FARM COMMONS

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# Exploring Qualifications for a Nonprofit Farm

Learn about the legal requirements for forming and maintaining a 501(c)(3) nonprofit to set you and your farm up for success.

WESTERN EXTENSION RISK MANAGEMENT EDUCATION

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# Table of Contents

Getting Started 2

Four Tests to Pass on the Way to 501(c)(3) Status 3

- Test 1: Exclusive Qualifying Purpose 6
  - Practice Opportunity 9
  - Focus on Exclusivity 10
- Test 2: Commerciality Doctrine 11
- Test 3: No Private Inurement 12
- Test 4: Public Support Test 14
  - The Reality of Enforcement 15
  - Can't I use a Fiscal Sponsor Instead? 16
  - What about Farms with a For-Profit and a Nonprofit Entity? 17
  - A Few Words on State-Level Requirements 18

Moving Forward 21

# Getting Started

For farms with a specific focus on education, charitable programming, or scientific research, a nonprofit business model can enable access to grant funding and donations, among other benefits. However, deciding to form a nonprofit should be based on careful consideration, planning, and attention to legal details. If you aren't familiar with the motivations and legal limitations of forming a nonprofit, we recommend that you start by reading *Basic Considerations for Choosing a Nonprofit Farm.*

If you already read that guide and are undaunted, this resource will help you understand more nuanced legal considerations for forming a 501(c)3 nonprofit.

It's possible that, after delving further into the details, you may decide that a for-profit business is a better fit for your farm goals. Don't forget to check out our *Exploring Social Purpose Business Structures* guide for alternatives to the 501(c)(3) nonprofit.

### The word Nonprofit = 501(c)(3) charitable organization

Before we get into details, let's clarify some terminology. When folks talk about "a nonprofit organization," they usually mean an organization that has 501(c)(3) tax status granted by the IRS. Organizations with 501(c)(3) status are exempt from federal corporate tax and are able to receive tax-deductible donations. Many grants require that receiving organizations be IRS tax-exempt organizations.

This is different than "forming a nonprofit" in a legal sense. Forming a nonprofit entity is done at the state level and is considered a logistical precursor to applying for 501(c)(3) status. Forming a nonprofit entity at the state level is easy, carries few legal complications, and is addressed briefly later in this guide. For now, we are focused on what it takes to get and keep the federal IRS tax status of the 501(c)(3).

Please note that throughout this guide, when we say "a nonprofit" or "nonprofit organization," we mean an organization with 501(c)(3) charitable status with the IRS, which means the ability to accept tax-deductible donations, avoid corporate tax on profits, and receive donations from foundations that must only give to 501(c)(3) entities. As attorneys, it pains us to use a word somewhat inaccurately, but we also have to be understood. We use the same terms normal people use, even though we are attorneys!

# Four Tests to Pass on the Way to 501(c)(3) Status

The ability to accept tax-deductible donations and be eligible for many foundation and governmental grants is reserved for organizations that qualify under the 501(c)(3) section of the tax code. These organizations are considered **charities**. There are other sections of the tax code with various other classifications. For example, 501(c)(5) organizations are **farm advocacy groups**. They are tax-exempt but cannot accept tax-deductible donations.

Many farms and farm-related nonprofits seek both tax-exempt status and the ability to receive tax-deductible contributions, which is reserved only for 501(c)(3) organizations. Let's look closely at the obligations of 501(c)(3) organizations, also called charities.

To form a 501(c)(3), the entity completes and submits IRS Form 1023, "Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code" or its shorter version, IRS Form 1023-EZ. The application is designed to illustrate to the IRS whether the organization meets the obligations contained within the federal tax code for a 501(c)(3) organization. The application requires:

1. **Employer Identification Number (EIN)**. This is true whether or not the organization has employees.
2. **Paperwork demonstrating state-level incorporation (or the equivalent)**. Organizations completing the shorter Form 1023-EZ don't have to include a copy of the incorporation documents with their application, but they may be asked to provide it during the review process.
3. **Bylaws**. There are certain cases in which the bylaws can substitute for #2 above. The bylaws need certain clauses, such as those relating to conflicts of interest.
4. **Qualifying Purposes**. These must be consistent in the organizational documents, bylaws, and application and adhere to IRS rules. See below for much more information on how to pass the qualifying purpose test!
5. **Financial information**. Those filing Form 1023-EZ do NOT have to provide this information, but all others must report revenues and expenses.

