Tax Planning for Marijuana Dealers

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ABSTRACT: In recent years, many states have legalized marijuana while the federal government has not. But marijuana industry insiders consider not federal criminal law but federal tax law to be the biggest impediment to the development of a legitimate marijuana industry. State-sanctioned marijuana sellers are required to pay federal income taxes pursuant to I.R.C. § 280E, a formerly largely symbolic provision that Congress enacted to punish drug dealers, but which now could potentially drive legitimate marijuana sellers underground.

This Article proposes a tax strategy that enables state-sanctioned marijuana sellers to avoid the impact of § 280E by qualifying as a tax-exempt organization. The IRS has already stated that a marijuana seller cannot be exempt under I.R.C. § 501(c)(3) because the so-called "public policy doctrine" does not permit a charity to have purposes that are contrary to law. This Article proposes for the first time that the public policy doctrine does not apply to § 501(c)(4) organizations, which opens the door for marijuana sellers to qualify as tax-exempt. The organization would have to be operated to improve the social and economic conditions of a neighborhood blighted by crime or poverty by providing job training, employment opportunities, and improved business conditions for commercial development in the neighborhood, just like many existing community economic development corporations that run businesses.

This novel argument is more than just a "tax loophole" to avoid the impact of § 280E. Rather, IRS recognition of tax-exempt status for marijuana sellers could actually provide a mechanism to resolve the federalism issues raised by the conflict between state and federal marijuana laws. A federal policy that incentivizes marijuana sellers to be nonprofit, neighborhood-based organizations in effect ties federal approval to local support.

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INTRODUCTION

In the past decade and a half, twenty states and the District of Columbia have legalized medical marijuana.[1] Last November, Colorado[2] and Washington[3] became the first states to legalize the sale and use of recreational marijuana, and more states are considering following their lead.[4] The trend appears to be toward liberalization of state marijuana laws not just for medical purposes, but to advance a number of other state policy goals, including reducing crime, improving blighted neighborhoods, giving opportunities to youth impacted by the drug trade, increasing marijuana users' safety, and raising state and local government revenue.[5]

Currently, federal laws prevent states from achieving their policy objectives. Legal scholars have focused on the conflict created by the fact that selling marijuana is a federal crime.[6] But, marijuana industry insiders do not cite federal criminal law as the biggest impediment to the development of a legitimate marijuana industry. Instead, the marijuana industry's lead trade publication reports that "[t]he federal *tax* situation is the biggest threat to [state-sanctioned marijuana] businesses and could push the entire industry underground."[7] To date, very little scholarly attention has been

1. *See 20 Legal Medical Marijuana States and DC: Laws, Fees, and Possession Limits*, PROCON, http://medicalmarijuana.procon.org/view.resource.php?resourceID=000881 (last updated Sept. 16, 2013, 11:41 AM) (describing the laws pertaining to medical marijuana in Alaska, Arizona, California, Colorado, Connecticut, DC, Delaware, Hawaii, Illinois, Maine, Massachusetts, Michigan, Montana, Nevada, New Hampshire, New Jersey, New Mexico, Oregon, Rhode Island, Vermont, and Washington).

2. *See* COLO. CONST. art. XVIII, § 16.

3. *See* WASH. INITIATIVE MEASURE No. 502 (July 8, 2011).

4. *See* Paul Szoldra, *The Next 8 States That Could Legalize Marijuana*, BUS. INSIDER (Mar. 23, 2013, 2:00 PM), http://www.businessinsider.com/legalize-marijuana-2013-3?op=1 (suggesting that Rhode Island, Vermont, Massachusetts, Maryland, Nevada, Maine, Oregon, and Pennsylvania may legalize marijuana for recreational purposes in the near future).

5. *See, e.g.*, LEGISLATIVE COUNCIL OF THE COLO. GEN. ASSEMBLY, RESEARCH PUBL'N NO. 614, 2012 STATE BALLOT INFORMATION BOOKLET AND RECOMMENDATIONS ON RETENTION OF JUDGES 7 (2012) [hereinafter COLORADO VOTER GUIDE], *available at* http://www.colorado.gov/cs/Satellite?blobcol=urldata&blobheader=application/pdf&blobkey=id&blobtable=MungoBlobs&blobwhere=1251822971738&ssbinary=true; OFFICE OF THE SEC'Y OF STATE, STATE OF WASHINGTON VOTERS' PAMPHLET 31 (2012) [hereinafter WASHINGTON VOTER GUIDE], *available at* https://wei.sos.wa.gov/agency/osos/en/press_and_research/PreviousElections/2012/General-Election/Documents/22-%20Stevens.pdf.

6. *See, e.g.*, Sam Kamin, *Medical Marijuana in Colorado and the Future of Marijuana Regulation in the United States*, 43 MCGEORGE L. REV. 147, 152–53 (2012); Robert A. Mikos, *On the Limits of Federal Supremacy: When States Relax (or Abandon) Marijuana Bans*, 714 CATO INST.: POL'Y ANALYSIS, Dec. 2012, at 1 (presenting an updated and revised version of Robert A. Mikos, *On the Limits of Supremacy: Medical Marijuana and the States' Overlooked Power to Legalize Federal Crime*, 62 VAND. L. REV. 1421 (2009)).

7. *Marijuana Business Conference Wrapup: 36 Tips, Lessons & Takeaways for the Cannabis Industry*, MED. MARIJUANA BUS. DAILY (Nov. 15, 2012), http://mmjbusinessdaily.com/marijuana-business-conference-wrapup-36-tips-lessons-take-aways-for-the-cannabis-industry/ [hereinafter *36 Tips*] (emphasis added).

paid to the federal tax situation of state-sanctioned marijuana sellers.[8] This Article proposes the first tax strategy that entirely solves the "tax situation" for state-sanctioned marijuana sellers.

In the early 1980s, Congress added § 280E to the Internal Revenue Code,[9] largely for the purpose of punishing drug dealers.[10] Section 280E provides that sellers of controlled substances must pay taxes on their gross revenue instead of their net income.[11] This way of calculating taxable income produces much higher taxes than those faced by any other business, which was presumably okay when it applied only to drug dealers. Now that the provision applies to state-sanctioned marijuana sellers as well as illegal drug dealers, it creates a federal tax situation that some believe may drive legitimate marijuana sellers out of business.[12] Unlike the Department of Justice, which has not generally pursued criminal charges against state-sanctioned marijuana sellers,[13] the Internal Revenue Service has been vigorously enforcing § 280E against those same people.[14] It is this active enforcement of § 280E that has the marijuana industry so alarmed.

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8. *See* Edward J. Roche, Jr., *Federal Income Taxation of Medical Marijuana Businesses*, 66 TAX LAW. 429 (2013).

9. I.R.C. § 280E (2006).

10. S. REP. NO. 97-494, at 309 (1982) ("To allow drug dealers the benefit of business expense deductions at the same time that the U.S. and its citizens are losing billions of dollars per year to such persons is not compelled by the fact that such deductions are allowed to other, legal, enterprises.").

11. I.R.C. § 280E.

12. *See, e.g.*, Al Olson, *IRS Ruling Strikes Fear in Medical Marijuana Industry*, CANNABIS HEALTH NEWS MAG. (Oct. 5, 2011), http://cannabishealthnewsmagazine.com/legal/1094/irs-ruling-strikes-fear-in-medical-marijuana-industry/ (quoting an industry insider as saying, "[n]o business, including ours, can survive if it is taxed on its gross revenue. The IRS is trying to tax us out of existence.").

