June 17, 2013

The Honorable Daniel I. Werfel
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224
Fax: (202) 622-5756

Dear Acting Commissioner Werfel:

Enclosed is a petition for IRS rulemaking submitted by Cause of Action.

Sincerely,

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Daniel Z. Epstein
Executive Director
Cause of Action

Before the Internal Revenue Service
U.S. Department of the Treasury

Petition for Rulemaking on Fiscal Sponsorship

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1. This petition for rulemaking, filed by Cause of Action, calls on the Internal Revenue Service (IRS) to revise its existing regulations relating to fiscal sponsorship in order to: (1) provide a comprehensive definition of fiscal sponsorship, (2) require fiscal sponsors to file all sponsorship agreements with their Form 990s, (3) require fiscal sponsors to disclose on their Form 990s gross receipts of their projects that exceed $50,000, and (4) require termination of a fiscal sponsorship relationship if the facts and circumstances reveal indicia, whether financial or otherwise, of independence from the sponsor sufficient to warrant separate corporate status.
2. The existing IRS regulations do not provide sufficient clarity as to how a fiscal sponsorship relationship must be operated. This lack of clarity has subjected fiscal sponsorships to significant abuse. As a result, rulemaking is needed to address the lack of guidance on this important issue.
3. Petitioner Cause of Action is a non-profit, non-partisan corporation organized under section 501(c)(3) of the Internal Revenue Code. In furtherance of its mission, Cause of Action educates the public on federal government corruption, waste, cronyism, and fraud.

Statutory and Regulatory Background

4. The Internal Revenue Code (IRC), pursuant to 26 U.S.C. § 501(c)(3), grants nonprofit, tax-exempt status to applicant organizations whose mission serves a charitable purpose. Organizations that have been granted 501(c)(3) status may receive tax-deductible grants

and contributions on behalf of an organization or individual without a tax exemption.[1] In this case, the nonprofit organization serves as the fiscal sponsor of the non-501(c)(3) organization, referred to as the "project." This relationship is known as "fiscal sponsorship."

5. A fiscal sponsorship relationship can be effectively and lawfully utilized in a variety of situations where a person or group intending to engage in charitable activities wishes to attract tax-deductible contributions without being recognized as tax-exempt by the IRS under section 501(c)(3), which can be a lengthy process.[2] For instance, a newly formed nonprofit corporation that is in the process of applying for tax-exempt status may want to receive tax-deductible contributions while its application is still pending.[3] In such a situation, an existing 501(c)(3) "fiscal sponsor" would be enlisted to accept grants and donations on behalf of the project, which are then disbursed to the project in "the form of payments to employees, vendors, contractors, or grantees."[4]

6. According to IRS Revenue Ruling 68-489, the most concrete statement of IRS policy on fiscal sponsorship arrangements, a 501(c)(3) organization is allowed to accept tax-deductible funds on behalf of a non-501(c)(3) entity if the following three conditions are satisfied:

    a. The project being carried out by the non-501(c)(3) organization is "in furtherance of [the 501(c)(3)'s] own exempt purposes."

    b. The 501(c)(3) organization "retains control and discretion as to the use of the funds."

[1] Rev. Rul. 68-489, 1968-2 C.B. 210; GREGORY L. COLVIN, FISCAL SPONSORSHIP: 6 WAYS TO DO IT RIGHT 3 (1993).
[2] TAX ECON. CHAR. GIVING § 3.02.
[3] *See* Sandy Deja, *Fiscal Sponsorship*, 501CFREEBOOK, http://501cfreebook.com/Fiscal_Sponsor.html (last visited June 12, 2013).
[4] *Id.*

c. The 501(c)(3) organization "maintains records establishing that the funds were used for section 501(c)(3) purposes."[5]

7. Unfortunately, fiscal sponsorship arrangements can and have been exploited by both the fiscal sponsors and project organizations involved. Ineligible organizations may seek to attract tax-deductible donations they do not deserve; sponsors may seek to attract projects for the sole purpose of improperly seizing the donations they accept on the project's behalf. Sandy Deja, a former IRS auditor with over thirty years of experience as a tax consultant, noted, "While not necessarily illegal, these kinds of arrangements can be risky, precisely because they are carried on within a gray area of the law where IRS guidance is quite limited."[6] Thus, the abuse of fiscal sponsorship arrangements is due in part to the lack of guidance regarding the proper structuring of the relationship.

