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USE OF

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FISCAL AGENTS:

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A TRAP FOR

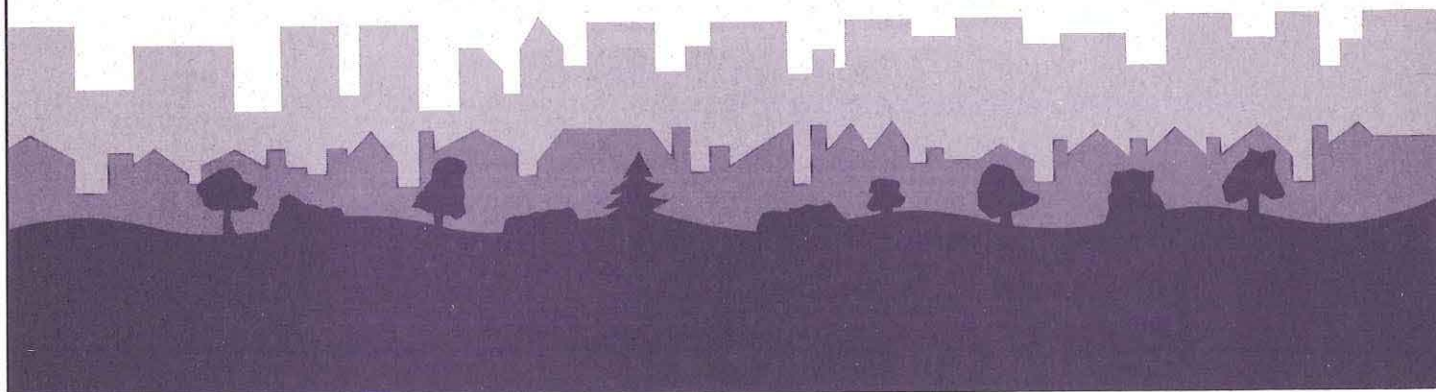
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THE UNWARY

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COUNCIL ON FOUNDATIONS



# **Use of Fiscal Agents: A Trap for the Unwary**

by

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## Foreword

In many communities throughout the country there has been a persistent legal misunderstanding that leads to potential problems for grantmaker and grantee alike. It is often assumed that if a grant cannot be made directly for some reason or another, all one need do is funnel the funds through an intermediary organization (a fiscal agent) and the problem is solved. This approach has become generally accepted in some areas: it's alright because everybody does it.

In 1986, our General Counsel, John A. Edie, wrote an article for *Foundation News* entitled "Fiscal Agents Can Be Illegal." It caused quite a stir. Yet, the practice still persists due in large part to a basic misunderstanding of the legal requirements and principles involved.

In an effort to provide more detailed guidance to our members and to others who may be concerned about the use of fiscal agents, we asked Mr. Edie to expand his earlier article into this paper. With this publication, we are hopeful that the misuse of fiscal agents will disappear and that more organizations will understand how the use of intermediary grantees can be legally utilized.

James A. Joseph  
President and CEO  
Council on Foundations



## **Part I: Introduction**

When computing one's tax return, most Americans know that they cannot count tuition payments as a charitable deduction—even though the check is made out to a Section 501(c)(3) educational institution. In addition, most taxpayers know that their tuition payments are still not deductible if they are paid to a community foundation or other public charity with instructions to forward the funds to the appropriate college or university.

Unfortunately, far too few donors and charitable institutions apply the same logic to other similar circumstances. In too many communities, it is generally accepted that when grants or gifts cannot be made directly, all one must do is "launder" the money through a convenient "fiscal agent" which is frequently the local community foundation or some other well established public charity. While there are some appropriate ways to use a fiscal agent, many others do not square with the Internal Revenue Code and present potential problems and possible penalties for individual donors, private foundations, company foundations, community foundations and other public charities.

The purposes of this paper are: 1) to highlight the types of circumstances when fiscal agents are misused; 2) to explain the fundamental legal rules which govern the use of fiscal agents; 3) to acquaint the reader with the potential problems and penalties which can occur; and 4) to illustrate several proper uses of the fiscal agent concept.





## Part II: Examples of Improper Fiscal Agents

There are at least six common examples of the misuse of a fiscal agent. Before describing these examples, two general rules of philanthropic giving should be clarified.

