort law, the sponsor has unlimited liability for the project's activities.

As with Model A, the sponsor of a Model C project sets up a restricted fund into which it takes contributions for the purposes of charitable activities proposed by outside project leaders. At this point, however, the similarity between the two models ends. Instead of taking the project in as an internal program, the Model C fiscal sponsor enters into a pre-approved grant relationship with the individuals or entity that will conduct the project: the sponsor reviews the prospective grantee, determines that the grantee is able to carry out the proposed project, and commits to take in funds for the charitable purposes of the project and make periodic disbursements to the grantee. The sponsor retains full discretion and control over this funding stream—the funds are devoted to a charitable project purpose, not earmarked for the specific grantee.

The advantages of both models of fiscal sponsorship can be immediate and substantial, not least of which is the fact that a project can begin to solicit tax-deductible contributions to support its work as soon as the sponsorship agreement is signed. With Model A, project leaders can receive benefits as employees of an established charity while being able to focus wholly on running a charitable program, with the sponsor's other staff undertaking the administrative tasks that project personnel may not have the experience or desire to manage. With Model C, if a new nonprofit corporation has been formed, it can effectively offer its supporters the ability to make bona fide tax-deductible contributions to support the nonprofit's work immediately, as the new organization goes through the lengthy process of securing its own tax-exempt recognition. (As with Model A, a Model C grantee might even engage the sponsor to provide back-office services, letting project leaders focus on program activities.)

Both models do have significant legal exposures, however. With Model A, the sponsor in principle has unlimited liability for project activities, since the project is legally no different from any other internal program or division of the sponsor. This can be scary for the sponsor if project leaders plan to pursue an activity with a high degree of risk, such as anything involving children or outdoor recreation. Other important drawbacks to Model A include the difficulty of spinning off the project to a new sponsor, which can involve not only transferring the balance in the restricted project fund but also possibly assigning contracts and moving employees, as well as the possibility that project leaders may not have enforceable legal rights against the sponsor, which is essentially just operating another internal division.

Model C can be used to address these drawbacks—the liability of a Model C sponsor is limited to that of an ordinary grantor; the sponsor can more easily extricate itself from a Model C arrangement simply by transferring the project fund to another public charity; and the project itself, as the grantee, is the contractual counterparty to the sponsor, with rights under the sponsorship agreement and applicable law. At the same time, however, Model C can bring its own disadvantages. Care needs to be taken in setting up a Model C sponsorship in order to properly preserve the sponsor's discretion and control over project funds and avoid earmarking contributions for the project grantee. Also, the sponsor naturally has less control over an outside project grantee than it would over an internal Model A project. Furthermore, there can be a question of how the grantee should be reporting the funds it receives for tax purposes.

The Advantages of "Model L"

In 2011, we initially explored how a public charity might conduct a fiscally sponsored project through a wholly owned LLC as a way to avoid some of the drawbacks of Model A or C arrangements. Since an LLC both has limited liability for state law and is disregarded as separate from its sole member for federal tax purposes, we proposed that Model L might be especially useful as an alternative for Model A where a project carried a high potential for tort liability, particularly where the usual alternative of a Model C pre-approved grant relationship was otherwise undesirable or infeasible.

In a Model L arrangement, the sponsor operates the project out of an LLC in which the sponsor is the sole member. The sponsor controls the LLC, but it may or may not manage its daily affairs—to avoid having the LLC become the alter ego of the sponsor, which could lead to unlimited liability for the sponsor notwithstanding the LLC form, and to engage project leaders in operating the project, it may generally be more desirable for the sponsor to install the project leaders as managers with fiduciary duties to the sponsor. As with Model A, the activities and income of the project in a Model L sponsorship are attributed directly to the fiscal sponsor charity itself for federal income tax purposes, with the project being viewed by the IRS as simply another internal division of the sponsor. Unlike Model A, however, the project is operated from a separate legal entity for state corporate law purposes, and the sponsor will not have general tort liability for the project's activities unless there are grounds for the court to pierce the veil of limited liability between the sponsor and the project LLC. Moreover, differently from both Models A and C, financial supporters of the project can make their grants and contributions directly to the project itself, without having to go through the fiscal sponsor, since for federal tax purposes these contributions are treated as having been made directly to the public charity that serves as the sole member of the LLC. Private foundations do not need to conduct expenditure responsibility over grants made directly to the LLC,[4] and (as a result of IRS guidance published after our previous article) donors can write their checks directly to the project LLC and claim a charitable deduction.[5] This possibility may lessen some of the cognitive dissonance that can arise in traditional fiscal sponsorship relationships, where project leaders themselves, rather than the sponsor, are likely to have the primary relationship with the projects' outside contributors.

