

# Legal Structures, the Charitable Tax Exemption and Operational Concerns with Food Hubs

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Rural communities across the United States face significant, long-term economic challenges. Structural adjustments to food production along with shifts in manufacturing, eroding tax-base, wide-spread depopulation and unmet infrastructure needs have reshaped the rural United States over a period of more than five decades.

Recently, economic development professionals and community leaders have begun work to create new relationships between producers and consumers in part to respond to the need for targeted economic advancement in rural communities.



*“Skyrocketing consumer demand for local and regional food is an economic opportunity for America's farmers and ranchers. Food hubs facilitate access to these markets by offering critical aggregation, marketing, distribution and other services to farmers and ranchers. By serving as a link between the farm or ranch and regional buyers, food hubs keep more of the retail food dollar circulating in the local economy. In effect, the success of regional food hubs comes from entrepreneurship, sound business sense and a desire for social impact.”*

— USDA Secretary Tom Vilsack, May 2013

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# The Foodhub Model of Economic Development



- Food is playing an increasing role in economic development efforts. Consumer demand for “local food” has rapidly increased since 2003.
- The positive impact of this approach is due to the breadth of activities that make up a “food system” and ability to connect producers and consumers through shared values.
- The range of activities within a food system is incredibly broad, including local and worldwide activities and businesses along with micro-farms.



- Community economic development advocates are promoting food-based economic development projects for the promise such projects have to promote CED.
  - Food based economic development projects also provide ready community building mechanisms.
  - New consumer interest in local foods and broader public awareness of food systems have combined to create meaningful opportunities for community economic development in low-wealth, rural communities.
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The term “foodhub” captures a wide range of activities, including the aggregation, distribution, marketing of food along with related services that may include value added activities such as canning and processing. Regardless of the discrete activity, food based economic development projects generally focus on two primary goals: marketing food using a shared brand or affiliation among producers and production activities in shared facilities. The operations that surround and enable these goals create a range of issues both legal and operational.



## **Legal questions include:**

- Best strategies for protecting intellectual property – brands are valuable because they are connected to producers as source identifiers. As such, it is important that the brand be protected from unauthorized use.
  - Effective methods for distributing profit – for most food hubs, profits are not distributed based on equity ownership. Alternatives are needed.
  - Management and governance – food hub managers require very specialized knowledge, not only of production but also of markets and consumer needs. Food hubs also require significant producer support and therefore must be governed in a manner that allows for producers input and direction.
  - Land Use Regulation Compliance – facilities must comply with local zoning and other use regulation.
  - FDA/USDA Regulation Compliance – food handling facilities are required to meet FDA/USDA regulations, some of which may be very stringent.
  - Tax Exemption – depending on the source of funding for the food hub, the organization may need to obtain tax exempt recognition under IRC 501(c)(3), which brings with it a higher level of complexity.
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## **Operational issues can similarly be cataloged, and include:**

- Location –
  - Facility Logistics –
  - Transportation –
  - Spoilage –
  - Returned or refused produce –
  - Loss mitigation –
  - Accounting and Profit Distribution –
  - Staffing –
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Aggregation and marketing programs assemble the production from multiple producers and then grade, clean and distribute produce or other agricultural products under a common brand or label.

By aggregating produce, foodhubs achieve efficiencies of scale and enable individual producers to sell into larger markets, including markets where centralized purchasing requires large production volume.

In addition to increased efficiencies, such projects also allow for coordinated marketing efforts that leverage the unique stories and relationships among the producers or the region.

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Marketing and aggregation projects require a centrally positioned organization, which may be a standalone company or corporation or may operate as a part of a larger organization, such as an economic development office.

Functionally, the central organization serves to create the relationships between producers that are needed to coordinate production, and then to market the agricultural products to a broader group of consumers.

These tasks include: identifying the producers who will participate in the program; defining a marketing strategy; in some cases fulfilling orders; arranging for transportation; and setting production standards.

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Common elements may be found among successful marketing and aggregation projects.

First, there must be a common affinity among participants. Most often this commonality is based on geographic location or production standards. The affinity allows for a shared interest among producers that allows for a common marketing approach.

Second, the project must have a way of assuring consistent quality and quantity from the participating producers. Production standards reflect great value and, as such, the time and effort required to develop appropriate standards.

Third, the project must have a shared sense of benefit and risk.

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Marketing and aggregation projects can be operated in a number of corporate forms and in a manner that complies with IRC 501(c)(3) if the activities comply with the organizational and operational tests under the section.

These projects may be organized as either for-profit or non-profit entities, as a stock corporation or as a true producers cooperative.

Ultimately, the seemingly commercial, for-profit character of such efforts are not necessarily non-exempt.

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Once the food is graded and aggregated, the food hub serves as a distributor. Distribution can be accomplished in several ways. In some cases the hub will directly distribute the food to consumers, restaurants, markets and groceries. In other cases the hub will work with larger distributors and wholesalers. The range of relationships and roles is fairly broad. As food hubs move into distribution, they encounter several challenges, including adequacy of storage, payment mechanisms, transportation costs, and risk management.