The first rule concerns the individual donor or taxable corporation wishing to make a charitable contribution and to qualify the gift as a charitable deduction. The Internal Revenue Code makes it clear that gifts and contributions are only deductible if they are given to specifically defined types of *organizations*.<sup>1</sup> Gifts or contributions to a person, or persons, are simply not deductible no matter how charitable the use of the funds or the intent of the donor. Types of organizations to which charitable contributions can be made include: churches, schools, certain medical institutions, publicly-supported organizations that assist government-owned educational institutions, organizations meeting a public support test, governmental units and supporting organizations.<sup>2</sup> Similar gifts or contributions to private operating, and private non-operating foundations are also deductible although the degree of deduction may be more limited.<sup>3</sup> Not only must the *recipient* be a certain type of organization, but (except for governmental units) the organization must be officially recognized by the Internal Revenue Service (IRS) as tax exempt. The organization must have an IRS determination letter in hand, or it must have applied for the exemption within 15 months of the date of creation.

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<sup>1</sup>Section 170(c).

<sup>2</sup>See Section 170(b)(1)(A) and Section 509(a).

<sup>3</sup>For a description and a chart explaining the varying degrees of deductibility depending on the type of organization, see *First Steps in Starting a Foundation* by John A. Edie (Council on Foundations, 1989). Organizations of war veterans and non-profit cemetery companies may also receive contributions that are deductible; and individual donors (not corporations) may obtain deductions for gifts to fraternal orders operating under the lodge system if the contribution is used exclusively for charitable purposes—see Section 170(c)(3), (4), and (5).

The second general rule involves only private foundations (including company foundations). When making gifts or grants, private foundations are not concerned about whether the contribution will count as a charitable deduction. Private foundations pay no income tax,<sup>4</sup> so a deduction is not important or useful. However, a private foundation may incur a penalty tax if it makes a grant to any organization that is not a public charity—or that has not actually received its determination letter from the IRS. Although the term “public charity” is not used in the tax code, the “safe” charities are specifically defined,<sup>5</sup> and they include: churches, schools, medical institutions, governmental units, publicly supported charities, and supporting organizations. Grants to other types of organizations can escape the penalty tax if the private foundation is willing to exercise “expenditure responsibility.”<sup>6</sup> Many private foundations refuse to make expenditure responsibility grants because of the added administrative costs and the potential for penalty if the required procedures are not followed correctly.

With these rules as background, here are some common examples of the improper use of a fiscal agent. This list is not exclusive, and proper uses of a fiscal agent are detailed in Part V.

1. *Gifts or grants for individuals*—Since gifts or contributions to individual persons are not deductible, donors or corporations will attempt to obtain a charitable deduction by making the check out to an existing charity while earmarking the funds for a specific individual. A common example of this misuse of a fiscal agent is a contribution to assist an injured or sick child where the community rises to the emergency situation by attempting to raise special funds.

2. *A new charity without an IRS determination letter*—Under most circumstances, private and company foundations will not make grants to public charities that have not actually received their tax determination letters from the IRS. Frequently, there is some urgency to help a new public charity get off the ground with a “seed money” grant, and determination letters from the IRS normally take at least four to six months. In some cases, the new organization may never intend to seek official status with the IRS because of a short life span. For example, a temporary civic organization may be formed to raise funds for a one-month celebration of the town’s centennial. To avoid penalty and the need to exercise expenditure responsibility (see above), the private or company foundation will seek out an existing charity to accept the funds as “sponsor” or fiscal agent for the new charity.

3. *A non-charity*—Certain organizations often run programs that are clearly charitable in nature, but the organization is not one to which contributions may be given that qualify as charitable deductions. Grants to these same organizations by private or company foundations would be subject to penalty unless the foundation exercises expenditure responsibility. To obtain the charitable deduction or to avoid the penalty, donors and foundations will seek out an existing charity to accept the

<sup>4</sup>Private foundation do pay an excise tax on net investment income—see Section 4940.

<sup>5</sup>See Section 4945(d)(4)(A).

<sup>6</sup>See Section 4945(h). There are four basic requirements: 1) a pre-grant inquiry; 2) a specified written agreement with the grantee; 3) regular reports on the grant’s status from the grantee; and 4) a description of the status of the grant on the grantor’s tax return.



funds on behalf of the non-charity. Examples of non-charities where such a fiscal agent might be used are: chambers of commerce, trade associations, business leagues, fraternal orders, and sometimes volunteer fire departments if they are not part of a governmental unit.