The prospect of limited tort liability for the fiscal sponsor parent can be a powerful reason to choose Model L, particularly if the sponsor has large reserves of unrestricted assets[6] that could be an enticing target for tort plaintiffs. Conversely, however, Model L can also be a way for the project itself to protect its own funding from the *sponsor's* creditors. (Although rare, it is not unheard-of for a fiscal sponsor to collapse, as happened in the debacle of the fiscal sponsor International Humanities Center in Los Angeles,[7] where projects lost approximately $1 million in the aggregate as a result of the sponsor's alleged mismanagement.) This possibility is due to an artifact of partnership law, where creditors are permitted to acquire a debtor's economic interest in a partnership but do not acquire the right to vote the debtor's partnership interest, as a creditor would otherwise be able to do with respect to a debtor's corporate holdings after it seized the debtor's stock. (It was traditionally perceived as unfair to innocent partners to allow the creditors of an irresponsible partner to obtain an interest in the partnership and compel its dissolution.) This sole remedy for creditors—a "charging order" against the debtor's economic interest in a partnership—has been imported into the LLC realm by statute, and in many (although not all states) it is the sole remedy for the creditors of an LLC member.[8] In some states, the charging order has even been applied to single-member LLCs, where the original rationale for the concept in the partnership realm does not really apply. Accordingly, in an *ideal* outcome in the Model L context, a creditor who obtained a charging order against the sponsor's interest in the project LLC would not be able to reach project assets. (As discussed below, this rule may have significantly less efficacy in some circumstances, however.)

Drawbacks to Model L

Of course, Model L is not without its own drawbacks. As explained in our previous article, state and local LLC taxes are one of the chief remaining hurdles to the wider use of Model L. For example, California levies both an $800 annual tax and an LLC "fee" indexed to the entity's gross annual receipts (up to a maximum fee of $11,790), regardless of whether the LLC is wholly owned by a charity that itself is exempt from state income tax.[9] An LLC, which may be treated by local law as simply another business entity, may also be subject to municipal-level business taxes. This state of affairs clearly reduces the attractiveness of using Model L for projects that are not well funded.

With respect to liability for the sponsor, Model L would tend to protect the fiscal sponsor from tort liability as a result of the project's activities, but in some cases it can also pose federal tax risk for the fiscal sponsor. Because the Model L project takes in and controls its own funds, and because the Model L project LLC will often be run on a daily basis by managers—indeed, it may be advisable to maintain operational separation to reduce the risk of having the single-member LLC

become the alter ego of the sponsor—a project LLC might "go rogue" by, for example, using its funds for unapproved non-charitable purposes, operating out of its own bank account. With a Model C project, where the project entity is also legally separate from the sponsor, this would be a troublesome development and could be grounds for terminating the sponsorship and retrieving unspent grant funds, but the impact to the sponsor itself would be minimal. In Model L, however, the stakes are much higher for the sponsor, since all of the LLC's income and activities are attributable directly to the fiscal sponsor for federal tax purposes, potentially putting the sponsor's own tax exemption at risk if, for example, a Model L project engages in prohibited political campaign activity without the sponsor's knowledge. (The liability consequences for a Model A sponsor would be similar, but the sponsor in a Model A arrangement would tend to have closer practical control over project activities, since the sponsor itself would hold the project funds and monitor all disbursements.) Accordingly, the sponsor needs to take special care to establish sufficient practical controls over the Model L project. At the same time, however, the sponsor needs to avoid the sort of daily involvement in the LLC's affairs that could prompt a court to pierce the veil of limited liability between the sponsor and the LLC in a tort lawsuit. This balancing act may prove difficult in some circumstances, depending on the nature of the project and the project's leaders.