8. It has been observed that there is "virtually no law on the subject of fiscal sponsorship."[7] The IRS has only sparsely referred to such relationships by any sort of name and, when it does discuss such arrangements, statements on the appropriateness of fiscal sponsorship are ambiguous.[8] For instance, in its Exempt Organizations Continuing Professional Education Technical Instruction Program textbook, the IRS states that fiscal sponsorship "occurs when one or more charities choose to financially support another charity or nonexempt project" but does not extensively detail what manner of financial support is appropriate.[9] Due to the IRS's failure to concretely classify and directly regulate these

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[5] Rev. Rul. 68-489, 1968-2 C.B. 210; *see also* Rev. Rul. 67-149, 1967-1 C.B. 133 ("An organization was formed for the purpose of providing financial assistance to several different types of organizations which are exempt from Federal income tax . . . It carries on no operations other than to receive contributions and incidental investment income and to make distributions of income to such exempt organizations at periodic intervals.").
[6] Deja, *supra* note 3.
[7] Gregory Colvin, 30 EXEMPT ORG. TAX REV. 283 (December 2000).
[8] *Id.*
[9] *See* George Johnson & David Jones, *Community Foundations*, 94 TNT 71-46 (1993).

arrangements, there is substantial confusion about how fiscal sponsorships can be properly conducted.

Factual Background

9. Fiscal sponsorship arrangements, if not structured and conducted properly, can have serious negative effects.[10] In particular, these arrangements have been described as vehicles to "launder" funds,[11] to conceal information,[12] and to receive tax-deductible donations that organizations do not deserve.[13] These concerns about the improper use of fiscal sponsorships led the Council on Foundations to place the use of fiscal sponsorships on its list of "Top Ten Ways Family Foundations Get into Trouble."[14]

10. While the IRS has thus far declined to comprehensively define fiscal sponsorship, former IRS officials have recognized that the arrangement has inherent risks. Marcus Owens, the former Director of the IRS Exempt Organizations Division, cautioned practitioners to "keep [an] . . . eye out" for potential danger zones in fund-raising efforts that involve fiscal sponsorship.[15] The IRS has acknowledged that fiscal sponsorships can and have been misused, providing an example of a donor who attempts to do indirectly what he or she cannot do directly: "Such a situation arises when the donor uses a community

[10] Beth Kingsley & Doug Smith, *Fiscal Sponsorships: Do It Right and Stay Out of Trouble*, NONPROFIT NAVIGATOR, May 2001, *available at*: http://www.harmoncurran.com/?fuseaction=eUpdate.getArchives&newsletter_id=77#article2.
[11] Neal Cuthbert, McKnight Foundation, *Why We Don't Make Grants to Fiscal Agents*, 21 LEGALEASE at 2 (1997).
[12] Gene Takagi, *Fiscal Sponsorship Revisited*, NONPROFITLAWBLOG.COM, http://www.nonprofitlawblog.com/home/2009/09/fiscal-sponsorship-revisited.html (last visited May 7, 2013).
[13] Lee Sheppard, *Charitable Money Laundering*, 8 EXEMPT ORG. TAX REV. 645 (1993).
[14] COUNCIL ON FOUNDS., TOP TEN WAYS FAMILY FOUNDATIONS GET INTO TROUBLE (2008), *available at* http://www.washingtongrantmakers.org/s_wash/images/client/TopTenTrouble.pdf.
[15] Marlis L. Carson & John Iekel, *Official Addresses Charities' Concerns About Substantiation Rules*, 10 EXEMPT ORG. TAX REV. 1264 (1994).

foundation as a conduit to accomplish an otherwise prohibited transfer of money or property."[16]

11. The risk associated with fiscal sponsorship has led to substantial financial losses. For example, in 2012 alone, three large-scale fiscal sponsors shut down at the expense of their charitable projects: Projects sponsored by the International Humanities Center (IHC) lost an estimated $1 million;[17] Christian Community, Inc. (CCI) lost $600,000 in project funds for its two main projects;[18] and Help Is Here, Inc. (HIH) has been accused of, among other things, wrongly confiscating $300,000 from its fiscally sponsored projects.[19]

12. At the height of its success, IHC sponsored an estimated 300 projects, and it continued to sponsor over 200 charitable endeavors until its collapse.[20] In December 2011, however, some projects received a letter from the director and founder, Steve Sugarman, acknowledging that IHC was "running a considerable deficit that has severely impacted all operations," and warning the projects that future payments may not be processed. One month later, Sugarman informed some of these projects that IHC would be shutting down. The rest of the projects remained unaware that their sponsor—and all of their donations—would soon be gone.