13. *See, e.g.*, Memorandum from James M. Cole, Deputy Att'y Gen., to all U.S. Attorneys (Aug. 29, 2013), *available at* http://www.justice.gov/iso/opa/resources/3052013829132756857467.pdf (instructing U.S. attorneys to prosecute marijuana crimes only when certain federal enforcement priorities are implicated and not to "consider the size or commercial nature of a marijuana operation alone as a proxy for assessing whether marijuana trafficking implicates the Department's enforcement priorities"); Memorandum from David W. Ogden, Deputy Att'y Gen., to selected U.S. Attorneys (Oct. 19, 2009), *available at* http://blogs.justice.gov/main/archives/192 (urging U.S. attorneys not to "focus federal resources in your states on individuals whose actions are in clear and unambiguous compliance with existing state laws"); *see also* Sam Kamin & Eli Wald, *Marijuana Lawyers: Outlaws or Crusaders?*, 91 OR. L. REV. 869, 881 (2013) (describing the Attorney General's communications about its enforcement policy). *But see* Memorandum from James M. Cole, Deputy Att'y Gen., to U.S. Attorneys (June 29, 2011), *available at* http://www.justice.gov/oip/docs/dag-guidance-2011-for-medical-marijuana-use.pdf ("The Ogden Memorandum was never intended to shield [large-scale commercial marijuana] activities from federal enforcement action and prosecution, even where those activities purport to comply with state law.").

14. *See* Letters from Andrew J. Keyso, Deputy Assoc. Chief Counsel of Income Tax & Accounting, IRS, to Pete Stark et al., U.S. House of Representatives. (Dec. 16, 2010), *available at* http://www.irs.gov/pub/irs-wd/11-0005.pdf (explaining that the IRS "lack[s] the authority to publish" guidance making an exception to § 280E for state-sanctioned marijuana sellers).

I argue that a properly organized and operated marijuana seller could avoid the impact of § 280E by qualifying as an exempt organization under § 501(c)(4) of the Internal Revenue Code, which exempts so-called "social welfare" organizations.[15] Since social welfare organizations, like charities,[16] are exempt from federal income tax—they pay *no* tax on either gross revenue or net income—§ 280E does not affect them.[17] Therefore, qualifying as a social welfare organization would solve a marijuana seller's federal tax problem. At the same time, however, these statutes would not prevent states from imposing their own sales or excise taxes on marijuana sales, an important motivation for legalization in states like Colorado and Washington.[18]

To qualify as a § 501(c)(4) organization, a marijuana seller would have to meet four statutory requirements: (1) it must have a proper tax-exempt purpose; (2) it must not distribute its profits to any private persons; (3) it must avoid excessive campaign-related political activity; and (4) it must not operate in an excessively commercial manner.

First, any organization seeking § 501(c)(4) status must be operated for a proper tax-exempt purpose. I propose that a marijuana seller could operate to advance the purpose of improving a neighborhood's social and economic conditions by providing job training, employment opportunities, and enhanced business conditions for commercial development in the neighborhood. Many tax-exempt community development corporations run retail operations to accomplish these goals in distressed neighborhoods all over the country, and the IRS has developed criteria for determining when retail operations primarily advance social welfare purposes, and when such purposes are ancillary to a private business purpose.[19] While operating for tax-exempt purposes like these would entail a significant change of operations for any existing marijuana seller, the benefits of doing so may well exceed the burdens.

A § 501(c)(4) marijuana seller also would have to refrain from distributing its profits to any managers or owners; it may have to limit the amount of campaign-related political activities it engages in; and it may have

15. I.R.C. § 501(c)(4)(A) (2006).

16. Charities are exempt under § 501(c)(3) of the Code, and—unlike social welfare organizations—are empowered to receive tax-deductible contributions under § 170 of the Code in addition to having their own income exempt from tax under § 501(a). *Id.* § 501(a); I.R.C. § 170 (2006 & Supp. V 2011).

17. *See* I.R.C. § 501(a) (2006).

18. *See* COLORADO VOTER GUIDE, *supra* note 5, at 12 ("The measure will also add sales tax revenue and may add job opportunities to the state economy."); WASHINGTON VOTER GUIDE, *supra* note 5, at 31 ("Regulating and taxing marijuana will generate over a half-billion dollars annually in new revenue for state and local government."). For a discussion of the potential for legalization to provide revenue to states, see Jonathan P. Caulkins et al., *High Tax States: Options for Gleaning Revenue from Legal Cannabis*, 91 OR. L. REV. 1041, 1047–48 (2013).

19. *See infra* note 111.

to operate in a less "commercial" manner than ordinary, for-profit marijuana sellers. Some of these requirements could have a significant impact on how a marijuana seller operates its business. For example, the fact that it cannot distribute profits to owners or managers may affect its ability to raise start-up capital.[20] Other requirements would likely have little impact. For example, it is unlikely that a marijuana seller would want to devote the majority of its time, energy, or money to a political campaign. But whether the restrictions associated with tax-exempt status are onerous or easy from an operational standpoint, the point is that there is no legal impediment to a marijuana seller complying with all of them.

Even once an organization has met these four statutory requirements for exemption, however, the Supreme Court has held that the common law "public policy doctrine" prevents organizations from qualifying for tax-exempt status as charities if their charitable purposes are illegal or contrary to a well-established, fundamental public policy.[21] Because marijuana sales are still illegal under federal law, the public policy doctrine acts as an absolute bar to exemption as a charity under § 501(c)(3). However, this Article makes the novel argument that the public policy doctrine applies *only* to charities, and not to "social welfare organizations," and thus, marijuana sellers could organize as § 501(c)(4) organizations even if they would be barred from organizing under § 501(c)(3).[22] Even though the public policy doctrine does not apply to § 501(c)(4) organizations, it is plausible that the concept of social welfare excludes certain illegal activities. I argue that the proper measure of social welfare is *local*, rather than *national*, and while state or local law may be relevant to such a determination, inconsistent federal law is not.

This novel argument is more than just a clever strategy—a "tax loophole" so to speak—to avoid the impact of § 280E. Rather, IRS recognition of tax-exempt status for marijuana sellers, together with enforcement of § 280E, could provide a mechanism to soften the substantial federalism issues raised by the conflict between state and federal marijuana

20. These limitations may raise the costs of operating the organization, just as § 280E raises the cost of selling marijuana. So, let me be clear at the outset: I am not arguing that operating as a tax-exempt social welfare organization *necessarily* makes good business sense from a marijuana seller's perspective. The business case for operating as a § 501(c)(4) organization is beyond the scope of this Article. To determine if a marijuana seller operating as a § 501(c)(4) organization makes good business sense as an economic matter, one would have to compare the cost of so operating it with the cost of operating as a traditional for-profit (subject to § 280E) and to a black-market operation (which presumably avoids all taxation by committing tax fraud).

21. Bob Jones Univ. v. United States, 461 U.S. 574, 591 (1983).

22. In the time since this Article went to press, the IRS has issued a private letter ruling that takes the position that § 501(c) organizations that are not charities are nonetheless prohibited from being operated for illegal purposes, including purposes related to marijuana. *See infra* note 61 and accompanying text (discussing I.R.S. Priv. Ltr. Rul. 2013-33-304 (Aug. 16, 2013)).

laws. The recent legalization movements identify many state policy goals relating to local issues, like crime reduction, neighborhood improvement, and state and local tax revenue.[23] However, as the state-sanctioned marijuana industry matures and states begin the process of creating regulations for the industry, it is becoming more and more clear that the potential for conflict is between not only the state and federal government, but between states and their *local* governments and communities as well.[24] A federal policy that incentivizes marijuana sellers to be nonprofit, neighborhood-based organizations whose primary purpose is improving the neighborhood *in effect ties federal approval to local support.*[25] The federal tax laws, therefore, provide federal incentives to align state and local policy objectives. The IRS could promote state and local policy harmonization by permitting community-based nonprofits to sell marijuana, but only when local community groups favored it in states in which it is legal. This would surely be a better position for the IRS than its current role as a lightning rod of conflict between state and federal policy objectives.

