

THE USE OF LLCs IN FISCAL SPONSORSHIP— A NEW MODEL

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Fiscal sponsorship, in which a Section 501(c)(3) public charity extends the umbrella of its tax-exempt status to a previously unaffiliated project, offers a valuable tool for charitable entrepreneurs who want to attract tax-deductible donations from the public and facilitate grants from private foundations without going through the time and expense, at least initially, of obtaining tax-exempt status for a new organization. Large charitable organizations that regularly sponsor projects typically use one of three models of fiscal sponsorship: a “Model A” direct-project approach, a “Model B” independent contractor arrangement, or a “Model C” pre-arranged grantor-grantee relationship.¹

The following discussion explores a new model—“Model L”—in which the charity acts as the sole member of a limited liability company (LLC) from which the sponsored project is conducted. Model L shares many features with Model A, and would generally serve as a substitute for a Model A arrangement if the sponsor is concerned about potential liability from the project’s activities. Nevertheless, it also has characteristics of other models and is suffi-

ciently different from Model A that it deserves its own conceptual category. As this article will explain, the circumstances in which Model L will be appropriate are relatively narrow (at least for the moment), although it can be extremely useful in some situations. This is particularly true given recent IRS guidance permitting private foundations to make grants to LLCs wholly owned by public charities without conducting expenditure responsibility.²

The existing primary models of fiscal sponsorship

As mentioned above, and as shown in Exhibits 1 and 2 on pages 8 and 9, respectively (except for Model B), the most common forms of fiscal sponsorship fall into the following categories:

- *Model A.* The project becomes an internal program of the sponsoring charity. Project staff become employees or volunteers of the sponsor. Legally, the project is no different from any other activity that the sponsor carries on directly. The chief benefit of Model A is that the charity will usually handle the project’s back-office operations, leaving the project staff free to pursue program activities. Also, there is no need to maintain a separate legal entity for the project.

Model L may combine most of the benefits of other models, but may be impractical for smaller projects that are not well-funded.

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EXHIBIT 1
Basic Structures of Selected Sponsorship Models.

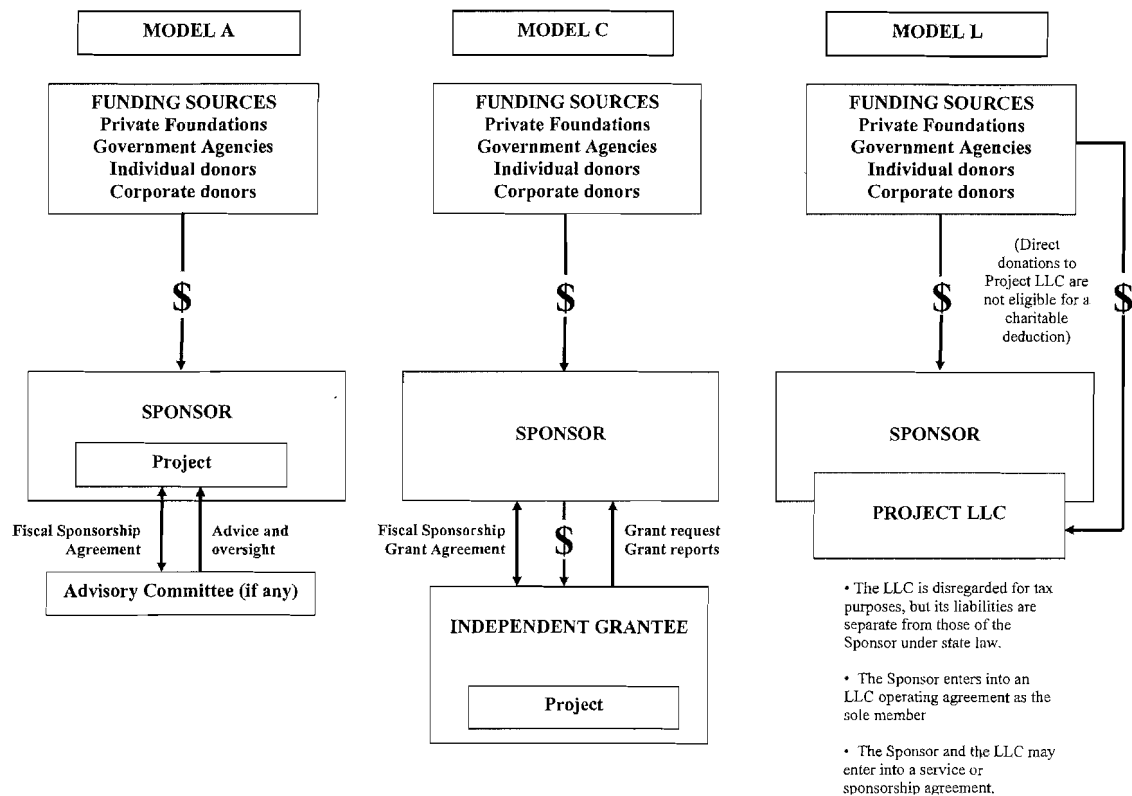
	Model A (Direct Project)	Model L (Single-Member LLC)	Model C (Preapproved Grant Relationship)
Basic Characteristics	Project belongs to sponsor and is implemented by its employees and volunteers	Project is operated in an LLC, wholly owned by the sponsor.	Project applies to sponsor for one or a series of grants, sponsor funds project only to extent money received from donors.
Is Project A Legal Entity?	No.	Yes.	Yes.
Basic Relationship	Employer-Employee.	Parent-Subsidiary.	Grantor-Grantee.
Charitable Donations For Project Belong To	Sponsor.	Sponsor.	Sponsor.
Private Foundations Issue Grants To	Sponsor.	Project LLC itself or Sponsor.	Sponsor.
Sponsor's Liability To 3d Parties	Total liability for acts of employees.	No liability for LLC's debts and obligations; akin to Model C as to grant funding.	Selection and payment of grantee, plus terms set by funding source.
Ownership Of Results	Sponsor.	Project (sponsor indirectly, via its interest in the LLC).	Usually the project.
Payments Shown On Tax Returns Filed By Sponsor	Form 990, payroll tax returns.	Form 990.	Form 990.
Payments Shown On Tax Returns Filed By Project	Individual 1040s.	Generally consolidated with sponsor-parent's returns; may need to file state and local returns, payroll tax returns.	Depends on grantee's legal status.
Comments	Legally, project is no different from any other activity carried on by sponsor directly.	Project is essentially internal to sponsor (as in Model A), but sponsor has no liability for project activities (akin to Model C).	Used by non-501(c)(3) project, in order to raise tax-deductible support from donors, private foundations, or government grants.