13. While IHC received donations on behalf of its non-501(c)(3) charitable projects, project directors did not receive any updates on accounting or submitted donations. There was

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[16] *Id*.
[17] Rick Cohen, *A Global Nonprofit Ponzi Scheme? Lessons Learned from a Fiscal Sponsor's Collapse*, NONPROFIT QUARTERLY (Feb. 14, 2012), http://www.nonprofitquarterly.org/management/19812-a-global-nonprofit-ponzi-scheme-lessons-learned-from-a-fiscal-sponsors-collapse.html.
[18] Dan Stockman, *Question: Where's Our Cash?*, J. GAZETTE (Mar. 18, 2012) http://www.journalgazette.net/article/20120318/LOCAL10/303189945.
[19] Geoff Link, *Arizona Fiscal Sponsor Accused of Taking $300,000*, FISCAL SPONSOR DIRECTORY (July 23, 2012), http://www.fiscalsponsordirectory.org/news.php.
[20] Joan Brunwasser, *Talking with Steve Sugarman of International Humanities Center*, OPED NEWS (Nov. 9, 2009, 7:17 PM), http://www.opednews.com/articles/Talking-with-Steve-Sugarma-by-Joan-Brunwasser-091109-375.html.

no system in place for relaying account information to projects—the true amount of funding lost in IHC's collapse remains unknown due to projects' constant ignorance of their own status. Accountability with project funds and communication regarding the amount of funds a project currently held in the IHC bank account could have alerted projects to Sugarman's irresponsible spending and prevented the situation from escalating to an estimated $1 million in losses. However, IRS regulations have little to say about IHC's arrangements. As a result, Sugarman took advantage of his role as a sponsor by seizing project funds to cover IHC's bills.[21]

14. In Fort Wayne, Indiana, just a month after IHC made the decision to shut down its operations, a small fiscal sponsor called Christian Community, Inc. (CCI) informed its two projects that it, too, would close its doors. Reverend Steven Clapp, the director of the fiscal sponsor, claimed that "there was never any intention to betray," and that "there is a significant difference between, I'll use the words 'mismanagement' and 'incompetency'—both of which I'm guilty of—and intentionally taking advantage of or harming others."[22] Clapp hoped to present a case to his projects and to the public that he had simply been a "lousy businessman." In reality, Clapp likely used fiscal sponsorship in an effort to misappropriate project funds, especially considering his lengthy criminal background.[23]

15. In an interview with the Fort Wayne Journal Gazette, Clapp acknowledged that CCI deviated from accepted forms of fiscal sponsorship but refused to define the exact model

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[21] Rick Cohen, *A Global Nonprofit Ponzi Scheme? Lessons Learned from a Fiscal Sponsor's Collapse*, NONPROFIT QUARTERLY (Feb. 14, 2012), http://www.nonprofitquarterly.org/management/19812-a-global-nonprofit-ponzi-scheme-lessons-learned-from-a-fiscal-sponsors-collapse.html.

[22] Dan Stockman, *Question: Where's Our Cash?*, J. GAZETTE (Mar. 18, 2012) http://www.journalgazette.net/article/20120318/LOCAL10/303189945.

[23] Dan Stockman, *Reverend Who Lost Money Has Criminal Past*, J. GAZETTE (Apr. 1, 2012, 3:00 AM), http://www.journalgazette.net/article/20120401/local10/304019948/1002/local.

due to his “pending legal issues.”[24] Clapp did note, however, that “the model Christian Community used was more of a partnership, where Christian Community would pay projects’ bills even if the project didn’t have money to cover them at the time . . . [a]nd since it was a partnership, Clapp said, when the money was used to pay Christian Community expenses, they were really everyone’s expenses.”[25] Clapp applied a loose interpretation of the relationship between a sponsor and project in an attempt to defend his actions, which many have suspected were fraudulent.[26] A clear IRS regulation defining fiscal sponsorship might have prevented Clapp from inventing his own version of fiscal sponsorship in order to abuse project funds.