4. *A foreign charity*—As the world grows increasingly interdependent, the need for charitable support in non-U.S. countries is more compelling. But the Internal Revenue Code only permits a charitable deduction to organizations that have obtained the appropriate tax determination letter from the IRS. While it is possible for a foreign charitable organization to obtain such status from the IRS, most have not taken the time and trouble to do so. Thus, it is not uncommon for a donor to seek some way to obtain the charitable deduction for gifts to foreign charities. Again, the donor seeks out a community foundation or other established local charity to handle the earmarked gift.

5. *Gift from one private foundation to another*—On some occasions, one private foundation may wish to make a grant to another private foundation. Usually, this type of grant occurs when the grantor is a non-operating (grantmaking) private foundation and the donee is an operating private foundation whose purpose is primarily to operate directly some charitable activity (a library, an art museum, or nature preserve). Grants from one private foundation to another are subject to a penalty unless the grantor is willing to exercise “expenditure responsibility”—most will not do so. Moreover, beyond expenditure responsibility, the grantor foundation must also obtain adequate records from the grantee foundation that the total amount of the grant was distributed for charitable purposes within 12 months after the close of the tax year when the initial grant was made.<sup>7</sup> To avoid all this additional administrative paperwork and potential penalty, a private foundation may seek a convenient “fiscal agent” or intermediary charity to make life easier.

6. *Avoiding the two percent limit*—Certain charities (including community foundations) maintain their public status (and avoid private foundation status) by meeting a public support test.<sup>8</sup> Briefly summarized, over the appropriate four-year calculation period, the charity must show that its public support is a substantial proportion of its total support. In calculating public support, however, the charity can count no more than two percent of total support from any one person, private foundation, corporation or bequest. Contributions from governmental units or other publicly supported charities are *usually not* subject to this restrictive two percent limit. Therefore, in order to assist a charity that is struggling to meet its public support test, it is tempting for the potential donor to funnel his or her contribution through an existing publicly supported charity so that the ultimate donee charity may count 100 percent of the gift as public support.

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<sup>7</sup>See Section 4942(g)(3).

<sup>8</sup>See Section 170(b)(1)(A)(vi) and related regulations.



## Part III:

# The Basic Legal Rules

When any donor makes a gift or grant to a secondary grantee by first routing it through an intermediary grantee, the IRS, the Internal Revenue Code and the relevant Treasury regulations consistently apply a basic legal principle. In short, if the gift or grant is “earmarked” and the intermediary grantee does not “exercise control” over the funds, then the gift or grant is treated as if it had been made directly by the donor to the secondary grantee. A gift or grant is “earmarked” if it is subject to an agreement, either written or oral, whereby the donor binds the intermediary grantee to transfer the funds to the secondary grantee (or to use the funds to assist a specified individual).

To say it another way: a donor cannot do indirectly what he or she cannot do directly.

The rules regulating the behavior of private foundations are particularly mindful of this concept of earmarking. To illustrate this point, a direct quotation from the Treasury regulations is instructive:

**Certain earmarked grants**—(i) In general. A grant by a private foundation to a grantee organization which the grantee organization uses to make payments to another organization (the secondary grantee) shall not be regarded as a grant by the private foundation to the secondary grantee if the foundation does not earmark the use of the grant for any named secondary grantee and there does not exist an agreement, oral or written, whereby such grantor foundation may cause the selection of the secondary grantee by the organization to which it has given the grant. For purposes of this subdivision, a grant described herein shall not be regarded as a grant by the foundation to the secondary grantee even though such foundation has reason to believe that certain organizations would derive benefits from such grant so long as the original grantee organization exercises control, in fact, over the selection process and actually makes the selection completely independently of the private foundation.<sup>9</sup>

<sup>9</sup> Treas. Reg. Section 53-4945-5(a)(6)(i).



A virtually identical section of the regulations governs grants by private foundations to intermediary grantees where payments (or scholarships) will eventually be made to individuals.<sup>10</sup>

Legal application of this principle is not limited to private foundations. In a case brought to the Tax Court as far back as 1943, the court ruled that amounts paid to provide special advantages for a particular child in the Illinois Childrens' Home and Aid Society were not deductible when earmarked for the benefit of that child.<sup>11</sup> This case established the principle that:

“an inquiry as to the deductibility of a contribution need not stop once it is determined that an amount has been paid to a qualifying organization; if the amount is earmarked, then it is appropriate to look beyond the fact that the immediate recipient is a qualifying organization to determine whether the payment constitutes a deductible contribution.”<sup>12</sup>