- *Model B.* The project is a program of the sponsoring charity, but it is operated externally by the project organizer as an independent contractor. Otherwise, Model B generally resembles Model A insofar as the project is an internal program of the sponsor.
- *Model C.* The sponsoring charity and the project organizers, acting either individually or through their own entity, enter into a pre-approved grant relationship. The project applies to the sponsor for one or a series of grants, the sponsor adopts the project as a charitable program, and the sponsor funds the project only to the extent that

it receives money from third-party contributors. Because the project in a Model C arrangement is conducted by an outside grantee, the sponsor's liability is generally limited to that of a normal charitable grantor. On the other hand, the project's administrative costs may be higher than with Model A or B, especially if the Model C grantee is a corporation, with its own governance structure and filing obligations. Also, there may be tax consequences for the person or entity acting as the grantee.

In each of these models, donations and grants in support of the project are made di-

EXHIBIT 2
Basic Structures of Selected Sponsorship Models.



rectly to the sponsoring charity, which owns the funds and has full discretion and control over how to use the money (subject, of course, to state charitable trust law and to any contractual obligations of the sponsor under agreements with third-party contributors). In return for surrendering control over its funding to the fiscal sponsor, the project gets the benefit of the sponsor's tax exemption and public-charity status. The result is that outside donors may make tax-deductible contributions to the sponsor in support of the project, and private foundations may make grants to the sponsor without conducting expenditure responsibility.

A number of factors are involved in determining which model is best for any given project. For example, Model C may be appropriate if

project organizers have formed a nonprofit corporation and simply need the benefit of the sponsor's tax exemption to raise money as they apply for recognition of the new organization's own tax-exempt status. On the other hand, Model A would be more appropriate if the project has an uncertain future, or if the organizers have no intention of going through the expensive process of setting up a new corporation, obtaining IRS recognition of tax-exempt status, and then administering a stand-alone nonprofit.

The need for a Model L sponsorship

What if project organizers strongly prefer a Model A structure, but the prospect of liability from the project's activities is unacceptable to the sponsor?

¹ These model categories and others are presented and described in greater detail in Colvin, *Fiscal Sponsorship: 6 Ways To Do It Right* (Study Center Press, 2005). Another category is Model D, in which a sponsor that has obtained a group exemption ruling from IRS includes the project entity in its annual listing of subordinate organizations that are affiliated with the sponsor and under its general supervision or control. By virtue of being listed as a subordinate organization, the project entity is able to receive Section 501(c)(3)

tax status without applying independently to the IRS. As a practical matter, however, a Model D fiscal sponsorship is less likely to be available, particularly for projects outside of the sponsor's natural constituency. The charity would need already to have a group exemption ruling, and organizations that typically have such rulings (e.g., religious groups or territorial groups with local clubs or chapters) are less likely than community foundations or other public charities to open themselves to sponsoring outside projects.

For example, consider a scenario where a group of teachers approaches their local community foundation with an idea to organize summer camping trips for disadvantaged inner-city youth. The organizers apply to the sponsor as a Model A project. With the program being run only one season a year, it would be inefficient to set up a separate nonprofit corporation, and the teachers do not want to be Model C grantees themselves because of the prohibitive cost of obtaining their own liability insurance, among other expenses.