## So, how long does this take?

The IRS estimates preparation time of over 100 hours for a novice preparer for Form 1023 alone. That's two and a half weeks if you do nothing else but work on the application! Many folks hire an expert to help prepare their Form 1023. This investment can help speed the process, but the expert still needs the careful attention of the founder and the initial board of directors to get everything in place. Either way, it's a significant investment of time and effort.

For a thorough, official application guide, refer to IRS Publication 557: Tax-Exempt Status for Your Organization.

Completing the application does not guarantee the organization will be granted 501(c)(3) status. Think of the application as a test. If you pass, you'll be awarded the status. However, if your application shows that your organization does not or will not meet all the obligations of a 501(c)(3) entity, you won't be granted the tax status. This is why special care must be taken to draft organizing documents that will be satisfactory for the IRS tax-exempt application. The articles of incorporation and bylaws must:

- Limit the organization's purpose to one or more exempt purposes. (See the next section for more information on this!)
- Include organizational rules that prohibit earning to inure—or accrue—to private shareholders or individuals (also discussed below).
- Prohibit political activity and limit legislative activity.
- Include a dissolution clause acceptable to the IRS.

If the IRS determines the entity has satisfied the above restrictions, they will issue a determination letter. The determination letter is what the IRS issues after a successful 501(c)(3) application. It's the evidence that the organization is a 501(c)(3), and many entities will request a copy of the letter if they need confirmation of your tax-exempt status.

Okay, so now we understand that the process of becoming a charity is quite involved and that it involves multiple separate things that we must prove to the IRS to be awarded the status. We can summarize these into four broad tests that the IRS will

consider. Note that the fourth test, the public support test, is determined after five years and on an ongoing basis. The first three tests are assessed with the application.

Here's a short overview of the four tests for tax-exempt status:

1. **Test 1: Qualifying purpose.** Every nonprofit must have a purpose that qualifies them as a 501(c)(3) organization. The allowable purposes include religious, charitable, scientific, public safety testing, literary, educational, national or amateur sports competition, or preventing cruelty to children or animals. Multiple purposes may be combined, e.g., charitable and educational.

2. **Test 2: Commerciality test.** The IRS regulates how much commercial activity a nonprofit can conduct. To be clear, nonprofits can engage in commercial activity but within a limited scope.

3. **Test 3: No private inurement.** Nonprofits may not use their assets and resources to benefit any specific individual persons. The IRS will be looking at how the organization is structured to determine if private inurement is potentially present.

4. **Test 4: Public support test.** Generally, this test focuses on identifying where the organization gets its money. If revenue is mainly from the public as a whole, the organization meets the test.

Let's explore each of these tests in detail.

### Is a nonprofit right for your farm?

That's our essential question for you! This guide is meant to help you determine if forming a nonprofit organization is the best decision for your farm. We are doing that by walking you through the legal obligations of a nonprofit organization. If you can and want to meet these obligations, then this may be the right choice for you!

It's also possible your operation can't or doesn't want to meet these obligations. Don't despair—you have other options. Consider our resource on E*xploring Social Purpose Business Structures*. Consider also our resource on doing good as a for-profit business in our resource *Basics of Food Donations and Bartering as a Farm.*

## Test 1: Exclusive Qualifying Purpose

In order to achieve 501(c)(3) status, a nonprofit must be exclusively dedicated to a qualifying purpose. This means that all the organization's activities must be in service of a qualifying purpose. Qualifying purposes include religious, charitable, scientific, public safety testing, literary, educational, national or amateur sports competitions, or preventing cruelty to children or animals. These are the only qualifying purposes.

Farms seeking 501(c)(3) status will likely have educational, scientific, religious, or charitable purposes.

### Educational Purpose

Organizations can satisfy an educational purpose when they are dedicated to producing educational materials and doing broader outreach on educational subjects. This could look like publishing papers and resources, being open to the public, and hosting tours, events, and workshops. Farms operated as part of a school program will likely be able to incorporate an educational purpose smoothly. However, simply saying that employees learn while performing farm tasks on the job would not be a qualifying educational purpose. Conducting education must be the entire purpose of the farm for a farm to meet this qualifying purpose.