- Food hubs may also work to create new markets for local or regional producers through efforts that build relationships between local producers and consumers. In many instances, such efforts also include a mechanism to provide food to consumers with limited incomes.
  - The range of such projects is, again, fairly broad, but in most models an intermediary organization, working between consumers and producers, works to establish new local market outlets for producers. Farmer's markets serve as a good example of such projects.
    - Farmers markets are typically held on land owned by an organization or entity that then rents space to producers, manages the and promotes the market through advertising.
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The activity of food hubs also includes value added processing.

Value added processing centers enable producers to process raw agricultural products into a value added product that can then be sold to consumers or other processors.

By processing food locally, producers can retain more of the profits to be made from the food and local economies can benefit from job creation as well as the additional inputs that may be required as part of the processing.

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Examples of value added processing centers cover a broad range of nonprofit and for profit endeavors.

A common example that works well for rural economic development efforts is the shared production facility.

In this model, the center is owned by a government or nonprofit organization that rents the facility, on a daily or hourly basis, to producers who process and package value added products for the market. The nonprofit sets rent rates based on the costs of operating the facility, and in many cases rent rates are subsidized by grant support.

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# Legal and Operational Considerations When Establishing Food-system Economic Development Projects



As food hub managers and economic development offices begin to develop and launch new food hubs, they should be aware of the following considerations.

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1. The need to develop and protect intellectual property – Brands are valuable because they are recognized by consumers as source identifiers.

It is important that the brand be protected from unauthorized use and maintained. One method for protecting the brand from unauthorized use or dilution is to register the marks or marks that are developed and used with the food hub. Registration provides the mark holder with the right to get a court order, along with damages and attorneys fees, that will exclude others from using the mark. Closely related to decision on whether to register is the question of who will own the mark once registered. In most instances it is best for the mark to be owned by the corporation that operates the foodhub and not by an individual.

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2. Developing an effective and appropriate method for distributing profit or income. Food hubs will generate income and, in some instances, profits. A decision will need to be made regarding how profit will be distributed or how income will be used absent a profit. In for profit food hubs profits may be distributed based on ownership percentages or based on participation, similar to a cooperative. Profits may not be distributed in a nonprofit structure, but the foodhub will nevertheless need income and decisions will need to be made on how this income will be allocated. In most cases, the decision on how profit or income will be allocated will be made based on how the food hub will be capitalized at start-up.

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3. Management and governance – The corporation is an excellent form for separating management from governance. Due to the sophisticated nature of the food hub, managers are needed who possess very specialized knowledge, not only of production but also of markets and consumer needs. At the same time, food hubs require significant producer support to succeed. Without producer support food hubs can not coordinate production or distribution needed to succeed. Consequently, the food hub requires a structure that allows for producers input and direction while also allowing for appropriate management.

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4. Zoning and Land Use Regulation – Local zoning and planning regulations most often regulate the location of commercial land uses, including aggregation and distribution facilities that are not directly connected to a farm. As organizers plan to launch a new food hub enterprise, the effect of zoning regulations should be integrated into the planning and site selection.

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5. Tax Exemption – depending on the source of funding for the food hub, the organization may need to obtain tax exempt recognition under IRC 501(c)(3), which brings with it a higher level of complexity.

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The food hub may be organized in several different ways.

The following grid outlines the options and distinguishing factors of each:

	Organization	Ownership	Profit Distribution	Governance	Activities	Tax Treatment
<b>For-profit Corporation</b>	Filing of Articles with State	Owned by shareholder	Profits Distributed based on ownership	Board of Directors	Any lawful activity	Taxed at shareholder level – Subchapter S
<b>For-profit LLC</b>	Filing of Articles with State	Owned by Members	Profits distributed based on agreement of members	Members; Managers; Board of Directors	Any lawful activity	Taxed at member level – as a partnership
<b>Producers Marketing Cooperative</b>	Organized by filing Articles of Association	Majority owned by producers	Distribution based on 'patronage'	Governed by members through election	Restricted to marketing products from members	Tax exempt [members taxed]
<b>Nonprofit 501(c)(3) Corporation</b>	Organized by filing Articles of Incorporation	Not owned	No profits	Board of Directors	Only tax exempt purposes	Not taxed
<b>Nonprofit LLC</b>	Articles of Organization	Must be owned by 501(c)(3)	Profits, if any, go to 501(c)(3)	Appointed by the 501(c)(3)	Only activities related to exempt purpose	Taxed on unrelated income

- Food hubs often require some subsidy during the start up phase. For many projects, this subsidy is found through the charitable exemption for 501(c)(3) activities.
  - Organizations that are recognized as exempt under IRC 501(c)(3) received highly favorable tax-treatment at both the federal and state levels.
  - Most food-based economic development projects will base a claim to this exemption on the charitable nature of the activity.
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## “Charitable” defined as:

“...relief of the poor and distressed or the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments or works; lessening the burdens of government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lesson neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.”