In addition, there has been extensive application of the principle noted here to grants made to U.S. charities but earmarked for foreign charitable organizations. One benchmark ruling by the IRS stated that the requirements of the law “would be nullified if contributions inevitably committed to go to a foreign organization were held to be deductible solely because, in the course of transmittal to the foreign organization, they come to rest momentarily in a qualifying domestic organization. In such case the domestic organization is only nominally the donee; the real donee is the ultimate foreign recipient.”<sup>13</sup> This same ruling provided several examples where earmarking was present and where it was not; it concluded that “the test in each case is whether the organization has *full* control of the donated funds, and discretion as to their use, so as to insure that they will be used to carry out [the domestic organization's] function and purpose.”

Although other examples exist, one other illustration is worth noting. With respect to attempts to bypass the two percent limitation (explained in Part II-6), the regulations state that the two percent limitation will apply to contributions received by a publicly supported organization when received from a governmental unit or other publicly supported organization if the original contribution has been “expressly or impliedly earmarked by a donor” to the intermediary organization as being to, or for the benefit of, the secondary organization.<sup>14</sup>

<sup>10</sup>Treas. Reg. Section 53-4945-4 (a)(4)(i).

<sup>11</sup>*S.E. Thomason v. Commissioner*, 2 T.C. 441 (1943).

<sup>12</sup>See also Rev. Rul. 54-580, 1954-2 C.B. 97.

<sup>13</sup>See Rev. Rul. 63-252, 1963-2 C.B. 101 as clarified by Rev. Rul. 66-79, 1966-1 C.B. 48.

<sup>14</sup>Treas. Reg. Section 1.170A-9 (e)(6)(v).

## Part IV: The Results of Misusing Fiscal Agents

Despite the consistent application of these earmarking principles in the law and regulations, there is very limited evidence that improper fiscal agents have been questioned by IRS during the course of normal audits. The most likely reason for this apparent failure in enforcement is that such arrangements are not usually obvious. Nevertheless, regardless of the risk involved, donors and grantees alike should be scrupulous in understanding the basic legal principles and should not participate in attempts to circumvent established rules. What are the potential results of misusing a fiscal agent relationship?

1. *Loss of donor's deduction*—For the individual donor (person or corporation) an earmarked contribution funneled improperly through a fiscal agent can result in loss of that contribution as a charitable deduction. The donor will be required to amend the tax return for the year the deduction was claimed; moreover, he or she will likely owe back taxes complete with penalties and interest.

2. *Penalty tax on private foundations*—If a private foundation misuses the fiscal agent arrangement for a particular grant, several consequences can occur. First, the grant will be considered a taxable expenditure (Section 4945), and a penalty of 10 percent of the grant amount will be levied on the foundation. Similarly, a tax of two and one half percent may be applied to any foundation manager (board member or staff) who knowingly participated in approving the grant. Where possible, the grant will need to be repaid by the grantee. Finally, the grant will not count as a “qualifying distribution,” and for the year of the grant, the foundation will have to reduce its total qualifications by the grant amount. This reduction could result in failure of the private foundation to meet its minimum payout requirement (Section 4942) for the year of the grant; thus, an additional penalty of 15 percent could be applied to the amount by which the reduced total of qualifying distributions falls below the minimum payout requirement.

3. *Loss of public charity status*—In cases where the secondary grantee is attempting to avoid the two percent limitation on grants from private donors by funneling the funds through a governmental unit or another publicly-supported charity, the two percent limit *will* apply. Depending on the other sources of support for the secondary grantee and the size of the earmarked grant, the application of the two percent limitation could result in the grant “tipping” the secondary charity out of public charity status and having it reclassified as a private foundation.

4. *Damage to public reputation*—Regardless of the likelihood of IRS detection of the improper use of a fiscal agent, the public relations risk to the intermediary charity from sanctioning and participating in such a scheme is not worth the risk. This danger is especially acute for community foundations who are in business to assist donors, corporations and private foundations in their grantmaking work. Donors of whatever kind should be able to rely on the assumption that a community foundation (or other public charity) is familiar with Internal Revenue Code rules and is applying them properly. The good reputation of such an organization is vital to protect if it is to expect continued contributions and involvement from the public.

5. *Liability to directors and officers*—If improper use of a fiscal agent goes sour, it is certainly within the realm of possibility that the donor who is facing taxes, penalties and interest might very well bring legal action against the intermediary grantee and/or its directors and officers. While there are no examples of such a suit to date, the potential possibility is sobering.