16. Help is Here, Inc. (HIH), a fiscal sponsorship organization incorporated in California in 2007, also serves as another example of fiscal sponsorship abuse. HIH was founded to “facilitate the Community Spirit in start-up organizations that are passionately changing the communities they live in both locally and globally, whether it be Environmental, Humanitarian, or Educational by affording the tool [sic] and resources that seasoned 501c3 [sic] nonprofits have.”[27]

17. Under the leadership of director Maggie Lane-Baker, HIH’s tenure as a fiscal sponsor was marked by confiscation of donations to projects, attempted seizure of entire projects, avoidance of project managers, and missed court appearances in lawsuits against the organization. Some of these problems are similar to those associated with other fiscal sponsors, in particular, the lack of accountability regarding donation submissions and the projects’ account balance information. Unlike IHC and CCI, however, HIH went a step

[24] *Id.*
[25] *Id.*
[26] Stockman, *supra* note 22.
[27] HELP IS HERE, INC., http://web.archive.org/web/20120621020526/http:/helpishereinc.org/ (last visited May 1, 2013).

further by actively frustrating project donations. HIH's Standard Operations Manual claimed that "[o]nline contributions placed via the HIH Inc. website payment system will generate immediate acknowledgment messages back to the donor's email address."[28] Project directors, however, reported not receiving notification of donations to their projects. Further, HIH instituted a policy which required project directors to report a donation within 24-48 hours of its submission.[29] If not reported, the donation was seized and went to HIH's general fund.

18. HIH not only attempted to seize donations, but also claimed control over the charitable projects themselves. Judy Rogg, Project Director of Erik's Cause, attempted to end her agreement with HIH, but this request was denied and HIH refused to take down the project from its website.[30] In an interview with *Fiscal Sponsor Directory*, Lane-Baker acknowledged that she confiscated $50,000 in funding, including donations to Zawadisha Fund, Gregg's Goals, and Erik's Cause, but claimed that HIH has "the right to absorb the funds and shut down the projects if . . . we deem they are not in compliance with IRS regulations."[31] Rogg filed a lawsuit in Los Angeles County's small claims court in August 2012. Although Lane-Baker refused to attend the proceedings,[32] founder Bill Mack attended on behalf of HIH.[33] During the proceedings, HIH's abusive relationship

[28] *Standard Operations Manual*, HELP IS HERE, INC., http://web.archive.org/web/20111008080159/http:/helpishereinc.org/docs/som.pdf (last visited May 7, 2013).
[29] Wayne Heuring, *Scholarship Fund Out $7,900*, FISCAL SPONSOR DIRECTORY (Sept. 7, 2012), http://www.fiscalsponsordirectory.org/news.php.
[30] Marjorie Beggs, *Erik's Cause Wins Suit Against HIH*, FISCAL SPONSOR DIRECTORY (Sept. 7, 2012), http://www.fiscalsponsordirectory.org/news.php.
[31] Geoff Link, *Help Is Here CEO Responds*, FISCAL SPONSOR DIRECTORY (Aug. 2, 2012), http://www.fiscalsponsordirectory.org/news.php.
[32] Telephone Interview by Cause of Action Staff with Kay Mosko, Dir., Rosie's Rescue (Apr. 3, 2013).
[33] Marjorie Beggs, *supra* note 30.

with its projects became evident, prompting the judge to ask Mack, "Are you preying on these projects?"[34]

Need for New IRS Rules

19. As the foregoing facts illustrate, fiscal sponsorship relationships are frequently subject to abuse. In order to better define the proper boundaries of a fiscal sponsorship relationship, the IRS must formally define fiscal sponsorship and set clear expectations for sponsors and projects. The definition must describe fiscal sponsorship as an arrangement between a 501(c)(3) tax-exempt organization and a fiscally sponsored non-exempt organization, or "project," in which the 501(c)(3) receives and expends funds on behalf of the project in furtherance of a tax-exempt purpose while retaining discretion and control over the use of the funds. The definition must also define what types of organizations qualify as "projects" eligible to participate in fiscal sponsorship arrangements.

20. The definition must further describe the roles and responsibilities of both sponsor and project. For example, sponsors must act as trustees in handling project funds and render periodic accountings to projects. Additionally, sponsors must respect donor-intent by refraining from using project funds to cover the sponsoring organization's expenses. As a result, sponsoring organizations cannot borrow from project funds. In exchange, projects must defer to the sponsor's discretion and control and ensure that funds are used for a tax-exempt purpose. Projects must not attempt to control the 501(c)(3) organization or treat it as a conduit for receiving tax-exempt donations.