In this Article, I argue that a federal policy of recognizing tax-exempt status for properly-operated marijuana sellers is a way for the federal government to legitimately influence state and local marijuana policy while avoiding a direct inter-jurisdictional conflict with the states. But I should be clear that I do not mean to make the case in favor of legalizing marijuana. Current federal policy is that the sale and use of marijuana is bad for individuals and society, and apparently the majority of states still agree. A minority of states have legalized or decriminalized marijuana, but only for medical purposes, and only two states have so far taken the dramatic step of legalizing marijuana for recreational purposes.[26] Presumably, we will know more in the future about whether legalizing marijuana is a good or bad policy. We do know, however, that public opinion on marijuana legalization is changing rapidly. In April 2013, a Pew research poll found that 52% of Americans favored marijuana legalization, and a staggering 72% reported that the costs of enforcing marijuana prohibitions exceed the value to

23. *See supra* note 5 and accompanying text.

24. *See generally* Sam Kamin, *Marijuana at the Crossroads: Keynote Address*, 89 DENV. U. L. REV. 977 (2012) (describing conflict between states and localities over marijuana policy); Kamin, *supra* note 6, at 162–65; Patricia E. Salkin & Zachary Kansler, *Medical Marijuana Meets Zoning: Can You Grow, Sell, and Smoke That Here?*, 62 PLAN. & ENVTL. L., Aug. 2010, at 3 (describing conflicts between states and localities over marijuana policy).

25. California already recognized this in its original 1996 legislation, which requires that marijuana dispensaries be operated either as nonprofits or as cooperatives. CAL. HEALTH & SAFETY CODE § 11362.775 (West 2007); People v. Jackson, 210 Cal. App. 4th 525, 538–39 (2012) (applying CAL. HEALTH & SAFETY CODE § 11362.775). The argument is even stronger for recreational marijuana dispensaries, since the risk of them having an adverse social impact on the neighborhoods that house them is even greater.

26. *See supra* notes 1–3 and accompanying text.

society.[27] More importantly, 60% of respondents said that "the federal government should not enforce federal laws prohibiting the use of marijuana in states where it is legal," while only 35% say it should.[28] In the context of rapidly changing public opinion, it would not be surprising if the federal government was leery of direct confrontation with the states over marijuana policy. In that context, a legitimate mechanism for federal involvement in channeling marijuana selling activities in socially beneficial directions—like the one proposed in this Article—may be preferable to enforcement of federal criminal marijuana laws.[29]

I. THE FEDERAL TAX PROBLEM: SECTION 280E

Generally, the Internal Revenue Code requires a business to pay a percentage of its income in tax to the federal government. In order to determine the business's taxable income, one starts with all of the money coming in to the business—its gross revenue—and then subtracts out all of the business expenses like salaries, rent, advertising, employee health insurance, state and local taxes, license fees, bookkeeping, accounting and legal services, among other things.[30]

If the business is a retail operation, one expense will be "cost of goods sold" ("COGS"),[31] which consists primarily of the wholesale price that the

27. PEW RESEARCH CTR., MAJORITY NOW SUPPORTS LEGALIZING MARIJUANA 2–3 (2013), *available at* http://www.people-press.org/files/legacy-pdf/4-4-13%20Marijuana%20Release.pdf.

28. *Id.* at 3; *see also* WILLIAM A. GALSTON & E.J. DIONNE JR., GOVERNANCE STUDIES AT BROOKINGS, THE NEW POLITICS OF MARIJUANA LEGALIZATION: WHY OPINION IS CHANGING (2013), *available at* http://www.brookings.edu/~/media/research/files/papers/2013/05/29%20politics%20marijuana%20legalization%20galston%20dionne/dionne%20galston_newpoliticsofmjleg_final.pdf (discussing PEW RESEARCH CTR., *supra* note 27).

29. Of course, there are other solutions to this problem. Congress could solve the tax problem by repealing § 280E, or by creating an exception to § 280E for marijuana sales in states where such sales are legal, as has recently been proposed. *See* Marijuana Tax Equity Act of 2013, H.R. 501, 113th Cong. (2013). In addition, the IRS could presumably decide unilaterally not to enforce § 280E. *See, e.g.*, Samuel D. Brunson, *Watching the Watchers: Preventing I.R.S. Abuse of the Tax System*, 14 FLA. TAX REV. 223, 227 (2013) ("[W]here no taxpayer suffers direct harm, nothing in the tax law prevents the I.R.S. from misinterpreting or ignoring the law as written."); Leandra Lederman & Ted Sichelman, *Enforcement As Substance in Tax Compliance*, 71 WASH. & LEE L. REV. (forthcoming 2013), *available at* http://ssrn.com/abstract=2261507 ("The reality is that agency enforcement discretion already exists."); Gregg D. Polsky, *Can Treasury Overrule the Supreme Court?*, 84 B.U. L. REV. 185, 239 (2004) (pointing out that the Treasury is often insulated from oversight of invalid taxpayer-friendly regulations by restrictive standing rules, a point which is equally true of IRS enforcement decisions). Either Congressional or IRS action of this type would solve the § 280E problem but would not enable the federal government to wield the kind of less-intrusive influence that I argue is enabled by the granting of tax-exempt status.

30. *See* I.R.C. § 61 (2006); I.R.C. § 162 (2006 & Supp. V 2011). Obviously, this very brief explanation is a simplification of business taxation under the federal income tax.

31. This description of cost of goods sold is a further simplification. According to the Treasury Regulations, "gross income" consists of total sales less cost of goods sold. All other ordinary and necessary business expenses are then deducted from gross income, so the

business pays its suppliers to get the goods that it sells at a retail price. Other expenses such as employee salaries, rent, equipment costs and other "ordinary and necessary business expenses" are also subtracted, and the remaining amount is the taxable income.

To illustrate, take as an example someone whose business is the retail sale of marijuana. If she paid federal income taxes like other businesses, she would perform the following calculations. Imagine that she had gross receipts of $3,000,000 and paid $2,600,000 in cost of goods sold, the wholesale cost for the marijuana she sold.[32] She then had the following other expenses:

Advertising	5,000
Legal Services	45,000
Office	10,000
Rent/Utilities	21,000
Taxes/Licenses	9,000
Wages/Payroll	175,000
Equipment Depreciation	15,000
Other	20,000
Total	**300,000**

To calculate the business's taxes, she would subtract the $2,600,000 of COGS and the $300,000 of other business expenses from her gross revenue of $3,000,000 to get a taxable income of $100,000. If we apply a hypothetical 35% tax rate to that amount, her federal income taxes for the year would be $35,000 and she would take home an after-tax income of $65,000.

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subtraction of the cost of goods sold is actually a first step that precedes the subtraction of all other business expenses. *See* Treas. Reg. § 1.61-3(a) (as amended in 1992) ("In a manufacturing, merchandising, or mining business, 'gross income' means the total sales, less the cost of goods sold . . . ."). The end result is the same: total revenue less gross income and all other ordinary and necessary business expenses results in taxable income. For a much more detailed discussion of the taxation of marijuana businesses, devoted specifically to the question of how to calculate costs of goods sold, see Edward J. Roche, Jr., *Federal Income Taxation of Medical Marijuana Businesses*, 66 TAX LAW. 429 (2013).

32. This hypothetical is based loosely on the expenses provided by the petitioner in *Olive v. Commissioner*, 139 T.C. 19 (2012), but I have simplified the numbers and decreased the cost of goods sold slightly to reflect expert testimony suggesting that the petitioner had overstated its cost of goods sold.

That is how the calculation would work if marijuana sales were taxed like other businesses in America. But marijuana sales are treated differently under the federal tax code. Instead, § 280E of the Internal Revenue Code dramatically alters the way that state-sanctioned marijuana sellers must calculate their taxes.[33] Marijuana industry insiders believe that § 280E is the biggest impediment to the development of a legitimate marijuana industry, and could drive all legitimate sellers out of business.[34]

Under § 280E, "[n]o deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business . . . consists of trafficking in controlled substances . . . which is prohibited by Federal law."[35] Under federal law, marijuana is a "Schedule I" controlled substance,[36] and the Tax Court has ruled that the sale of it constitutes "trafficking" even when such sale is legal under state law.[37] Thus, a marijuana seller cannot deduct her expenses prior to calculating her taxable income.