Few farm-related 501(c)(3) determinations are taken to court, so we don't have access to much legal analysis of nonprofit farms' missions and visions. One farm's experience in the 1980s demonstrates how a farm can have an exclusive educational purpose. This farm was initially denied 501(c)(3) status, but they appealed. Because they did, we have insight into the legal nuances of their qualifying educational purpose in the court records.

This farm was formed to demonstrate that ecological farming techniques can:

1. Effectively restore land depleted from years of monoculture farming, and

2. Be economically viable. In their appeal, they framed their exclusive purpose as increasing awareness of their ecological farming techniques and the scientific principles behind the methods.

Since this was proven to be the farm's focus, the IRS found that they had an exclusive, qualifying educational purpose. Additional factors that worked in the farm's favor were that the farm was open to the public as educational outreach and that the farm also published articles on their agricultural and financial results. We'll refer to this farm as the Teaching Farm.

→ Watch for the farm described above to reappear when we talk about the "commerciality doctrine." This farm sold its products through standard commercial markets in order to test the theory that ecological farming techniques could still be profitable. Read about the commerciality doctrine below to understand how, in many situations, this would be fatal to a 501(c)(3) application.

## Scientific or Religious Purposes

The Teaching Farm also had a scientific purpose as part of their larger educational project. They were demonstrating ecological farming practices and exploring the impact those practices had on soil health and plant production. Some of the published educational material they produced addressed these scientific concerns.

Many social service-oriented farms are connected to or owned by religious institutions and may be dedicated to fulfilling religious purposes. Scientific and religious purposes

may be shared with charitable or educational ones. In other words, a nonprofit can have multiple purposes. At the same time, all of those purposes must qualify for tax exemption, and the organization must be entirely devoted to the qualifying purposes to secure 501(c)(3) status.

## Charitable Purpose

Another qualifying purpose a farm might pursue is the charitable purpose. What could this mean for a farm? Qualifying charitable purposes include combating poverty, alleviating discrimination, and stimulating economic development in economically depressed communities. For example, farms dedicated to providing job training and skills development in regions that suffer from a lack of opportunity might qualify as charitable. There also may be the opportunity to use farming to alleviate discrimination or to ease neighborhood relations.

Selling food that helps people live healthier lives, selling better or lower-priced produce in communities without access, or teaching people to farm so they can run their own farm business do not, on their own, qualify as a charitable purpose. The specific elements listed above are the accepted definitions of charitable purposes:

- Combating poverty,
- Alleviating discrimination, and
- Stimulating economic development in economically depressed communities.

While it is possible that selling high-quality, reasonably priced food will combat poverty, a nonprofit would need to prove that relationship in its application. It would also need to demonstrate how its operations, specifically, lead to a reduction in poverty. There is an important distinction here between market opportunities and charitable purposes. At first glance, these differences aren't always apparent.

Let's take a non-farm example: a bicycle shop sells bikes to folks so they can exercise. The bicycle is a tool that helps customers live healthier lives. Promoting health and wellness could further a charitable purpose. However, this doesn't mean the bicycle salesperson is doing charity work. Similarly, farming is generally a business. Using

market opportunities to gain business might benefit new customers in various ways, but it doesn't automatically create a qualifying purpose for a tax-exempt nonprofit organization.

To summarize, qualifying charitable purposes cannot be market opportunities dressed up in charitable clothes. The farm has to be laser-focused on discrimination, relief of poverty, or job training.

## Practice Opportunity

For each round, note which farms you think might satisfy the highlighted qualifying purpose. Our answers are below, based on our understanding of IRS regulations.

### Round 1

Which of the following organizations is likely to meet **an educational purpose?**

A. A farm dedicated to conducting crop trials for climate resilient varieties that they publish papers on available to the public

B. A farm dedicated to growing seed crops that sells seed with informational brochures on how to grow and save seeds

C. An incubator farm dedicated to teaching ten farmers a year how to set up and operate a farm business

### Round 2

Which of the following organizations would meet **a charitable purpose**?