By the same token, however, the community foundation is concerned about the potentially vast liability to itself of running camping trips for children as an internal program—a child could be severely injured or die as a result of a chaperone's negligence, and the foundation, with its large asset base, would be a natural target for tort plaintiffs.³ A Model B sponsorship, in which the project organizers would be retained as independent contractors to run the project, may not significantly alter the prospect for liability because the project would still be the foundation's own. In any case, the teachers would not really fit into the mold of independent contractors, since they are not otherwise in the business of conducting camping trips for other clients. A Model C arrangement would largely mitigate the foundation's exposure to liability, but for the reasons discussed above, it is not appropriate.

Model L may, however, provide most of the benefits of Model A, while offering the sponsor the limited liability of Model C. At the same time, some aspects of Model L may make it impractical for many projects, particularly those that are smaller and not well-funded.

Model L fiscal sponsorship

The first LLC law was adopted in Wyoming in 1977. Florida enacted its own statute five years later. After the IRS issued Rev. Rul. 88-76, 1988-2 CB 360, clarifying that LLCs would be treated as partnerships for federal tax purposes, a number of other states followed suit. By the mid-1990s all 50 states and the District of Columbia had adopted LLC laws.⁴

An LLC offers the limited liability of a corporation without itself being subject to federal tax. A multiple-member LLC will be treated as a partnership for federal tax purposes, and a single-member LLC will be disregarded entirely.⁵ Consequently, the members of an LLC, like corporate shareholders but not general partners, are usually liable only to the extent of their investment in the company. Unlike a corporate shareholder, however, a member's distributions from the LLC are not subject to federal tax at the entity level. Moreover, LLC laws typically give members great flexibility in designing the structure of the company—far more so than the typical corporation statute. For example, an LLC need not have a board of directors. It may instead be managed by its members, or the LLC's operating agreement (analogous to a corporation's bylaws) might give management responsibility to one or more non-member managers, who may even be constituted as a board of managers in approximation of a corporation's board of directors. Furthermore, while managers will generally by default owe corporate-like fiduciary duties to the members, the scope of these duties may be varied or even eliminated by the members in the operating agreement.⁶

² See IRS Information Letter 2010-0052, (6/25/10). In making a grant to an organization that is not described in Section 509(a)(1) or Section 509(a)(2) or in certain parts of Section 509(a)(3), or is not an exempt operating foundation under Section 4940(d)(2), a private foundation must exercise expenditure responsibility strictly in accordance with Reg. 53.4945-5 to avoid having the payment be a taxable expenditure under Section 4945, which would subject the foundation to significant excise taxes.

³ In practice, tort plaintiffs would have difficulty reaching restricted assets that the sponsor holds in charitable trust for specific projects. Any unrestricted funds of the sponsor would generally be available; the extent to which restricted funds would be vulnerable would largely depend on the nature of the charitable trust with which the assets are impressed and particularly the language giving rise to it. Consequently, where donors have not expressly restricted their donations in writing, it may be prudent for fiscal sponsors, among other things, to send project donors an acknowledgment that contributions will be restricted to the specific purposes of the project and will not be used for the sponsor's general purposes, which would help to buttress the charitable trust. Nonetheless, the use of an LLC may provide a more complete shield for the sponsor, particularly with respect to its unrestricted funds. See generally Body, "The

Charity in Bankruptcy and Ghosts of Donors Past, Present and Future," 29 Seton Hall Legis. J. 471 (2005).

⁴ See generally the discussion of the history of the LLC form in Sargent and Schwidetzky, *Limited Liability Company Handbook* (Thomson West, 2007) at § 1.2.

⁵ An LLC may make an affirmative election to be treated as a corporation for federal tax purposes by filing Form 8832, and it is automatically considered to have made such an election if it files Form 1023 for recognition of its own tax-exempt status under Section 501(c)(3). Reg. 301.7701-3(c)(1)(v)(A).

⁶ See, e.g., Delaware Limited Liability Company Act § 18-1101(e) ("A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement [other than] for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing."); *Bay Center Apartment Owners, LLC v. Emery Bay PKI, LLC et al.* (Del. Ch. 4/20/09), available at courts.delaware.gov/opinions/download.aspx?ID=120380 (explaining that, in the absence of a contrary provision in an LLC's operating agreement, an LLC manager owes the traditional duties of loyalty and care to the LLC's members).