The situation is not quite as dire as it initially may seem. A marijuana seller is not required to actually calculate her income tax strictly as a percentage of her gross income. The Tax Court has explained that "COGS is not a deduction within the meaning of [the tax code] but is subtracted from gross receipts in determining a taxpayer's gross income."[38] In addition, when Congress enacted § 280E, the Senate Report stated that "[t]o preclude possible challenges on constitutional grounds, the adjustment to gross receipts with respect to effective costs of goods sold is not affected by this provision of the bill."[39] In other words, while a marijuana seller cannot deduct the ordinary and necessary expenses incurred in running her business, at least she can subtract the wholesale cost of the marijuana itself from her gross revenue before calculating how much tax she owes. Thus,

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33. *See generally* Carrie F. Keller, Comment, *The Implications of I.R.C. § 280E in Denying Ordinary and Necessary Business Expense Deductions to Drug Traffickers*, 47 ST. LOUIS U. L.J. 157 (2003).

34. *See 36 Tips*, *supra* note 7; s*ee also* Kamin & Wald, *supra* note 13, at 884 (explaining that § 280E "could decimate the industry; few businesses can afford to pay income tax on their gross receipts").

35. I.R.C. § 280E (2006).

36. *See* 21 U.S.C. § 812(c)(c)(10) (2012); *see also* United States v. Oakland Cannabis Buyers' Coop., 532 U.S. 483, 489–90 (2001) (holding that the distribution of marijuana is prohibited under the Controlled Substances Act except for distribution pursuant to a government-approved research project exempt under § 823(f)). The United States Supreme Court has held that Congress is within its constitutional authority to impose criminal sanctions on possession of marijuana. *See* Gonzales v. Raich, 545 U.S. 1, 22 (2005).

37. Californians Helping to Alleviate Med. Problems, Inc. v. Comm'r (*CHAMP*), 128 T.C. 173, 182 (2007).

38. Olive v. Comm'r, 139 T.C. 19, 20 n.2 (2012).

39. S. REP. NO. 97-494, at 309 (1982). For a discussion of the legislative history, see Roche, *supra* note 31, at 443–44.

§ 280E disallows business deductions for marijuana sellers, but does not prevent them from subtracting COGS in arriving at taxable income.[40]

So, because of § 280E, the tax calculation of the hypothetical marijuana seller described above would be as follows: gross revenue of $3,000,000 less COGS of $2,600,000 leaves $400,000. Instead of deducting the $300,000 of legitimate business expenses, the taxpayer would be required to calculate her tax based on the whole $400,000 of gross income. Again, at the hypothetical rate of 35%, she would owe $140,000 in tax. Her pre-tax profit, however, is still the same $100,000 it was in the original hypothetical. The effect of § 280E, then, is to turn this marijuana seller's $65,000 of after-tax profit into a $40,000 *loss*. She owes more in federal income tax than her entire net income for the year. Presumably, if she has a negative profit margin year after year, it will not be long before she has to shut down.[41]

To be clear, this over-taxation of a marijuana seller's income is not simply the result of her engaging in an illegal business activity. If she were engaged in murder for hire, she would owe federal income tax on the profits she made from such activity, but would be allowed to deduct as ordinary and necessary business expenses the cost of her gun and bullets, the cost of overnight travel to and from the crime scene, any amounts she paid to employees or contractors who helped her carry out her crime, and other expenses associated with her criminal activity.[42] Section 280E only applies to income from selling controlled substances.

Currently, state-sanctioned marijuana sellers are employing two legal strategies to minimize the impact of § 280E, but neither provides a complete solution. In 2007, the Tax Court held that a business that *both* operated a marijuana dispensary *and* provided caregiving services to patients could bifurcate its business expenses and deduct the expenses associated with the caregiving activities even though § 280E prevented it from deducting any of

40. *See, e.g.*, *Olive*, 139 T.C. at 28 (in which the IRS argued that the taxpayer's cost of goods sold should be disallowed because of a substantiation failure, but did not argue that such expenses are disallowed under § 280E).

41. I have purposely chosen a hypothetical that illustrates the worst-case scenario for a marijuana seller: total pre-tax profits of less than her federal tax bill. If the hypothetical marijuana seller wanted to avoid shutting down, she could always raise her prices. If she increased her prices by 10% and therefore had $3,300,000 of gross revenue, she would have $155,000 of after-tax profit (*3,300,000 – 2,600,000 = 700,000 x 0.35 = 245,000; 700,000 - 300,000 - 245,000 = 155,000*). Whether she can raise prices or not depends on the elasticity of the demand for legal marijuana, which presumably depends to a large degree on the availability and cost of *illegal* marijuana, which is a pretty close substitute for legal marijuana. But, as discussed below, one significant policy goal of legalizing marijuana for many states is driving illegal marijuana sales out of business, and the price of legal marijuana is relevant to the question of whether that goal will be met.

42. *See, e.g.*, Comm'r v. Tellier, 383 U.S. 687, 691 (1966) ("Income from a criminal enterprise is taxed at a rate no higher and no lower than income from more conventional sources . . . . With respect to deductions, the basic rule, with only a few limited and well-defined exceptions, is the same.").

the expenses associated with its dispensary operations.[43] In effect, the Tax Court held that § 280E only applied to expenses related to the activity of selling marijuana, rather than to all expenses of any business that sold marijuana. Following this case, marijuana sellers were advised to allocate as many expenses as possible to caregiving services and deduct the expenses associated with such services fully.[44]

In addition, because § 280E still permits a marijuana seller to subtract COGS from gross revenue prior to calculating taxable income, a marijuana seller could try to allocate as much as possible of her expenses to COGS.[45] If a marijuana seller is vertically integrated, growing the marijuana she sells, then opportunities to shift expenses to COGS are multiplied, because cultivation costs are properly classified as costs of goods sold.[46] So, in the hypothetical above, costs such as advertising, legal services, taxes, and wages could all be allocated between retail operations and cultivation operations using some reasonable method. Only those expenses allocated to the retail operations would be subject to § 280E. The rest would be deductible as a part of COGS.

Either of these strategies could decrease federal taxes and therefore increase profits, possibly to the point where a seller could avoid going out of business. But the primary point remains the same: § 280E *dramatically* increases the cost of operating a marijuana business that complies with federal tax law, much more so than any other business tax. When the cost of running a legitimate business is raised, the financial benefit of running an illegal or quasi-legal business is increased. At a certain point, the costs of legitimacy get too high, and black-market providers thrive.

II. ONE POSSIBLE SOLUTION: TAX-EXEMPT STATUS

As discussed above, § 280E imposes a tax regime that makes it extremely expensive to operate a state-sanctioned marijuana store. This Part offers a solution that relieves state-sanctioned marijuana sellers of the burden of § 280E. It proposes that they operate as nonprofit, tax-exempt organizations. If state-sanctioned marijuana sellers could qualify as a tax-exempt organization, § 280E would not apply to them because an

43. *See CHAMP*, 128 T.C. 173 (2007).

44. *See* William Hoffman, *Medical Marijuana Dispensaries Persist Despite Tax Obstacles*, 135 TAX NOTES 825, 827 (2012) (quoting attorney Henry Wykowski as saying, "[o]ne of the things that I encourage dispensaries to do now is to very carefully allocate their expenses between the services they are providing versus the sale of the medical cannabis"). The limit of this strategy is illustrated in *Olive v. Commissioner*, 139 T.C. 19 (2012), in which the Tax Court held that an organization could not allocate expenses to a caregiving business if it was not really providing services other than the provision of marijuana.

45. *See* Roche, *supra* note 31, at 443–64.