A. A farm operating in an economically depressed area that donates all its produce to the local community

B. A farm that takes all the produce remaining unsold at the end of the market and donates it to a food shelf.

C. A farm organized for the purpose of providing workforce training for formerly incarcerated individuals

### Round 3

Which of the following organizations would meet **a scientific or religious purpose?**

A. A farm that is focused entirely on conducting crop trials for climate-resilient varieties where they publish the results in papers available to the public

B. A church-owned community garden growing food for donation to food banks

C. A farm that hosts church groups for tours and religious events periodically

Answer key

*Round 1*: A and C; *Round 2*: A and C; *Round 3*: A and B

## Focus on Exclusivity

There are two prongs to the qualifying purpose test! The nonprofit's purpose must first "qualify" as sufficient for 501(c)(3) status, but it also has to be the nonprofit's "exclusive" purpose. For example, if teaching and outreach are a side benefit of raising or selling crops and livestock, the educational purpose isn't exclusive. A qualifying tax-exempt nonprofit can make a profit **as long as the profit generation is in service of the nonprofit's qualifying purpose**. For example, the farm above was allowed to make a profit to educate the public about how ecological farming techniques can be profitable. **However, the profit motive cannot outweigh or overshadow the qualifying purpose of the organization.**

### What about political activity?

501(c)(3) nonprofits cannot engage in substantial lobbying or work to influence legislation by propaganda or direct contact with legislators. Furthermore, 501(c)(3) organizations are prohibited from participating in political campaigns either for or against any candidate for public office. This means tax-exempt organizations cannot make campaign contributions or endorse candidates.

However, 501(c)(3) organizations with a social mission regularly engage in many activities that might be considered "political" by some definitions. Political work can extend beyond electoral campaigns. The IRS has determined that a 501(c)(3) organization that advocates for social or civic changes or presents an opinion on a controversial issue intending to mold public opinion is not a barrier to its tax-exempt status.

There is a different tax-exempt designation for organizations that want to be free to participate in some political activities. 501(c)(4) social welfare organizations may make political contributions and support or oppose candidates for office, but this work still cannot become their primary activity. No limit exists on how much lobbying a 501(c)(4)

organization can do. Some organizations operate as 501(c)(3) organizations and then form affiliated 501(c)(4) organizations through which to conduct political activity.

## Test 2: Commerciality Doctrine

Achieving tax-exempt status goes beyond having an acceptable qualifying purpose. 501(c)(3) organizations have to have the correct, or qualifying, purpose, but they also cannot have the *wrong* purpose.

Substantial commercial activity undertaken solely to make a profit is prohibited for 501(c)(3) organizations. This can get confusing quickly because tax-exempt organizations can make a profit. And yes, 501(c)(3) organizations can engage in **some** commercial activity, but that activity has to have a causal relationship with the organization's qualifying purpose.

Let's back up and think about the reasoning here. 501(c)(3) organizations get benefits from the government. They can avoid paying federal corporate taxes, can accept tax-deductible contributions, and will likely get state tax benefits as well. These benefits come at a price. A big piece of the price a 501(c)(3) organization pays for those privileges is giving up the ability to compete in the free marketplace. Most farms contemplate selling the fruits (or vegetables or meat) of their labor, so this is a serious consideration.

What about a nonprofit that sells products at the farmer's market for lower prices than the other farmers at the market?

*This is likely a problem*.

**Reduced rates are seen as a competitive advantage in the marketplace, so an organization doing this would be considered to be competing in the marketplace.** This competition would be quite unfair as well, assuming the farm received donations and/or grants for their business. Other farmers in the marketplace have to invest into their businesses and won't be able to compete if another farm is undercutting their prices. However, price isn't the only factor that would be considered

when trying to determine if a 501(c)(3) farm is being 'overly commercial.' The IRS would also be interested in whether the farm was participating in the market in other ways—by advertising, for example. Nonprofits offering their products at truly nominal rates may be able to sell on the market without violating their tax-exempt status IF they do not advertise and sales directly serve their qualifying purpose.

*Dumaine Farms*, the Teaching Farm described earlier, is a classic example of being able to walk the fine line of commerciality in a 501(c)(3) setting. *Dumaine*'s purpose was to demonstrate that farms could adopt ecological practices and be commercially viable. Since commerciality was a key component of the farm's qualifying purpose, they were allowed to sell their products on the open market like any other farm. In order to achieve their purpose, they had to collect data on whether their ecological farm could be commercially successful, and the only way to do that was to participate in commercial activity. That is a small needle to thread and a difficult mission and vision to replicate.