## Part V: Proper Uses of a Fiscal Agent

Not all uses of the fiscal agency concept are improper or illegal if one keeps the basic principles in mind. The contribution or grant cannot be earmarked and the intermediary grantee must control, in fact, the selection of the secondary grantee organization or individual. Here are some examples of how a fiscal agency relationship might be legitimately utilized.

1. *Establishing a special project*—Instead of merely acting as a laundering agent for donor earmarked funds, the intermediary grantee could establish its own program or project to accomplish the goals of the donor. Under such circumstances it is always wise to have the governing body of the initial grantee pass a board resolution approving the new program or project. Obviously, the purpose of the program or project must be consistent with the charitable purposes of the grantee as set out in its creating documents. Grants to this project, if not earmarked for other secondary grantees will be perfectly legitimate. For example, several donors and private foundations in a particular community wish to provide seed money to a new organization established to combat teenage pregnancy. The new organization has no IRS determination letter and has not applied for charitable status. The local community foundation is approached for help. By establishing through board resolution a program or project to combat teenage pregnancy, the community foundation could accept the donations and grants for this program so long as there is no earmarking of funds by donors for the new agency and the final determination of who may be funded is completely in control of the community foundation. Suggestions from individual donors and from private foundations that express interest in this new agency would not subvert this approach so long as control remains with the community foundation.

2. *An emergency fund*—When a catastrophic illness or accident leaves a child or other person in economic hardship for medical or other expenses, direct gifts from donors to the person or child are not deductible, nor are earmarked funds to an intermediary grantee. However, if the intermediary grantee (community foun-

dation or United Way) has an established emergency fund (for loans or grants or both) roughly the same result can occur. Such an emergency fund should have general funding, written eligibility requirements applicable to the public at large, and an open process for applying. Thus, in any emergency situation, any person or family could receive funds if they were eligible and were approved in accordance with the procedures established. Members of the public concerned about the plight of a particular child or individual could make non-earmarked contributions to the general emergency fund while the child, person or family simultaneously made an application for assistance. So long as the charity that established the fund exercised control, in fact, of any funds contributed through its established process, all non-earmarked contributions should be deductible. For the donor to obtain a deduction in this event, he or she must realize that the decision to assist any individual will be made independently of any contributions made to the charity. Establishing such a fund should be undertaken with the assistance of a knowledgeable attorney.

3. *Private foundation scholarship program*—A private foundation may avoid the requirement of obtaining advance IRS approval for a scholarship or fellowship program, but only if it is willing to give up decision-making control over which student will receive the award. In matter of fact, most scholarship grantmaking by foundations is done in this manner, usually by making the grants to specific universities or colleges and letting the institution make the selection of the student.

In some instances, the decision is made by a third party (like a local school board) and the foundation simply makes the grant to the university of the student's choice.

4. *A designated or donor-advised fund*—Many community foundations, and other federated funds offer donors the option of creating designated funds which become part of their organizations. Such funds are usually endowed with the annual income granted to a charity designated by the donor *at the time of making the gift*. So long as the donor retains no control over the future selection of grantees and the community foundation or fund owns the assets and controls their management, full deductibility is available to the donor. Of course, the designated grantee must be a charitable organization.

A legitimate variation on this theme is the donor-advised fund, where the donor may from time to time offer suggestions as to how funds might be granted; under such a program, the community foundation or other funds must be totally free to reject any or all donor suggestions.

5. *Service as bookkeeper*—A common sense meaning of the term "fiscal agent" would suggest employing an intermediary agency to perform the accounting and other fiscal duties for a secondary organization whose bookkeeping practice is deficient. For example, the only reason a donor or private foundation may not wish to make a grant directly to a small, or relatively new charity, might be that the charity has a poor accounting system. Because the donor or private foundation may not wish to oversee the bookkeeping itself, it may route the funds to an intermediary charity who is willing to provide the necessary bookkeeping required. Even though the grant to the intermediary is earmarked, no problems occur so long as the secondary grantee has obtained IRS status as a public charity and is a bona fide grantee to which the donor or private foundation could have made a direct grant in

the first place. In this fiscal agent arrangement, the assets involved would appear on the balance sheet of the secondary organization, but not on the books of the intermediary fiscal agent.

In short, not all uses of fiscal agents are inappropriate. Quite the contrary, in fact, is true. A fiscal agent can be a very useful device if it is designed and handled carefully.





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