The characteristics of Model L. Under Model L, the fiscal sponsor would act as the sole member of a limited liability company, and the project would be operated from within this separate entity. Model L has attributes of existing models of fiscal sponsorship, with some crucial differences. As in Model A, the Model L project is (for purposes of federal tax law, at least) internal to the fiscal sponsor, and the LLC's activities are imputed to the sponsor itself.⁷ As in Model A, the Model L sponsor would have ultimate control over the very existence of the project. Subject to any contractual obligations with third parties, the sponsor could disband an internal Model A program or dissolve a Model L company, whereas it would have no corporate power *per se* over a Model C grantee entity. Like a Model C project, however, the sponsor would be shielded from most liability for the project's activities. Model L also bears a certain resemblance to Model D, under which a charity confers its tax-exempt status on affiliated organizations under its supervision or control.⁸

Model L has additional distinct qualities that differentiate it from the other models, however, as well as some unique pitfalls and drawbacks.

Relationship of the project to the fiscal sponsor. In the summer camp scenario presented above, the prospective fiscal sponsor would form a new LLC by filing articles of formation in the appropriate state. (The jurisdiction in which the LLC is formed would not necessarily depend on the sponsor's own location. In the for-profit sector, it is standard to form LLCs in Delaware.⁹) The fiscal sponsor would serve as the LLC's sole member.¹⁰

As a result, the LLC would fall within the sponsor's federal tax exemption, and the LLC itself would not be required to satisfy the organizational test for exemption under Section 501(c)(3).¹¹ Rather, because the disregarded LLC is treated as an activity of its sole charita-

ble owner for federal tax purposes, the sponsor's own articles of incorporation would be relevant to this analysis. In general, a standard provision in the LLC's articles of formation permitting the LLC to be operated "for all purposes for which LLCs may be operated" would suffice.¹² Some states may require specific provisions in the LLC's articles, however. One such requirement might be for the company to qualify for an exemption from property taxes.¹³ In any event, the LLC's governing documents should not *prohibit* it from operating exclusively for exempt purposes.¹⁴

In both Model A and Model C arrangements, the provisions of the sponsorship arrangement are set out in a central fiscal sponsorship agreement. This may also incorporate by reference a standard set of sponsorship policies on issues such as administrative fees, check-writing protocols, and so forth, particularly if the charity acts as the sponsor for a large number of projects. In a Model L situation, the sponsorship provisions could be addressed in the LLC's operating agreement itself. Alternatively, the sponsor/parent could opt to have the LLC governed by a simple operating agreement, with terms of the fiscal sponsorship addressed in a separate agreement between the parent-sponsor and the LLC. (This latter approach may be more efficient if the parties anticipate that the sponsor will eventually transfer its interest in the LLC to a successor sponsor or to a new nonprofit organization.)

The role of the project organizers in a Model L arrangement is very different from their role in other forms of fiscal sponsorship. In a Model A sponsorship, the project is typically (although not always) directed by a lead project director and supervised by an advisory or project committee composed of the people who represent a community of support for the proj-

⁷ With a Model A project, the project staff are the employees or volunteers of the sponsor. In a Model L project, the sponsor would act through its membership interest by electing and removing LLC's managers, as explained in greater detail below.

⁸ See note 1, *supra*. Of course, one crucial difference between Model L and Model D is that a Model L sponsor, unlike a Model D sponsor, does not need to obtain a group exemption ruling beforehand because the wholly owned LLC is disregarded for federal tax purposes.

⁹ This results from Delaware's well-developed corporate jurisprudence, the flexibility of its LLC law, and the reluctance of its courts to pierce the veil of limited liability between the company and its members, an issue discussed below.

¹⁰ While it might be possible to have a shared fiscal sponsorship situation with two or more charities as members, multiple-member LLCs trigger complicated issues of partnership taxation that are beyond the scope of this article. A single-

member LLC, which is disregarded entirely for federal tax purposes, avoids these issues.

¹¹ See Ann. 99-102, 1999-2 CB 545; McCray and Thomas, "Limited Liability Companies as Exempt Organizations—Update," *IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2001* (2000) (the "2001 CPE Text") at 28.

¹² Moreover, a provision in the LLC's articles requiring distribution of remaining net assets on dissolution to the LLC's members would be permissible because the sole member, the fiscal sponsor, is a public charity.

¹³ See, e.g., California Board of Equalization Rule 136, "Limited Liability Companies as Qualifying Organizations for the Welfare Exemption" (requiring LLCs wholly owned by a Section 501(c)(3) organization to meet certain organizational criteria in order to be eligible for an exemption from property tax).

¹⁴ 2001 CPE Text at 28.

ect, sometimes including representatives of grantors and other stakeholders. Some committee members and others may be employees or volunteers of the sponsor for the duration of the project. It is also useful to have the project director or the advisory committee (usually an unincorporated association, though perhaps a separate corporation) enter into the fiscal sponsorship agreement with the sponsoring charity. That would provide a counterparty with standing to enforce the terms of the agreement against the sponsor. Under Model C, the lead project organizer could personally be the grantee, or the organizers could operate the grantee entity that enters into the fiscal sponsorship agreement with the charity.