46. *See* I.R.C. § 263A(d)(1)(A) (2006); Treas. Reg. § 1.263A-4(a)(2) (as amended in 2000) (explaining that "costs of producing plants with a preproductive period of 2 years or less" are not capital expenditures and therefore should be deducted as costs of goods sold).

organization that does not owe *any* income tax is unaffected by a provision that alters income tax calculation. No matter how many deductions are denied, an exempt organization still owes no federal income tax.[47] Thus, some sort of tax-exempt status is the holy grail of marijuana dispensaries.[48] Can they qualify?

Section 501 provides that any organization described in subsection (c) (among others) is exempt from federal income tax.[49] Subsection (c) contains twenty-eight numbered paragraphs, each describing a different sort of exempt organization.[50] The most familiar, probably, is § 501(c)(3), which describes "corporations . . . organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes."[51] Less known among the general public, but widely used by nonprofits, is § 501(c)(4),[52] describing "organizations not organized for profit but operated exclusively for the promotion of social welfare."[53] If given a choice, most organizations would select classification under § 501(c)(3) instead of § 501(c)(4) because contributions to § 501(c)(3) organizations are deductible for the donor, while donations to § 501(c)(4) organizations are not.[54] Thus, § 501(c)(4) tends to be used by organizations that could not qualify under § 501(c)(3).[55]

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47. It is important to note that exemption from federal income tax under § 501(c)(4), as proposed in this Article, does not relieve an organization from paying state sales taxes or any special marijuana excise taxes a state may impose. While each state's sales tax system is unique, and so it is hard to say with certainty that commercial sales of marijuana by a § 501(c)(4) social welfare organization would be taxable, I know of no state law that exempts commercial sales by social welfare organizations. Therefore, a state would still be able to collect taxes on the sale (or cultivation) of marijuana even if the organization was exempt from federal income tax.

48. In some states, marijuana sellers are required by state law to be nonprofit or cooperative organizations. *See, e.g.*, An Act for the Humanitarian Medical Use of Marijuana, MASS. GEN. LAWS ANN. ch. 94C, § 1–2(H) (West 2013) (defining "Medical marijuana treatment center" as "a not-for-profit entity, as defined by Massachusetts law only . . . ."). Such organizations may be nonprofits under state law, but if they do not qualify as tax-exempt under federal law, their non-profit status does not help them avoid the impact of § 280E.

49. I.R.C. § 501(c) (2006).

50. *See id.*

51. *Id.* § 501(c)(3).

52. According to the most recent estimate, as of 2009, there were just over one hundred thousand § 501(c)(4) organizations, compared to well over one million § 501(c)(3) organizations. NAT'L CTR. FOR CHARITABLE STATISTICS, NUMBER OF NONPROFIT ORGANIZATIONS IN THE UNITED STATES 1999–2009 (2010), *available at* http://nccsdataweb.urban.org/PubApps/profile1.php?state=US.

53. I.R.C. § 501(c)(4). For the purposes of this Article, I only consider whether a marijuana seller could qualify under § 501(c)(3) or § 501(c)(4) and not any other paragraphs of subsection 501(c).

54. *See* I.R.C. § 170 (2006 & Supp. V 2011).

55. For example, § 501(c)(4) is often used by organizations that want to engage in campaign-related political activity, which § 501(c)(3) organizations are not permitted to do. *See* I.R.C. § 501(c)(3) (2006) (stating that § 501(c)(3) organizations may not "participate . . . or

Both § 501(c)(3) and § 501(c)(4) and the regulations that apply to them provide a series of requirements that an organization must meet to qualify for exemption. First, each requires that an organization be organized and operated for certain *purposes*. In the case of § 501(c)(3) organizations, those purposes must be "charitable."[56] In the case of § 501(c)(4) organizations, the purpose is "the promotion of social welfare."[57] Second, both § 501(c)(3) and § 501(c)(4) organizations must meet a statutory requirement that "no part of the net earnings of such entity inures to the benefit of any private shareholder or individual."[58]

Third, both types of organizations are restricted in the types or quantities of political activities they may engage in. Fourth, both types of organizations are bound by the "commerciality doctrine," which holds that the primary activity of a tax-exempt organization cannot be one that "has a direct counterpart in, or is conducted in the same manner as is the case in the realm of for-profit organizations."[59]

In addition to all of these tests, however, the Supreme Court has held that § 501(c)(3) organizations are also constrained by the "public policy doctrine."[60] The public policy doctrine holds that the purpose of a charitable organization may not be illegal or contrary to fundamental public policy. Because selling marijuana is illegal under federal law, the public policy doctrine disqualifies a marijuana seller from exemption as a § 501(c)(3) organization. However, no court has ever held that the public policy doctrine applies outside the confines of § 501(c)(3), and even though the IRS has recently stated flatly that an "illegality" principle applies to all exemptions,[61] there is good reason to believe that it does not. I argue

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intervene in . . . any political campaign on behalf of (or in opposition to) any candidate for public office").

56. Section 501(c)(3) actually lists a number of possible purposes, including "charitable." *See id.* (stating that § 501(c)(3) organizations are "operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals"). However, the Supreme Court has held that "in enacting both § 170 and § 501(c)(3), Congress sought to provide tax benefits to *charitable* organizations," thus interpreting the term "charitable" to extend to *all* organizations exempt under § 501(c)(3). Bob Jones Univ. v. United States, 461 U.S. 574, 586–88 (1983) (emphasis added).

57. I.R.C. § 501(c)(4)(A).

58. *Id.* § 501(c)(4)(B). Almost identical language appears in § 501(c)(3): "no part of the net earnings of which inures to the benefit of any private shareholder or individual." *Id.* § 501(c)(3).

59. BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS § 4.10(a)(i) (10th ed. 2011).

60. *See Bob Jones Univ.*, 461 U.S. at 591 ("[T]he purpose of a charitable trust may not be illegal or violate established public policy.").

61. *See* I.R.S. Priv. Ltr. Rul. 2013-33-014 (Aug. 16, 2013) (explaining its view that the "general and well-established principle [that organizations must adhere to certain laws and doctrines in exchange for tax exemption] is not limited to exemptions for charitable

that the public policy doctrine, which is derived from the common law of charities, simply does not apply to § 501(c)(4) social welfare organizations, which are not charities.[62] And so, a marijuana seller could qualify as tax-exempt under § 501(c)(4).

Therefore, I am arguing that the IRS should recognize the tax-exempt status under § 501(c)(4) of a social welfare organization whose primary activity is illegal—even criminal—under federal law. I understand that such an argument is controversial, and I want to make clear at the outset that I do not have any reason to believe that the IRS has any institutional motivation for accepting such an argument. In fact, I think it would be surprising if it did so, even though I think the argument is consistent with existing law. Rather, the point of this Article is to argue that the recognition of the tax-exempt status of qualifying marijuana sellers is not only right doctrinally, but has the potential to serve a useful policy space between outright conflict and passivity in the face of a stark inter-jurisdictional conflict.

A. PURPOSES TEST: COMMUNITY ECONOMIC DEVELOPMENT CORPORATIONS

If a marijuana seller wants to qualify as a § 501(c)(4) social welfare organization, the first question it must ask is whether it can be operated exclusively for proper purposes. As discussed below, an organization can meet the purposes test of § 501(c)(4) if it has purposes that meet the requirements of § 501(c)(3).[63] Therefore, it is worth exploring whether a marijuana seller could meet the purposes requirement of § 501(c)(3) as a way of exploring whether it could meet the requirements of § 501(c)(4). I argue that if organized and operated correctly, the answer is an unqualified yes.

Section 501(c)(3) requires that an organization be organized and operated exclusively for "religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition . . . or for the prevention of cruelty to children or animals."[64] The IRS has previously denied § 501(c)(3) status to an organization that sold marijuana.[65] That organization argued that it advanced charitable purposes by educating individuals about legal medicinal use of marijuana and by promoting health when it provided seriously ill

organizations, but applies to all deductions and exemptions from federal tax"); *infra* notes 130–33 and accompanying text.