Most farms seeking 501(c)(3) status will not be able to engage in substantial commercial activity and be awarded a positive determination letter from the IRS.

## Test 3: No Private Inurement

**The operations, assets, and resources of a nonprofit *cannot* be used for or paid out to a specific person, particularly an insider, like a founder or key employee.** If this happens, it's called "private inurement," and it can jeopardize an organization's 501(c)(3) status. When the life of the organization comes to an end, the assets of a nonprofit must be distributed to another nonprofit organization. Even when the nonprofit ceases to exist, its earnings and assets are not available for any one person associated with the organization!

The rule against private inurement is also associated with keeping salary levels reasonable for nonprofit employees. Charitable organizations can provide reasonable compensation to their employees. However, the IRS may scrutinize how those salaries are determined. Salaries *cannot* appear to be a mechanism for distributing profits to get around the private inurement rule. If salaries are high in a nonprofit as compared to

other comparable positions, this may trigger an inquiry into the nonprofit's practices around private inurement. Nonprofit organizations have to disclose how they determine their salaries and the amount of compensation paid to employees on their tax returns. Violations of the rule against private inurement give the IRS the right to revoke an organization's tax-exempt status. They also have the power to impose a tax on the "improper" benefits received.

A different but related rule governs private benefits: **the nonprofit cannot operate to benefit a specific person(s)**. This means a person cannot start a community garden nonprofit organization just so they can have a place for their own private garden. Neither can nonprofits host fundraisers for one single individual.

## Farmer Pat's Retirement Plan

Farmer Pat has worked for 30 years for a nonprofit farm and does amazing work. However, Pat never made enough in wages to save for retirement, so as that time nears, she is getting concerned about how to fund her later years. In thinking about all she's done for the community, she starts to think of ways she could now help herself and how the community could step in for her in this time of need.

She prepares a proposal for the board of directors. She asks if the board would be willing to do any of the following:

- Give her some of the land with a small home on the property. She'd have a place to stay and the possibility of financing.
- Sell a portion of the land on the market and give her funds as a lifetime bonus.
- If none of the above, then simply hold a fundraiser and give her the money donated at the event.

## What might the board do?

Unfortunately, even if the board agrees that Farmer Pat is more than deserving of these things, their hands will be tied. Any of these options would likely be considered private inurement and would thus be prohibited. Granting Farmer Pat any of these things will put the organization's tax-exempt status at risk.

These rules make sense. For example, we don't want organizations taking grant funds and donations only to use them to support a single individual. When donors give, they don't necessarily expect to fund someone's retirement. The result can be difficult, though, and can have a disproportionate impact on BIPOC farmers who want to pursue

social purposes but also need to build wealth. When our culture has such a disproportionate wealth distribution (the Federal Reserve Board reports that white households have eight times the wealth of Black households and five times the wealth of Latinx ones), any barrier to wealth building should be viewed through a critical lens.

## Test 4: Public Support Test

A 501(c)(3) organization must also pass the public support test. This test is designed to separate private foundations from public entities. Most organizations would like to be public entities since they enjoy fewer restrictions and greater tax benefits.

Generally, this test focuses on identifying where the organization gets its money. If revenue is largely from the public as a whole, the organization meets the test.

Organizations can pass the public support test in two ways. Both tests are measured over a five-year period:

- First, if an organization receives a substantial part (more than one-third) of its total income from government grants, grants from other charities, donations from the public, membership fees, and mission-related revenue, it passes part of the first test. However, if more than 2% of the organization's total support comes from a single individual, that portion should be excluded from the one-third calculation.

If an organization fails this test, it may try for the second option: the "facts and circumstances" test, which it has two ways to pass:

- First, the organization's percentage of income from public sources may be as low as ten percent if other circumstances, such as the makeup of the board of directors, its programming, and its accessibility to the public all demonstrate that it is a public entity.
- The second way to pass the fact and circumstances test is different. Two elements must be met. The organization must receive more than one-third of its support in contributions from the general public or from sales directly related to tax-exempt purposes. Then, the organization must also receive no more than

one-third of its support from investment income and sales from purposes unrelated to its tax-exempt purpose.

These tests can be difficult and complex, especially for organizations that don't yet know where their support will come from. Farms going down this path should seek information from the IRS and from organizations that support nonprofit entities.