21. The problems that are associated with fiscal sponsorship are very similar to those that once plagued the "donor-advised fund." Notably, the Pension Protection Act of 2006

[34] *Id.*

(PPA) formally defined the concept of a donor-advised fund by statute, removing much ambiguity. In addition to defining a donor-advised fund, the PPA included special rules regarding the operation of such funds.

22. The addition of a formal definition of a donor-advised fund was very important for attorneys advising nonprofit organizations. According to Allen Bromberger, an attorney with over twenty years of experience representing nonprofit organizations, the statutory definition of what constituted a donor-advised fund was very helpful when advising clients on how to use these funds properly.[35] Bromberger also noted that having a formal definition of fiscal sponsorship would help simplify the process of advising clients on the proper use of these arrangements, as confusion on what constitutes fiscal sponsorship has contributed to many errors in its usage.[36]

23. The clarification of fiscal sponsorship will likely prevent confusion amongst projects about the practice and how it can be legally arranged. After interviewing John Raymond, a former project director under HIH, Cause of Action discovered that "many nonprofits were unaware of the system [of fiscal sponsorship] and when approached about the arrangements, many believed it would be illegal." Clarification of the proper practice would allow nonprofits and projects to more easily and safely organize.

24. The IRS must also require that organizations engaged in fiscal sponsorships file copies of all actual sponsorship agreements with their Form 990s. Lane-Baker, CEO of HIH, was able to temporarily disarm her projects by constantly changing her requirements for fiscal sponsorship. HIH even made claims to a court that based on the fiscal sponsorship

[35] Interview of Allen Bromberger (Apr. 16, 2010) (on file with author).
[36] *Id.*

agreement, HIH could commandeer the funds and take control of a project.[37] Official agreements disclosed to a third party would prevent the type of fraud experienced by projects of HIH.

25. Further, the IRS must require sponsors to disclose the gross receipts of their projects that exceed $50,000. One purpose of fiscal sponsorship arrangements is to support the incubation of poorly funded organizations by better funded ones. The IRS currently requires 501(c)(3) organizations with gross receipts greater than $50,000 but less than $200,000 to file Form 990-EZ[38] whereas organizations with gross receipts equal to or below $50,000 must file a Form 990N (the "e-Postcard").[39] IRS protocol set these limitations to reflect the heightened risk of abuse that results when 501(c) corporations hold receipts in excess of $50,000. Because non-exempt clients of sponsoring organizations share similar risks, 501(c) revenue limits must apply to fiscal sponsorships arrangements as well. Thus, once the gross receipts of a project exceeds $50,000, the 501(c)(3) sponsoring organization must be required to disclose this information in its Form 990.

26. Lastly, the IRS must terminate a sponsorship arrangement if the facts and circumstances reveal indicia, whether financial or otherwise, of independence from the sponsor sufficient to warrant separate corporate status. Such indicia may include, but are not limited to, separate: incorporation, bank accounts, accounting staff, human resources staff, legal officers, insurance, or office expenses.

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[37] *See* Geoff Link, *Arizona Fiscal Sponsor Accused of Taking $300,000*, FISCAL SPONSOR DIRECTORY (July 23, 2012), http://www.fiscalsponsordirectory.org/news.php.

[38] *Which Forms Do Exempt Organizations File?*, IRS.gov, http://www.irs.gov/Charities-&-Non-Profits/Form-990-Series-Which-Forms-Do-Exempt-Organizations-File%3F-(Filing-Phase-In) (last visited June 12, 2013). Technically, they could file a regular 990 (rather than an EZ) if they choose to do so.

[39] *Annual Electronic Filing Requirements for Small Exempt Organizations – Form 990-N (e-Postcard)*, IRS.GOV, http://www.irs.gov/Charities-&-Non-Profits/Annual-Electronic-Filing-Requirement-for-Small-Exempt-Organizations--Form-990-N-(e-Postcard) (last visited June 12, 2013).

Conclusion

27. The original intent of fiscal sponsorship was to create opportunities for charitable projects to start their endeavors and give them the tools to become recognized charities and foundations. This intent has been subverted through the frequent abuse of fiscal sponsorship. The absence of clear definitions regarding the practice paves the way for scams, mismanagement, and general bewilderment for new projects attempting to further a nonprofit mission. Accordingly, petitioner Cause of Action requests that the IRS act immediately to initiate rulemaking that will address the confusion regarding fiscal sponsorship in order to prevent the fraud, corruption, and abuse of charitable projects and taxpayer funding which has become increasingly commonplace, as illustrated above.

Respectfully submitted,

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June 17, 2013