62. *See, e.g.*, Daniel Halperin, *Income Taxation of Mutual Nonprofits*, 59 TAX L. REV. 133, 133 n.2 (2006) (explaining that § 501(c)(4) "operates as a catch-all for other organizations that fail to qualify under § 501(c)(3) but still provide a significant public benefit").

63. *See infra* text accompanying notes 84–89.

64. I.R.C. § 501(c)(3) (2006). The list is not intended to be exclusive, but is intended to represent a number of purposes that Congress considers "charitable."

65. *See* I.R.S. Priv. Ltr. Rul. 2012-24-036 (June 15, 2012).

individuals with "safe, legal access to cannabis."[66] Promoting health is a proper charitable purpose, as is education, but the IRS determined that the organization did not qualify as a § 501(c)(3) organization because—among other things—"[d]istributing cannabis does not further any exempt purpose"[67] presumably at least partially because "[f]ederal law does not recognize any health benefits of cannabis."[68]

But promoting health and educating individuals are not the only possible charitable purposes a marijuana seller could have. The Treasury Regulations expand the statutory list of charitable purposes as follows: "[s]uch term includes: Relief of the poor and distressed or of the underprivileged; . . . or (i) to lessen neighborhood tensions; . . . or (iv) to combat community deterioration and juvenile delinquency."[69] Could a marijuana seller be operated to provide relief to the poor, distressed, or underprivileged? Could it be operated to lessen neighborhood tensions, combat community deterioration, or combat juvenile delinquency? I argue not only that a marijuana seller *could* be operated to meet those objectives, but also that those objectives are important to the legalization movement.[70]

One type of organization that has been long recognized to have proper charitable purposes because it promotes social welfare by relieving poverty and combating community deterioration is the "community development corporation" ("CDC"), whose tax-exempt purpose generally includes economic development of a poor or distressed neighborhood.[71] It is quite common for CDCs to operate retail businesses in their neighborhoods as a central, or even primary, activity.[72] If a marijuana seller could be organized as—or operated as a project of—a CDC, then the "purposes test" would presumably be met.

CDCs have in common the fact that they are all located in, and devoted to, improving the quality of life in some poor or distressed community. Indeed the fact that they are devoted to improving the conditions in a poor

66. *Id.*; *see also* I.R.S. Priv. Ltr. Rul. 2010-13-062 (Apr. 2, 2010) (revoking the tax-exempt status of an organization that primarily runs clinics for potential medical marijuana patients when such activities were not described in its application for exempt status).

67. I.R.S. Priv. Ltr. Rul. 2012-24-036 (June 15, 2012).

68. *Id.*

69. Treas. Reg. § 1.501(c)(3)-1(d)(2) (as amended in 2008).

70. *See infra* Part II.E.3.

71. *See generally* SUSAN D. BENNETT ET AL., COMMUNITY ECONOMIC DEVELOPMENT LAW: A TEXT FOR ENGAGED LEARNING (2012); ROBERT HALPERN, REBUILDING THE INNER CITY: A HISTORY OF NEIGHBORHOOD INITIATIVES TO ADDRESS POVERTY IN THE UNITED STATES (1995).

72. The Regulations state explicitly that "[a]n organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes." Treas. Reg. § 1.501(c)(3)-1(e)(1) (as amended in 2008).

or distressed community is the central factor justifying their tax exemption.[73] Thus, the CDC beneficiaries are the members of a poor or distressed community. The community is most often a neighborhood in a city or town, but it can also be a rural or even suburban community, so long as its members are poor or distressed.[74]

The IRS has long recognized that retail operations that provide jobs for residents who are hard to employ and provide work-skills training for people from disadvantaged backgrounds can be exempt organizations. Work-skills training is a proper educational purpose, and training and employing hard-to-employ persons is a proper charitable purpose.[75] Furthermore, job-skills training is not the only proper purpose for an otherwise commercial enterprise. The IRS has held that businesses can be operated to provide other charitable benefits to beneficiary workers, like to "help [emotionally disturbed] youths to become responsible and self-supporting citizens, and thus able to be reintegrated back into the community"[76] and to help residents of a halfway house for transitioning alcoholics "to develop regular work habits and a sense of self discipline and independence at a time when they are not able to cope emotionally with the outside pressures of the everyday world."[77]

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73. *See* I.R.C. § 501(c)(3) (2006); Treas. Reg. § 1.501(c)(3)-1(d)(2) (as amended in 2008).

74. There is some support for the argument that 501(c)(4) organizations may be exempt because they improve the conditions of neighborhoods even if those neighborhoods are not poor or distressed. For example, Rev. Rul. 65-195, 1965-2 C.B. 164, held that a junior chamber of commerce could qualify for tax-exempt status under § 501(c)(4) because its activities improved the community, especially through youth programs, with no mention of whether the community described was poor or distressed. Rev. Rul. 75-286, 1975-2 C.B. 210, held that an organization promotes social welfare if it seeks to "beautify and preserve public property" even if the public property is a single city block, and the ruling made no mention of the community being poor or distressed.

75. *See, e.g.*, Rev. Rul. 76-37, 1976-1 C.B. 149 (holding that an organization that buys houses, renovates them, and sells them at a profit is tax-exempt because the renovations are performed by students learning the building trade); Rev. Rul. 73-128, 1973-1 C.B. 222 (holding that an organization that employs "residents of a particular economically depressed community" to make toys "sold through regular commercial channels" is exempt because it provides vocational training to unemployed or underemployed persons); Rev. Rul. 57-297, 1957-2 C.B. 307 (holding that an organization that rehabilitated older unemployed persons is tax-exempt).

76. I.R.S. Gen. Couns. Mem. 36,393 (Sept. 2, 1975) (holding that an organization that operates a grocery store that employs emotionally disturbed adolescents as part of "a residence facility and therapeutic program" for its workers is exempt even though running a grocery store is not itself a proper tax-exempt purpose).

77. Rev. Rul. 75-472, 1975-2 C.B. 208 ("The work in the furniture shop is transitional employment, rather than occupational training. The instruction or training received at the shop is not intended to achieve a significant increase in saleable skills since most of the residents already have other saleable skills."). *But see* I.R.S. Gen. Couns. Mem. 39,752 (Sept. 6, 1988) (holding that a furniture manufacturing operation and a packaging service are not

One example of a current organization that operates numerous businesses to train and rehabilitate formerly disadvantaged persons is Homeboy Industries. Homeboy Industries is a § 501(c)(3) organization that hires former Los Angeles gang members to run a silkscreen business, a bakery, a café, a maintenance company, and a retail store.[78] The organization's mission is to "assist[] at-risk and formerly gang-related youth to contribute to society through job placement, training and education."[79] Some of the services it provides "include mental therapy for former gang members, housing assistance, job development counseling and tattoo removal treatments."[80] But the main thing Homeboy Industries does is provide good honest jobs for former gang members.[81] These former gang members are hard to employ in the regular economy, and Homeboy Industries provides a job, is willing to train its workers, and gives them services they need to succeed. The retail operations, therefore, serve the purpose of relieving poor, distressed and underprivileged persons (the former gang members). In addition, by providing a legitimate way out of a life of crime within a gang, the organization combats juvenile delinquency. Finally, both because the retail operations themselves provide a stabilizing commercial presence in poor and distressed neighborhoods, and because they turn some gang members away from criminal activities that harm neighborhoods, the retail operations lessen neighborhood tensions and combat community deterioration.

If a retail marijuana operation were to seek to qualify for tax-exempt status as a CDC like Homeboy Industries, there are several things it should do. First, it should identify itself with a poor or distressed neighborhood and direct its activities to improving the living conditions in that neighborhood. Ideally, that neighborhood would be a place that historically has felt the negative effects of the *illegal* marijuana market.[82] The organization's case

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related to the exempt purpose of a church school because it was only teaching "the importance of the work-ethic" to its students).