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With an emphasis on economic advancement for low-wealth farmers, education on issues related to healthy food systems and sustainability, the types of food based economic development projects described here seem aligned with charitable organizations under 501(c)(3). Given such activities, food-based economic development projects may satisfy 501(c)(3) as charitable activities that “lessen the burden of government.”



Establishing the presence of an actual government burden, that therefore satisfies the first prong of the test, requires that there be an “objective manifestation” that the government considers the activity to be its burden. The applicant must show an “objective manifestation that the governmental unit considers the activity in question to be its burden. What is required is more than the mere fact that such activities might improve the general economic well-being of the Nation or a State or reduce any adverse impact from the failure of Government to carry out such activities is not enough. What must be shown is the organization’s activities are activities that a governmental unit considers to be its burdens, and whether such activities actually ‘lessen’ such governmental role in addressing those burdens.

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The second part of the test requires a showing that the activity actually lessens the burdens of government. Whether or not an activity actually lessens the burden of government is determined under a facts and circumstances test. Facts and circumstances showing a favorable working relationship between a charitable organization and a governmental unit may be strong evidence that the activity lessens the burden of government and a significant factor to consider when determining whether the activity is charitable. So too circumstances showing that an organization engaged in activities that would otherwise be pursued by the governmental unit.

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Under 501(c)(3), the term “charitable” includes relief of the poor and promotion of social welfare. A nonprofit organization’s charitable purpose is abundantly clear when it provides benefits directly to members of a charitable class, including the poor or underprivileged. When, however, an organization benefits a class indirectly, for example by improving a community through advancement of social or economic conditions, whether or not the organization deserves exemption recognition will depend on if the activity furthers a charitable purpose. Food based economic development projects accomplish their goals by assisting individual farmers, small food producers and related business owners who are not themselves members of any charitable class. How then does an organization operating such a project qualify for recognition as a tax-exempt entity under IRC 501(c)(3)?

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Providing assistance to individuals or companies engaged in for-profit activity may, under some circumstances, further charitable goals. Such goals may include stemming community deterioration, relief of the poor, addressing racial inequality and enabling economic advancement for classes of people who have been discriminated against. When assistance to private companies or individuals further such charitable goals, organizations may be recognized as exempt under IRC 501(c).

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Economic development corporations may be classified under various sections of the tax code, include 501(c)(4), 501(c)(6) and 501(c)(12) but the classification that is of most relevance to such efforts in many cases is that as a charitable organization under 501(c)(3).

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The traditional business incubator follows a strategy of promoting economic development in a defined community by providing a range of technical assistance and other supports to start-up or growth businesses in that community. Supports include office space, production space, back office services and marketing effort. Technical assistance can include business consulting, IT support and assistance with business law matters. Business incubators are funded through donations, grants from government and private sources and fees paid by the businesses that receive assistance.

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The business incubator analysis applies to rural food based economic development efforts if the following factors are established by the organization:

- The organization target assistance to an economically depressed or blighted area;
  - The activities benefit a disadvantaged group, such as minorities, the unemployed or underemployed,
  - The activities aid businesses that have actually experienced difficulty in obtaining conventional financing
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The prohibition against private benefit is fairly clear, an organization will not be recognized as exempt under IRC 501(c)(3) unless it serves a public rather than a private interest:

- An organization is not organized or operated exclusively for one or more of the purposes specified in \* \* \* [section 501(c)(3) unless it serves a public rather than a private interest. Thus, \* \* \* it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.
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Organizations recognized as exempt under IRC 501(c)(3) must establish that they operate “exclusively” for tax-exempt purposes. Many charitable activities, however, may be pursued for both exempt and non-exempt purposes. When considering these activities, the IRS and the Courts have to decide whether the activity is, in fact, being pursued for exempt purposes or, instead, is merely a for-profit activity attempting to be disguised.



The Commerciality Doctrine measures how closely the activities align with a profit motive as compared to a charitable motive. “[T]he particular manner in which an organization’s activities are conducted, the commercial hue of those activities, and the existence and amount of annual accumulated profits” are all relevant when assessing the motive behind an activity.

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The scale of the activities also matters. An incidental non-exempt purpose will not disqualify an organization but even a single non-exempt purpose or activity will if that activity is substantial, regardless of the number of other exempt purposes. Whether an organization's non-exempt activities arise to the level of being substantial is determined based on the purpose toward which the organization's activities are directed. If the activity bears a nexus to and furthers the organization's exempt purpose, then the activity will not impact the exemption. On the other hand, substantial activities that do not further the exempt purpose will result in the exemption being lost.

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It is possible, and usually unavoidable, to structure operations within food based economic development projects to comply with the limitations on commercial activity. While many projects involve the sale of food to the general public, projects often integrate below cost programs into their efforts.

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# Conclusion