Under Model L, the project organizers themselves could form the board of managers if the managers will be involved in the day-to-day operation of the LLC. The project organizers are, after all, the people most likely to understand the project's activities and to have an interest in managing them. Alternatively, the project organizers could run the project as LLC staff, with various stakeholder representatives forming the board of managers and generally supervising the LLC's operations, though not actually conducting its daily activities. (In any event, there should be LLC managers separate from the sponsor. Although the sponsor itself is legally able to manage the LLC in its capacity as the sole member, doing so would not be advisable, since it might expose itself to liability for the LLC's activities. Also, a sponsor such as the community foundation in the summer-camp scenario may not have sufficient experience in managing the type of activities envisioned for the LLC.)

The fiscal sponsor, as the sole member, would have the right to appoint and remove the LLC's managers at will. The LLC itself would hire staff or engage volunteers to administer the project, although the LLC would *not* be disregarded for employment-tax purposes and would be responsible for paying any such taxes.¹⁵ The LLC's managers could be compensated for their duties. Since the LLC's activities

are viewed as the sponsor's own for federal income tax purposes, however, the normal strictures against the use of the sponsor's charitable assets for private benefit would apply. Therefore, the charity's managers could be subject to excise taxes for any excessive benefits paid to a manager if he or she was a "disqualified person" under Section 4958 with respect to the sponsor.

One of the primary benefits of Model A is that, for a fee, the sponsor provides back-office services to support the project (check-writing, payroll administration, grant-reporting coordination, and so forth). Similar services may also be provided to Model C projects, although this sometimes confuses vendors as to whether the project or the sponsor is legally liable for their fees, and could subject the sponsor to UBIT on project fees associated with these services.¹⁶ With a Model L project, the fiscal sponsor could still perform administrative services for the LLC pursuant to a written agreement. As will be discussed below, however, the project organizers serving as managers would have greater administrative responsibilities and would need to observe corporate formalities to a much greater extent than a Model A advisory committee.

Funding the project. The fiscal sponsor in a Model A or Model C project receives, in its own name, charitable donations and foundation grants in support of the project. In a Model A arrangement, the sponsor spends these funds directly on the project, which is its own internal program. In a Model C arrangement, the sponsor re-grants the funds to the recipient project with which it has entered into a pre-approved grant relationship. The fiscal sponsor necessarily has full discretion and control over the incoming grants and contributions and has the right to use these funds in a manner that it believes would best accomplish the purposes for which they were given. In practice, a sponsor's hands will be bound by the grant agreements and gift instruments to which it is a party with outside funders, as well as by state charitable trust law and its fiscal sponsorship agreement with the project committee or grantee. Nevertheless, the sponsor does have very real rights. For example, it may not re-grant funds to a Model C recipient that the sponsor believes is no longer capable of successfully administering the project. Similarly, it may terminate a Model A project and use the funds on another internal program that it feels could better accomplish the charitable purposes for which the funds were given.¹⁷ This power of the sponsor sometimes creates a cognitive disso-

¹⁵ See the discussion of tax reporting, below.

¹⁶ In Ltr. Rul. 200832027, the IRS ruled that the management services provided by a community foundation (a public charity) to other Section 501(c)(3) organizations were not substantially related to the charity's exempt functions. Since the services also constituted a trade or business and were regularly carried on—the other two necessary criteria for finding unrelated business activity—the fees that the community foundation derived from these services were subject to UBIT.

nance, particularly since organizers often have an existing relationship with the private foundations that are interested in funding their efforts.

A Model L arrangement would offer somewhat more flexibility. As under Model A or Model C, the project could solicit private, tax-deductible donations in the sponsor's name. The sponsor would receive the donations and issue any required receipts and acknowledgments to donors. To fund the project, the sponsor would then make a traditional grant of these funds to the LLC. The activities of the LLC are considered those of the sponsor for federal tax purposes, however. Therefore, unlike a Model C sponsor, the LLC would not need to make grant reports to the sponsor, although the sponsor would obviously want to ensure that the project's managers were using the funds appropriately. (The operating agreement would give the sponsor inspection rights over the LLC's books and records and could require the board of managers to brief the sponsor periodically on the company's operations.)

Significantly, however, the Model L fiscal sponsor would no longer need to be the initial recipient with respect to foundation grants. In an information letter, the IRS indicated that where a public charity under Section 509(a)(1) is the sole member of a disregarded entity, a grant by a private foundation directly to the disregarded entity generally will not be considered a taxable expenditure even if the foundation does not conduct expenditure responsibility (provided that the foundation does not control the public charity).¹⁷ Of course, the fiscal sponsor ultimately would have control over the funds in the LLC by virtue of its ability as the sole member to appoint and remove the LLC's managers and to compel a dissolution of the LLC. Nevertheless, the fact that private foundations can make non-expenditure responsibility grants directly to the project entity may help to attenuate some of the cognitive dis-

sonance often felt by the project organizers, and in any case would preserve their primary relationship with foundation grantors.