## The Reality of Enforcement

Did you read the information about these tests and feel suspicious? That's a common reaction. We can all likely name several functioning nonprofits offhand that wouldn't pass these tests if asked to do so right now. How can we square what we see in nonprofits with what the law says about what is 'required'?

Essentially, we live in a world where enforcement is a matter of prioritizing effort and resources. And in the realm of tax-exempt status, the world can appear to be full of noncompliance. The law sets the standard, but that standard is certainly breached more often than the law can keep up with. The truth is, though, that any business that doesn't comply with the law is at risk.

Why is there a disconnect between reality and the letter of the law? First, it is very common for nonprofits to drift from their original mission and purpose. This can happen for a variety of reasons: new funding opportunities, changes in leadership, and new social or cultural developments. The IRS has the most contact with a nonprofit at the initial 501(c)(3) application stage. After the initial application is approved, there is little enforcement of things like qualifying purposes, the commerciality doctrine, and the public support test. There also is not a clear way to report noncompliance.

This scenario puts the compliance burden on the folks applying for 501(c)(3) status. Organizations applying for tax-exempt status have the most scrutiny, and they often cannot fully start work or get fully funded until they have the tax-exempt status that will open up new revenue opportunities. It is difficult for a novice to successfully complete the 501(c)(3) application and find the correct, magic-seeming words to include to get the coveted determination letter. It can feel unfair that the bulk of the

regulatory inspection takes place at this early, vulnerable stage of an organization. This is often when the organization will be as close to its original mission and purpose as it will ever be. Though the reality of enforcement makes this true—that most nonprofits do not face enforcement beyond this stage—nonprofits that fall out of line with IRS regulations are at risk, no matter when the noncompliance happens in the life of the nonprofit.

## Can't I use a Fiscal Sponsor Instead?

Some organizations might be fully aligned with the nonprofit structure but are still discouraged by the complications of incorporation or pursuing 501(c)(3) status. Wanting to focus on their charitable work, these organizations may not want to expend energy on pursuing formal legal status. For organizations such as these, fiscal sponsorship might be a good option.

Fiscal sponsorship does not require an enabling statute, registering or incorporating with the state, or applying for 501(c)(3) status. Rather, this alternative is simply a contractual relationship between the sponsored organization and an already established, independent 501(c)(3) nonprofit corporation. Organizations wanting the benefits of tax-advantaged funding can seek the support of an organization with whom they share a purpose and goals.

The 'sponsoring' organization essentially lets the smaller organization or project borrow its 501(c)(3) status. Some fiscal sponsors only provide the service of administering and controlling charitable contributions on behalf of the sponsored organization. Other fiscal sponsors will be more involved, providing other overhead support for the sponsored organization. Frequently, fiscal sponsors will require a fee paid to them for their sponsorship. Often, this will be a percentage of the budget of the sponsored organization.

A fiscal sponsorship's main benefit is that the sponsored organization can apply for grants reserved for 501(c)(3) organizations and solicit tax-deductible donations without having to complete the IRS tax-exempt status applications themselves. The sponsored organization may not have to recruit its own board of directors or management team

but may have to comply with some administrative requests from the sponsoring organization.

**The same rules apply to fiscally sponsored programs!**

Having a fiscal sponsor only alleviates the burden of applying for nonprofit status yourself, but it does not remove the requirements of having a qualifying purpose and being limited in what commercial activity the organization undertakes. The sponsored organization must act as a 501(c)(3), even though it isn't officially one. A sponsored organization not following the 501(c)(3) rules would put the sponsoring organization's tax-exempt status at risk.

Beyond aligning with the sponsoring organization, the sponsored organization must have its own qualifying purpose of religious, charitable, scientific, public safety testing, literary, educational, national or amateur sports competitions, or preventing cruelty to children or animals. Farms seeking fiscal sponsorship will likely fall into either the educational, scientific, religious, or charitable purpose camps. If the farm does not have a qualifying purpose, the sponsoring organization cannot engage in supporting the activity.

Sponsored organizations must also follow the commerciality doctrine limitations on competing in the marketplace. This means that a sponsored organization can provide services or sell goods, but this activity has to be substantially related to the sponsored organization's purpose. Do the sales further the purpose? Sales that are made to fund the organization's purpose without more of a connection are not sufficiently related.