From the perspective of project leaders, the relative operational independence of Model L and the fact that the project entity receives outside funding itself may be quite attractive, but the parent-subsidiary relationship may also present some concerns for them. In a Model L arrangement, project leaders may be installed as the LLC's managers and exercise significant daily authority, but the fiscal-sponsor sole member would typically be able to remove them as managers for any reason. Since sponsorship "portability"—i.e., the mechanism for enabling project leaders effectively to require a fiscal sponsor to transfer their project to a new sponsor that is mutually acceptable to the charity and the project leaders—is often something that project leaders specifically look for in a prospective fiscal sponsorship arrangement, the legal rights of the Model L sponsor could prove worrisome to project leaders, particularly if their relationship with the sponsor begins to sour. Various strategies, such as cementing the rights of project personnel with employment contracts[10] between them and the sponsor-owned LLC, or even a side agreement between the fiscal sponsor and project leaders that provides for liquidated damages if the sponsor unreasonably refuses to transfer its LLC interest to a new fiscal sponsor, may help to allay fears about sponsor control over the project LLC. (In any event, project leaders in a Model L should be no worse off in this respect than in Model A, where they would likely have even less legal leverage as advisors or at-will employees of the charity sponsor.)

Finally, the protection afforded to project assets from the sponsor's creditors by the LLC form, as discussed above, may be quite limited in practice, depending on the state where the LLC was formed and where the fiscal sponsor finds itself in court. Because the original fairness rationale from the partnership-law context for having charging orders as the sole remedy against a delinquent partner does not really apply to a single-member LLC, and because this legal device has a significant potential for abuse by debtors looking to shield personal property from creditors, many states allow other remedies for the creditors of the sole member of an LLC. For example, the Florida Limited Liability Company Act provides that a charging order is the exclusive remedy for multiple-member LLCs, but expressly not the sole remedy with single-member LLCs. Consequently, a court can order the Florida LLC interest of a sole member to be sold at a foreclosure sale, and the court can provide other equitable relief for creditors.[11]

In other states the charging order remains the sole remedy in a single-member context. Most notably, the Delaware LLC Act does not make a distinction between single-member and multiple-member LLCs in providing that a charging order is the exclusive remedy for a member's creditors, and that neither foreclosure nor compelled dissolution is allowed.[12] Nevada goes even further in expressly providing that charging orders are the exclusive remedy for creditors of a sole LLC member's interest.[13] That said, the protections under Delaware or Nevada law are not foolproof: where a fiscal sponsor holding the sole interest in a Delaware or Nevada LLC finds itself in federal bankruptcy court or as a tort defendant in a state inclined not to afford special protection to single-member LLCs, the sponsor's creditors may receive relief beyond a mere charging order. Moreover,

the Delaware and Nevada rules are defaults, and they can be overridden if the LLC agreement, deliberately or through a practitioner's oversight, provides other ways for the sponsor's creditors to access the LLC's assets. Accordingly, in laying the groundwork for a Model L project, the sponsor and project leaders should not only pay close attention to choosing the state under whose laws the LLC will be formed, but should also consider bolstering protections for the LLC's assets by including appropriate language in formation documents to create a restrictive charitable trust for the project's funds.[14]

Some Conclusions

For the moment, the inherent complexities of Model L as well as the possible exposure to annual state and local taxes may mean that Model L will prove most useful where the prospect for tort liability is unusually high and where the project is sufficiently well-funded to counterbalance these disadvantages. If state and local tax regulators eventually exempt LLCs wholly owned by charities from business franchise fees and sponsors gain experience with using the form, Model L may become much more widespread, particularly with larger fiscal sponsors who manage many Model A projects, in the same way that a charity might insulate its various real estate holdings in separate LLC subsidiaries. In any event, fiscal sponsorship itself can be a powerful strategy for those looking to pursue new charitable programs, and Model L clearly offers another useful tool in this regard for both sponsors and projects.

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1 The authors would like to thank Gene Takagi, Esq., for his invaluable comments offered as part of the presentation with them on September 5, 2014.