Unfortunately, the IRS has not yet issued similar guidance on the deductibility under Section 170(a) of contributions made directly to an LLC whose sole member is a public charity.¹⁸ A common practical difficulty with fiscal sponsorships is that project staff sometimes incorrectly solicit donations without mentioning the sponsor, and donors often send checks payable to the project instead of to the sponsoring charity. Clearly, this problem would be solved if the public could make tax-deductible donations to an LLC whose sole member is a Section 501(c)(3) organization. That would make Model L fiscal sponsorship more useful.

Finally, it would also be possible for the sponsor, as the sole member, to fund the LLC by using the money it receives from third parties to make capital contributions to the LLC. It is unclear, however, whether doing so would provide any significant advantages over a standard grant, except perhaps by avoiding state LLC fees on gross income (discussed below).

Fiscal sponsorship fees. It is standard for fiscal sponsors to charge projects a fee, usually around 10% of revenue, although for larger projects the fee may be smaller and may ratchet down after certain thresholds. A sponsor in a Model A or Model C project would deduct its fee from incoming grants and donations. There are a number of ways that a Model L sponsor could receive a fee.

The most straightforward approach may be for the sponsor and the LLC to enter into a management services agreement under which the sponsor would provide back-office services to the LLC in exchange for periodic fees.²⁰ Alternatively, a fiscal sponsorship agreement between the sponsor and the LLC could provide that the sponsor would deduct a percentage of donations and grants, as in a Model A or Model C arrangement. This approach may not be use-

¹⁷ Under Reg. 53.4945-5(a)(6), a grant from a private foundation to a grantee organization that the grantee subsequently re-grants to another recipient will not be regarded as a direct grant from the private foundation to the secondary grantee so long as the foundation does not earmark the grant for the secondary grantee. If a private foundation does not exercise expenditure responsibility over a grant that it earmarks to a secondary recipient that is not a public charity, the grant payments would be taxable expenditures for the foundation. To avoid having a grant considered earmarked for an outside recipient, the fiscal sponsor must have full discretion and control over the grant funding.

¹⁸ Info 2010-0052, 6/25/10, available at www.irs.gov/pub/irs-wd/10-0052.pdf. The information letter further explains that

the private foundation may generally treat such a grant as a qualifying distribution for purposes of Section 4942.

¹⁹ In the 2001 CPE Text, the IRS indicated that it was considering this issue, and that guidance would be forthcoming "in the near future." At the time of this writing, however, no such guidance has been issued. The IRS issued two private letter rulings in May 2001 regarding several LLCs, each of which had the same Section 509(a)(3) supporting organization as its sole member. It refused to issue a third requested ruling that property contributed to these LLCs would be deductible as a charitable contribution under Section 170(a).

²⁰ Although the back-office services would need to be conducted in the name of the LLC, they would be performed by sponsor staff members, using the LLC's letterhead and check stock, under the direction of the LLC managers.

ful if the bulk of the project's revenue consists of private foundation grants directly to the LLC, however, unless the operating agreement also provides for periodic distributions of a percentage of net grant income to the sole member.

Because the LLC is disregarded for federal tax purposes, the sponsoring charity would not have to be concerned about incurring UBIT on the administrative fees that it derives from the LLC. At the same time, a formal, documented arrangement would be necessary. Without a formal services contract, sponsorship agreement, or distribution provisions in the operating agreement, the sole member may create the impression that it has been skimming the LLC's assets for its own benefit. This could greatly increase the risk of having a court "pierce the veil" (see below) and view the LLC as the mere alter ego of the sole member.

Project assets and liabilities. The LLC would own its assets, but the fiscal sponsor would have an indirect interest through ownership of the sole membership. The debts and obligations of the project LLC would be its own, and because of the sole member's limited liability, the fiscal sponsor would usually not be held responsible, except in the rare instance of a veil-piercing (below).

Tax reporting. As explained in Ann. 99-102, 199-2 CB 545, and the 2001 CPE Text,²¹ when an entity is not regarded as separate from its owner, its operations are treated as a branch or division of the owner. Similarly, when a public charity is the sole member of a disregarded LLC, the LLC's finances and operations are to be included on the charity's own Form 990 information return. The disregarded LLC would generally use the sole member's taxpayer identification number (TIN) for federal tax purposes.²² The public charity sponsor would, however, need to disclose its interest in the disregarded LLC on Part IV, line 33 of its Form 990 and complete Part I of Schedule R.

The situation is different for employment-tax purposes, however, as the single-member LLC would *not* be disregarded and would be required to perform all acts (including withholding and making necessary filings) that would be required of a regular employer.²³

²¹ Note 11, *supra*.

²² Except as otherwise provided in regulations or IRS guidance, a single-owner disregarded entity *must* use its owner's TIN (Reg. 301.6109-1(h)(2)(i)). If the LLC has its own employees, however, it would need to obtain its own TIN.