## What about Farms with a For-Profit and a Nonprofit Entity?

When a farm has some aspects of the operation that are commercial and other aspects that are charitable, it sometimes makes sense to operate as two entities: one for-profit and one nonprofit. For example, the farm production and sales could be structured as an LLC with no limit on its commercial activities. This part of the business could conduct the farm production and sell the product competitively on the open market.

Then, the farmer could form a separate nonprofit to house the social benefit purpose. For example, the nonprofit could have the purpose of providing low-cost or free food distribution in low-income communities that don't have access to fresh, local food. The for-profit entity could donate a product to the nonprofit, and the nonprofit could give the product to food shelves. Alternatively, the farm may have substantial educational activities, such as teaching youths and young adults about agricultural careers. These activities could be housed in a separate nonprofit that can earn donations and grant support for its educational activities without threatening the commerciality of the production operation.

These two entities must be kept at arm's length! The two entities must have clear distinctions between them, and activities between the two cannot create a conflict of interest. For example, the nonprofit can source their food from the LLC portion of the business but couldn't go so far as overpaying for vegetables because the LLC is in a tough financial spot. In order to avoid the appearance of such things, there needs to be strong justifications for the business dealings between the two arms of the business and clear documentation. For example, the nonprofit should also seek to source food from other for-profit farms in the area as needed. Questions about conflicts of interest can also arise in situations if the same person is directing the nonprofit and directing the LLC. Again, the two entities would need clear policies and documentation between them to avoid conflicts. The additional administrative burden of duplicating efforts and having to work to keep the distinctions between the two entities clear might not be worth the benefits.

## A Few Words on State-Level Requirements

This section doesn't have much to do with the legal obligations of nonprofit organizations at the state or federal level. Rather, it discusses an important and sometimes misunderstood element of nonprofit organizations. In addition to receiving tax-exempt and charitable status from the IRS, most nonprofits are organized as corporations at the state level. Folks take the step of incorporating at the state level because it offers specific legal advantages.

Incorporating an entity with a state gives the benefit of personal liability protection. By incorporating, the entity will be legally recognized as a separate, stand-alone entity distinct from the individual who created it. This is not true when, for example, a person runs a business as a sole proprietor. A sole proprietor has no legal separation between themselves and their business. However, when a farmer incorporates as a formal business entity with the state, they secure this separation. With this separation comes the benefit of personal liability protection, which is desirable for protecting personal assets (land, second house, cash, investments, etc.) from any business liabilities that might arise.

It's possible to operate an unincorporated nonprofit association (UNA), which can happen without knowing that is what you are doing. How? When a group of people gather to undertake an activity for mutual or public benefit that is not meant to generate a profit, they form a UNA. It's as simple as that! A UNA may comprise as few as 2 people, although some states require 3 people to participate before the group will be deemed a UNA.

The beauty of this arrangement is that it is simple. There is no paperwork, filing requirements, or dictates that the organization have a board of directors. However, most associations that form this way only do so on a short-term basis. The reasons for this include:

- Unincorporated entities don't get the benefit of personal liability protection.
- Bylaws are required once a group wants to apply for IRS tax-exempt status. If a group of people takes the trouble to create bylaws for the IRS tax-exempt application, usually it makes sense to use that same work and organization to incorporate at the state level.
- If revenue exceeds $5,000, the IRS requires the UNA to file for tax-exempt recognition.
- Once UNAs grow, so do their potential liabilities and income. More revenue might trigger the need to file with the IRS, and more liabilities will trigger the desire for personal liability protection.
- Some states, like Washington, require almost all nonprofit organizations to register with the state. So be sure to check state laws to determine when and if you must incorporate.