78. *See* James Flanigan, *Small Businesses Offer Alternatives to Gang Life*, N.Y. TIMES (Mar. 20, 2008), http://www.nytimes.com/2008/03/20/business/smallbusiness/20edge.html; *see also* Homeboy Indus., I.R.S. Form 990 (2011), Return of Organization Exempt from Income Tax [hereinafter Form 990], *available at* http://www.guidestar.org/FinDocuments/2011/954/800/2011-954800735-089eeb6c-9.pdf.

79. *See* Form 990, *supra* note 78, at Part III, Q.1.

80. Flanigan, *supra* note 78.

81. *Id.* ("Homeboy's emphasis is on putting gang members to work.").

82. For the purposes of this Article, I have assumed that there are neighborhoods that have been negatively affected by illegal marijuana sales. While there is support for that factual premise, the evidence is somewhat mixed. *See* John Klofas et al., *The Problem with Mary Jane: Street-Level Marijuana Sales and Quality of Life in Urban Neighborhoods* 2 (Ctr. for Pub. Initiatives, Working Paper No. 2012-16, 2012), *available at* http://www.rit.edu/cla/criminaljustice/sites/rit.edu.cla.criminaljustice/files/docs/WorkingPapers/2012/2012-16.pdf (reporting that one project participant "argued that the problem of open-air, low-level marijuana markets is currently the most significant barrier to successful community development affecting urban

would be strengthened if the neighborhood had insufficient retail operations, and would benefit from a strong retail presence that could encourage other legitimate retail operations to locate nearby. Second, the organization should hire employees who are hard to employ in an ordinary commercial operation. For example, it could hire former sellers of illegal marijuana—especially youth—train them in legitimate retail operations and draw them away from the illegal marijuana industry. The jobs and job training provided to these former drug dealers would advance the purpose of providing relief to the poor and distressed youth themselves. They would also help combat the neighborhood deterioration of the communities in which former drug dealers' illegal activities took place. Finally, the organization would be well served to ensure that the community members it seeks to serve are prominently placed on its board of directors, so they can make sure that the organization serves the primary purpose of advancing the local community's social welfare. If the organization does these things then it would presumably qualify as having proper tax-exempt purposes even if its primary activity is operating a storefront retail marijuana sales business.

Admittedly, it is controversial to suggest that locating a state-sanctioned marijuana seller in a poor, distressed neighborhood and hiring former illegal marijuana sellers to work in it is good for the community. One could imagine a range of opinions on the matter, and it would certainly not be unreasonable for a person to believe that the existence of a state-sanctioned marijuana seller would negatively impact the community in many of the same ways that criminal marijuana selling does. However, all that is necessary to meet the requirements of § 501(c)(3) and § 501(c)(4) is a group of people who reasonably believe that their proposed activities plausibly advance their proper tax-exempt purposes. The law does not require any specific level of proof that such activities would have the desired result. As is discussed below, the strength of my proposal is that it incentivizes marijuana sellers to take an organizational form that maximizes their chances of promoting the community's social welfare and enables the IRS to defer to local community support of marijuana sellers in determining which to grant tax-exempt status to.[83]

While most CDCs are § 501(c)(3) organizations, they could equally well be classified as § 501(c)(4) organizations if that were in their interests. If an organization has proper purposes to qualify as a § 501(c)(3) organization,

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neighborhoods"). *But see* Jonathan P. Caulkins & Rosalie Liccardo Pacula, *Marijuana Markets: Inferences from Reports by the Household Population* 23 (Carnegie Mellon Univ.: Heinz Research, Working Paper No. 20, 2005), *available at* http://repository.cmu.edu/cgi/viewcontent.cgi?article=1021&context=heinzworks ("The [National Household Survey on Drug Abuse] data suggest that marijuana acquisition is almost the antithesis of the images of anonymous, drive-through street markets for cocaine or heroin that play a prominent role in media depictions of drug selling" since the majority of marijuana transactions are gifts between friends or relatives transacted in a residence).

83. *See infra* Part II.E.4.

then its purposes are sufficient to qualify as a § 501(c)(4) organization.[84] Remember, § 501(c)(3) organizations are operated for certain charitable purposes and § 501(c)(4) organizations are operated "for the promotion of social welfare."[85] The Treasury Regulations helpfully explain that "[a]n organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community."[86] Social welfare purposes (proper for a § 501(c)(4) organization) and charitable purposes (proper for a § 501(c)(3) organization) are in no way mutually exclusive. In fact, the regulations further explain that a social welfare organization will qualify for exemption "if it falls within the definition of *charitable* set forth in paragraph (d)(2) of § 1.501(c)(3)–1."[87] The definition of "charitable" set forth in the named paragraph is the one we have already seen, which states, "[s]uch term includes: Relief of the poor and distressed or of the underprivileged; . . . and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; . . . or (iv) to combat community deterioration and juvenile delinquency."[88]

In other words, an organization that qualifies as charitable because it relieves the poor, distressed or underprivileged, lessens neighborhood tensions, combats community deterioration, or combats juvenile delinquency *also qualifies as a social welfare organization* under § 501(c)(4) of the Code.[89]

The leading treatise on tax-exempt organizations law puts it like this: "of greatest importance, the concepts of what is charitable and what constitutes social welfare can be very much alike. Thus, the same organization may simultaneously qualify under both categories of tax exemption."[90] An organization that ran a retail marijuana establishment to provide jobs and job training to former drug dealers and to improve the economic development of the neighborhood in which the illegal drug trade flourished would meet the purposes requirement of § 501(c)(4) of promoting social

84. *See, e.g.*, ROBERT J. DESIDERIO, PLANNING TAX-EXEMPT ORGANIZATIONS § 23.02[1] (2012) ("[T]he cases and rulings defining social welfare in the context of IRC Section 501(c)(3) organizations should apply with equal force to social welfare organizations seeking exemption under IRC Section 501(c)(4).").

85. *See* I.R.C. § 501(c)(4)(A) (2006).

86. Treas. Reg. § 1.501(c)(4)-1(a)(2)(i) (as amended in 1990).

87. *Id.*

88. Treas. Reg. § 1.501(c)(3)-1(d)(2) (as amended in 2008).

89. Some examples of community economic development organizations that were recognized as tax-exempt under § 501(c)(4) include the organization described in Rev. Rul. 67-294, 1967-2 C.B. 193, an industrial development to relieve unemployment in an economically depressed area, and the organization described in Rev. Rul. 57-297, 1957-2 C.B. 307, for rehabilitation and job placement.

90. HOPKINS, *supra* note 59, § 13.4.

welfare at least as easily as it would meet the purposes requirements of § 501(c)(3) of being charitable.

But there is also evidence that the purposes requirement of §501(c)(4) is not as stringent as the requirements for § 501(c)(3) organizations. The IRS explains § 501(c)(4) as follows: "IRC 501(c)(4) remains in some degree a catch-all for presumptively beneficial nonprofit organizations that resist classification under the other exempting provisions of the Code. Unfortunately, this condition exists because 'social welfare' is inherently an abstruse concept that continues to defy precise definition."[91] And, indeed, the IRS has suggested that sometimes an organization's purposes may be sufficiently community-oriented to qualify for tax exemption under § 501(c)(4), when the same organization could not qualify under § 501(c)(3). This suggests that the community-benefit standard applied under § 501(c)(4) is less demanding than the standard applied to § 501(c)(3) organizations.[92] Thus, a community development corporation that sold marijuana may have even more leeway in its social-welfare purpose to qualify for tax-exemption under § 501(c)(4) than under § 501(c)(3).

B. NO INUREMENT REQUIREMENT

In addition to the requirement that an organization have an exempt purpose, there are a few other requirements under § 501(c)(3) and § 501(c)(4) that an organization must meet to qualify for exemption. First, both § 501(c)(3) and § 501(c)(4) explicitly require that none of the earnings of qualifying organizations may "inure[] to the benefit of any private shareholder or individual."[93] This statutory requirement should not bar marijuana sellers from qualifying for tax exemption, but it may well shape *the way* in which such organizations operate.