²³ See Regs. 301.7701-2(c)(2)(iv) and (v), and the discussion in Info 2010-0052, *supra* note 18.

Terminating the fiscal sponsorship. Fiscal sponsors terminate projects for a number of reasons. The sponsor may transfer a Model A project and its funding, or the Model C grant funds it holds, to a new nonprofit organization that was established specifically for the project and has obtained its own tax exemption. Similarly, the sponsor may transfer a project or grant funds to another public charity that would serve as a successor fiscal sponsor. Of course, funding may disappear, project organizers may lose interest in the program, or the project may naturally have a limited term, in which case the sponsor would spend down contributions or return them to funders and terminate the sponsorship entirely.

If a Model L project is to be transferred either to a new nonprofit corporation or to another fiscal sponsor, the current sponsor would assign its membership interest in the LLC to the successor charity and grant to the successor any contributions for the project that the sponsor itself held. Private foundation grants to which the LLC was a direct party would not be affected, although the sponsor and the LLC managers should take care to investigate whether the applicable grant agreements require the LLC to give notice to or obtain the consent of the grantor to any change in ownership of the LLC. (Such a provision is likely, since prudent managers of a private foundation would want to ensure that the sole member of the LLC remained a public charity.)

If a Model L project is no longer viable, the sponsor, as sole member, can compel the dissolution of the entity, and the LLC's net remaining assets will be transferred to the sponsor.

Potential pitfalls and drawbacks of Model L

In determining whether to pursue a Model L fiscal sponsorship, both the incoming project team and the sponsor should consider several features that may involve higher costs and administrative burdens relative to other sponsorship models, particularly for smaller, less well-funded projects.

Veil piercing. One of the primary benefits of Model L is the limited liability it gives to the sponsor. Of course, the wall of limited liability is not impervious. In certain instances, a court could disregard the separation between the LLC and its sole member and reach the assets of the fiscal sponsor to satisfy the LLC's debts. This is a serious threat in the summer camp example, where tort liabilities are potentially enormous, the community foundation has a large and vulnerable asset base,

and the project LLC probably has little beyond operating cash and grant receivables.

Courts in many states will examine the unity of interest and ownership between the limited liability entity and its owner. If that unity of interest is sufficiently strong, courts may conclude that the entity's separate existence has no basis in reality, and that treating the entity's acts as its own would lead to an inequitable result. Salient criteria in assessing the strength of this unity of interest include whether (1) the entity has observed corporate formalities, (2) the entity and its owner have commingled their assets, (3) the owner participates in day-to-day control over the entity's activities, and (4) the entity has been significantly undercapitalized.²⁴

There are a number of strategies that fiscal sponsors and project organizers can take to minimize the risk of a successful veil-piercing. First, regardless of where the LLC operates or where a lawsuit is heard, a court will apply the law of the state where the LLC was formed in determining whether to hold its sole member liable for its obligations. If the summer camp scenario involved a project based in Los Angeles, for example, the sponsor might be better advised to form the LLC in a jurisdiction such as Delaware or Nevada. Courts in those states are reticent about piercing the corporate veil, while courts in California have shown a greater willingness to do so. A sponsoring community foundation would further protect itself against a successful veil-piercing by giving a board of managers supervisory authority over the LLC instead of managing the company itself as the sole member. Likewise, the LLC should maintain its own books and records and hold its funds in its own separate bank account. Any resource-sharing and management-services arrangements should be memorialized in formal written agreements negotiated at arm's length. The LLC's managers should keep thorough minutes of their meetings. The sole member should take its actions by formal written consent.

Restricted assets held by a sponsor for one project generally would not be available to satisfy judgment debts arising from another, unrelated project, however. Consequently, Model L may ultimately prove meaningful and cost-effective only for sponsors with large amounts of unshielded, unrestricted assets or income, as well as sponsors who want the additional security of having the project operated out of a limited liability entity.

Exposure to state and local taxes. A single-member LLC is disregarded for federal income tax purposes (unless it elects on Form 8832 to be treated as an association). Many states, however, impose varying levels of franchise taxes on the entity itself. These fees may be indexed to the LLC's income, and may or may not be waived for an LLC whose sole member is a charity. For example, the base annual franchise tax for an LLC in California is \$800, in addition to a separate LLC fee based on total annual income from all sources inside or outside California, up to a maximum of approximately \$12,000 per year. As of this writing, these fees *do* apply to LLCs wholly owned by charities, although there are efforts to change the law to make these fees inapplicable to LLCs whose sole members are tax-exempt organizations.

While the fiscal sponsor charity itself will usually be exempt from state property taxes, the same may not be true for the project LLC. The California Board of Equalization has issued a special rule permitting an LLC wholly owned by a tax-exempt organization to qualify for exemption from regular property taxes, provided that the LLC's articles of formation contain very specific provisions limiting its purposes and activities, among other things.