## Why would a farmer want personal liability protection?

Imagine the neighborhood orchard group hosts a volunteer work day where a volunteer cuts themself while pruning an apple tree. Suppose there are substantial medical bills resulting from this injury (an ER visit and stitches). In that case, either the volunteer or the volunteer's health insurance company may sue the nonprofit seeking payment for the costs of the injury. If the nonprofit is legally incorporated, only its assets—bank account, property, etc.—could be used to pay if a court decides the nonprofit is at fault. But, if the nonprofit were not incorporated, the people who manage and work for it would be at risk of their personal assets being used to pay any outstanding judgment against the nonprofit. Most farmers incorporate their businesses to avoid this type of personal liability. **As incorporated entities, business liabilities are the company's responsibility, and judgments can only be satisfied from a business's assets.**

All 50 states have statutes that define how a nonprofit corporation is formed. Some states use the phrase "nonstock corporation" rather than "nonprofit corporation." This phrase is perhaps the most accurate as it illustrates the fundamental distinction between a nonprofit and a for-profit entity at the state level. It's not about profit since a nonprofit CAN generate profit. However, what a nonprofit CANNOT do is create stock. **No one can own a nonprofit organization.** It cannot be sold, and its assets cannot be used for the benefit of one or a group of private individuals.

The process for forming a nonstock or nonprofit corporation is similar in each state. Incorporation is handled through the secretary of state's office (or your state's equivalent). Once a nonprofit is incorporated, the entity no longer belongs to or is one with the incorporators. It is now its own distinct entity. It can sue folks or be sued. It can own property. All assets, like money, need to be kept separately from any involved individual's personal assets. This means the nonprofit will need its own bank account and accounting system. There are corporate requirements for how nonprofits operate (subject to the board-adopted bylaws). Records of activities and decisions must be kept, and you are required to submit an annual report every year on the anniversary of incorporation.

### Why Incorporate?

When a farm primarily grows food for donation to the community, they generally rely on donations to fund this work. The decision to incorporate has a bearing on whether monetary donations will be tax exempt or not.

***Do you want tax exempt status and the ability to accept tax-deductible donations?***

- **If you do, then you have much to gain by incorporating,** as it will make your ability to receive and account for monetary donations much easier while freeing you from corporate tax.
- **If not, then it may be that you'd prefer to be a for-profit farm**. In that case, incorporating with your state as a limited liability company (LLC) or corporation can still provide you with the benefit of personal liability protection. Read our guide, *Farm Business Structure Basics*, for help choosing a business structure.
- Alternatively, you may not be interested in tax-exempt status at this time. You aren't receiving monetary donations, and you aren't growing or donating enough farm product to substantiate forming a separate entity to house that operation. In that case, you can continue doing what you're doing with the knowledge that there may come a time when incorporation will help your social benefit farm to expand.

# Moving Forward

Forming a 501(c)3 nonprofit entity will work for some socially-minded farms, but not all. Some organizations learn the requirements to achieve nonprofit or 501(c)(3) status and grow discouraged, understandably.

Take a moment to consider how your vision for your farm operation aligns with the IRS's rules for gaining 501(c)(3) status by filling in the following table. Identify points of strength and weakness in terms of your farm's ability to meet the various tests.

| Factor | Strengths in alignment | Weaknesses in alignment |
|---|---|---|
| Test 1: Qualifying Purpose. Does your vision for your farm match an IRS qualifying purpose? Is it exclusive? | | |
| Test 2: Commerciality Test. Does your vision for your farm include commerciality that would offend this test? | | |
| Test 3: Private inurement. Is the prohibition on private inurement a complication in terms of who and how you want the community (and yourself) to benefit? | | |
| Test 4: Public Support. Do your envisioned revenue sources support this test? | | |
| Also, check the *Basic Considerations for Choosing a Nonprofit* guide to review your comfortability with governance and wealth-building challenges as well as insurance, financing, and zoning challenges on nonprofit farms. | | |

How are things looking?

Do you have more strengths or more weaknesses?

Are the weaknesses things that can be mitigated?

Can your strengths be further reinforced?

## Where is your gut taking you? Is a nonprofit a good idea?

If it is, take a look at IRS Publication 557: Tax-Exempt Status for Your Organization for robust information on how to apply for tax-exempt status.

If a nonprofit entity offers a clear path to success for your farm, consider forming a new nonprofit (or both a non- and for-profit) or seeking fiscal sponsorship. However, if a nonprofit is feeling like an uphill struggle, don't despair. The good news is there are other options for organizations that want things the tax-exempt nonprofit structure cannot give. You have other options.

Read *Exploring Social Purpose Business Structures* to learn about popular alternatives for social benefit farms, including:

- Benefit corporations
- B-Corporation certification
- Low-Profit Limited Liability Companies (L3Cs)

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