2 The IRS receives more than 70,000 tax-exemption applications every year, and until recently, most exemption applications typically would not even be assigned to an IRS reviewer for more than twelve months after they were submitted to the IRS. The IRS has been working to reduce this timeframe, and its stated goal is to resolve new applications within 270 days of their submission. One key recent development has been the introduction of the new Form 1023-EZ, a much-abbreviated application that can be used by small new charities that meet all of the 27 criteria for eligibility, and the processing time for these applications is considerably shorter. Nonetheless, many new charities will not be eligible to use Form 1023-EZ, and nine months is still a considerable time for a new charity to wait.

3 Steven R. Chiodini & Gregory L. Colvin, *The Use of LLCs in Fiscal Sponsorship—A New Model*, TAXATION OF EXEMPTS (May/June 2011).

4 *See* I.R.S. Info. Ltr. 2010-52 (Mar. 15, 2010).

5 *See* I.R.S. Notice 2012-52. Raising projects in its own name is an attractive feature for a project that otherwise would need to use the sponsor's legal name.

6 *Restricted* assets—e.g., restricted funds for separate projects of the fiscal sponsor—should have additional protection from another project's creditors as a result of the charitable-trust doctrine. *See* Gregory Colvin, *Doing Right by the Projects: Fiscal Sponsorship after IHC,* NONPROFIT LAW MATTERS BLOG (Feb. 16, 2012), http://www.nonprofitlawmatters.com/2012/02/16/doing-right-by-the-projects-fiscal-sponsorship-after-ihc-2/ (for a more detailed discussion of strategies for bolstering the charitable-trust argument as well as other practical steps that can be taken to protect other projects).

7 *See, e.g.*, Rick Cohen, *Vanishing Act: Activist Groups Say Donations Disappeared with Fiscal Sponsor,* NPQ (Feb, 3, 2012), http://www.nonprofitquarterly.org/management/19616-vanishing-act-activist-groups-say-donations-disappeared-with-fiscal-sponsor.html; *A Global Nonprofit Ponzi Scheme? Lessons Learned from a Fiscal Sponsor's Collapse,* NPQ (Feb. 14, 2012), http://www.nonprofitquarterly.org/management/19812-a-global-nonprofit-ponzi-scheme-lessons-learned-from-a-fiscal-sponsors-collapse.html; and *FBI Eyeing International Humanities Center Shutdown*, NPQ (May 17, 2012), http://www.nonprofitquarterly.org/policysocial-context/20353-fbi-eyeing-international-humanities-center-shutdown.html. The collapse of fiscal sponsors is not new, however; see, for example, the discussion of Media Network, a sponsor of documentary films that collapsed in 1997, in *Fiscal Sponsorship: 6 Ways To Do It Right.* GREGORY L. COLVIN, FISCAL SPONSORSHIP: 6 WAYS TO DO IT RIGHT 73 (2006).

8 Technically, a charging order granted by a court puts creditors of the LLC member in the position of an assignee of the LLC interest: the creditor acquires the right to distributions (if any) from the LLC, but it is not automatically admitted as a member with voting rights in place of the member unless the LLC operating agreement provides otherwise.

9 The "LLC" moniker and its inherent connotations of for-profit business may be off-putting to some in the charitable sector. Setting up the Model L project in a state that offers the "low-profit limited liability company" or "L3C" —a form of LLC required to have charitable-purpose limitations in its governing documents, among other things—may help to ameliorate these connotations, but care needs to be taken to ensure that other aspects of the LLC law in those states do not present substantive disadvantages (for example, by facilitating the seizure of a sponsor's LLC interest by its creditors).

10 If the LLC itself does hire project leaders or other employees of its own (and it may be prudent for the LLC to do so rather than the parent sponsor, to avoid having the parent held liable as an employer for torts committed by project employees), the LLC will not be a disregarded entity for federal employment tax purposes.

11 FLA. STAT. §§ 608.433(6) &(7).

12 DEL. CODE ANN. tit. 6, § 18-703.

13 NEV. REV. STAT. § 86.401(2)(a).

14 *See* note 6, *supra.*