Finally, even if it is wholly owned by a tax-exempt fiscal sponsor, a disregarded entity like an LLC may be subject to unincorporated business taxes as well as filing and licensing requirements at the municipal level.

The role of the project committee. As explained above, Model L is most clearly a substitute for Model A, with the additional feature of limited liability for the sponsor. Most project organizers who would otherwise opt for a Model A arrangement are eager for the fiscal sponsor to perform tedious back-office functions such as payroll administration and accounting so that they can focus on conducting charitable programs. To a certain extent, an LLC in a Model L arrangement can contract with the sole member to have it provide administrative services to the LLC. Because of the necessity of maintaining corporate formalities, however, the LLC's board of managers would need to observe certain practices, such as holding regular meetings where minutes are recorded, that might not otherwise concern a project advisory committee to the same degree. Furthermore, the LLC's managers would by default owe fiduciary responsibilities to the sponsor, although the terms

²⁴ A detailed examination of the jurisprudence of piercing the corporate veil is beyond the scope of this discussion.

of the LLC's operating agreement can be drafted to eliminate most of these duties. Nevertheless, the scope of an LLC manager's responsibilities may be much more extensive than what the project organizers or the sponsor originally anticipated. This is particularly true because the analogous body in a Model A situation, the project or advisory committee, may simply be composed of volunteers who represent grantors and community supporters but who otherwise have little desire to assume director-like responsibilities.

More significantly, there might be no clear counterparty in a Model L arrangement that is independent from the sponsor. In a Model A situation, the project organizers could insist that the sponsor enter into an agreement with either the project director or with a project or advisory committee, giving them standing to enforce the terms of the sponsorship against the charity. In a Model C situation, there would be a grant agreement between the sponsor and the project, which would be represented either by an entity or by the individual grantees. With Model L, however, the only parties to the arrangement are the sponsor and its controlled

LLC. The LLC's managers would be subservient to the sponsor, and project staff would answer to the LLC's managers.

There may be other ways to make the charity responsive to the project organizers' and other stakeholders' demands if relations sour. For example, they could be expressly included as third parties (individually or as a committee, with rights to terminate the sponsorship and transfer the project) in a fiscal sponsorship agreement between the charity and the LLC. Alternatively, they could be expressly included as third parties (individually or as a committee, with rights to terminate the sponsorship and transfer the project) in a fiscal sponsorship agreement between the charity and the LLC, or by including key-man provisions in grant agreements. This issue would need to be addressed in individual situations if the ability to enforce the terms of a fiscal sponsorship arrangement against the charity is important to the project organizers.

Project activity imputed to the sponsor for federal tax purposes. The activities of the wholly owned LLC are, for federal tax purposes, the sponsor's own. As a result, the LLC might cause the sole member to incur UBIT or excise taxes, or even threaten its tax exemption.²⁵ Accordingly, the sponsor will need to monitor the LLC's activities closely to ensure, for example, that it is not paying

²⁵ See generally 2001 CPE Text at 29.

²⁶ Repeat sponsors may incur lower costs in forming subsequent project LLCs once template agreements have been developed.

²⁷ See New York Limited Liability Law § 206(a).

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excess benefits to insiders, intervening in political campaigns, or engaging in what for the sponsor would be an unrelated business activity.

Transaction costs. Finally, setting up an LLC subsidiary will involve certain unique expenses. Among other things, the sponsor may incur legal expenses in preparing the LLC operating agreement, as well as any ancillary fiscal-sponsorship, resource-sharing, or management-services agreements.²⁶ There also may be significant legal costs in dissolving the LLC if the sponsor decides not to continue the project. The board of managers might reasonably request the LLC to indemnify them in the event of lawsuits, and they may request that the sponsor's directors and officers liability insurance be extended to cover the LLC. If the sponsor forms the LLC in other than the state in which it operates, there may be additional fees in qualifying the LLC to do business in the sponsor's home state. For example, New York requires foreign LLCs to publish notice in two newspapers as a condition for qualifying to do business there.²⁷ Finally, the state where the LLC is formed may have a minimum capitalization requirement, although most states (including Delaware) do not.

Conclusion

The Model L fiscal sponsorship offers at least two unique advantages—limited liability for the sponsor, which is normally an attribute only of Model C arrangements, and the ability to receive grants directly from private foundations. In some circumstances these benefits can have substantial value, and can create a viable fiscal sponsorship situation where one might otherwise not be possible. At the same time, however, there are drawbacks to the model. Chief among them is the fact it would be feasible only for large, long-term, well-funded projects in which the risk of liability for the sponsor is significant and a Model C relationship is not desirable. Otherwise, the transaction costs and the prospect of thousands of dollars in state fees are likely to dissuade sponsors and project organizers from pursuing a Model L arrangement.

If, however, state-level LLC fees were waived for companies whose sole members are Section 501(c)(3) organizations, and the IRS permitted donors to take a charitable deduction for their contributions directly to such an LLC, Model L would prove useful in many more circumstances. ■