The "no inurement" requirement may well have a significant effect on a marijuana seller. It is what makes a nonprofit a nonprofit, and its basic requirement is that no profits can be distributed to any private person. However, the "nonprofit" requirement is sometimes misunderstood. It does not require that the organization be operated so there are no profits. Quite the contrary, an organization may earn substantial revenue from its exempt activities, so long as that revenue is used to advance the organization's tax-

91. JOHN FRANCIS REILLY ET AL., IRC 501(C)(4) ORGANIZATIONS I-1, I-3 (2003), *available at* http://www.irs.gov/pub/irs-tege/eotopici03.pdf (quoting *Social Welfare: What Does It Mean? How Much Private Benefit Is Permissible? What is a Community?*, 1981 EXEMPT ORG. TECHNICAL INSTRUCTION PROGRAM).

92. *See* Rev. Rul. 75-286, 1975-2 C.B. 210 (holding that an organization that seeks to beautify a single commercial block can qualify as a § 501(c)(4) organization when it would not qualify under § 501(c)(3)); *cf.* Rev. Rul. 68-14, 1968-1 C.B. 243 (approving exemption under § 501(c)(3) for a beautification project aimed at an entire city rather than a single block).

93. I.R.C. §§ 501(c)(3), (4)(B) (2006).

exempt purpose.[94] A tax-exempt non-profit organization can use revenue generated from its activities to advance its other non-revenue generating activities, or it can re-invest that revenue in the activity that produced it, so long as the activity itself serves the tax-exempt purpose for which the organization was formed. So, for example, a tax-exempt university or school generally makes significant revenue from the tuition it charges its students. Its tax-exempt purpose is to provide that education, and so there is no impediment to it making more than it spends in any particular year and spending that excess revenue on improving its core tax-exempt function. The "no inurement" rule does not in any way require that none of the activities a tax-exempt organization pursues produce net revenues nor does it in any way second-guess the allocation of such excess revenues as among the exempt purposes of the organization.

What the "no inurement" requirement *does* do is prevent an organization from distributing any such profits to private persons. But the ban on distributions of profits is also sometimes misunderstood. It does not mean that employees or managers or even suppliers of capital cannot be compensated for their labor or capital.[95] It just means that when an organization provides an economic benefit to a private person, the organization cannot provide an economic benefit that exceeds the value of the labor or capital provided by the private person. That is, the organization cannot pay more than fair compensation to its managers and it cannot pay more than a fair-market rate for its capital. The "no inurement" requirement is not even as broad as that because it actually only applies when an organization provides an economic benefit to a person who is in a position to influence the organization.[96] So, the "no inurement" rule does not apply to compensation of ordinary (non-management) employees. It only applies to compensation of managers who are in a position to influence the organization.

The "no inurement" rule is supplemented by a statutory penalty regime that enforces it, the so-called "excess benefit transaction" penalties.[97] Under the penalty regime, an organization may be subject to very significant penalties if it provides an economic benefit to a person who is "in a position to exercise substantial influence over the affairs of the organization"[98] if "the value of the economic benefit provided [by the organization] exceeds the

94. *See* Treas. Reg. § 1.501(c)(3)-1(e)(1) (as amended in 2008).

95. *See, e.g.*, United Cancer Council, Inc. v. Comm'r, 165 F.3d 1173, 1176 (7th Cir. 1999) ("The [no inurement] provision is designed to prevent the siphoning of charitable receipts to insiders of the charity, not to empower the IRS to monitor the terms of arm's length contracts made by charitable organizations with the firms that supply them with essential inputs . . . .").

96. *See id.* ("The term 'any private shareholder or individual' in the inurement clause of section 501(c)(3) . . . has been interpreted to mean an insider of the charity.").

97. I.R.C. § 4958 (2006 & Supp. V 2011).

98. *Id.* § 4958(f)(1)(A).

value of the consideration . . . received for providing such benefit."[99] Furthermore, even if the payment for capital or labor was fair, it might result in penalties if it was directly tied to the revenues of the operation.[100] So the penalty provisions and the no inurement rule identify basically the same type of financial arrangements between management or investors and the organization—and a nonprofit marijuana seller should be sure to avoid those types of arrangements.

Whether a marijuana seller could operate subject to the no inurement requirement and the excess benefit transaction rules would depend on its ability to attract competent labor and sufficient capital without paying more than "fair market" wages and without raising equity capital. To qualify, it would have to decide in advance that it would not pay its managers more than a fair market wage for their services and that it would not pay them a percentage of its profits.[101] Similarly, if it sought start-up funding, it would not be permitted to pay above-market returns on such capital, and it would be prevented from raising equity capital. That is, it could not sell shares of itself to investors as a way of raising money. Instead, it would have to borrow its start-up capital in some sort of debt-like instrument. It is conceivable that these restrictions would be problematic for a marijuana seller seeking management or capital due to the unusual risk associated with the industry, but it is unlikely that they would be prohibitive. After all, there is no prohibition on paying its employees or its investors a fair return for their labor or capital, and fair return presumably includes some recognition of risks involved in the enterprise.[102]

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99. *Id.* § 4958(c)(1)(A).

100. *See id.* § 4958(c)(4) ("To the extent provided in regulations prescribed by the Secretary, the term 'excess benefit transaction' includes any transaction in which the amount of any economic benefit provided to or for the use of a disqualified person is determined in whole or in part by the revenues of 1 or more activities of the organization but only if such transaction results in inurement not permitted under paragraph (3) or (4) of section 501(c), as the case may be."). The Secretary has not prescribed any regulations on this topic, and so it is not clear whether penalties could apply to economic benefits that do not exceed fair market value but that are determined by the revenues of the operation.

101. *See generally* Peter Frumkin & Alice Andre-Clark, *Nonprofit Compensation and the Market*, 21 U. HAW. L. REV. 425 (1999); Benjamin Moses Leff, *The Case Against For-Profit Charity*, 42 SETON HALL L. REV. 819, 868–76 (2012) (explaining that purely profits-based compensation is not allowed, but that a wide variety of incentive-based compensation schemes are perfectly acceptable under current law).

102. *See* Leff, *supra* note 101, at 872 n.187 (explaining that a tax-exempt organization may create a "rebuttable presumption" that compensation of one of its employees is reasonable "if (1) the compensation arrangement is 'approved in advance by an authorized body . . . composed entirely of individuals who do not have a conflict of interest,' (2) 'the authorized body obtained and relied upon appropriate data as to comparability' of the compensation arrangement, and (3) 'the authorized body adequately documented the basis for its determination concurrently with making that determination" (quoting Treas. Reg. § 53.4958-6(a) (as amended in 2002)). Since the rebuttable presumption depends on "appropriate data as to comparability" a factual question is raised about whether marijuana selling employees are

C. LIMITED LOBBYING, NO CAMPAIGN ACTIVITIES

Section 501(c)(3) organizations are prohibited from devoting any "substantial part of the[ir] activities [to] carrying on propaganda[] or otherwise attempting[] to influence legislation."[103] This provision is generally called the "lobbying limitation," since it limits but does not prohibit § 501(c)(3) organizations from engaging in lobbying activities. Section 501(c)(4) organizations are not subject to this limitation and may conduct unlimited lobbying.[104] In addition, § 501(c)(3) organizations are absolutely prohibited from "participat[ing] in, or interven[ing] in . . . any political campaign on behalf of (or in opposition to) any candidate for public office."[105] This campaign intervention prohibition does not apply to § 501(c)(4) organizations, although campaign intervention cannot be the *primary* purpose of a § 501(c)(4) organization.[106]

The lobbying restriction and the campaign intervention prohibition would only have a minimal impact on a marijuana seller's operations. If it was a § 501(c)(3) organization, it would have to limit the amount of money it spent on lobbying,[107] and refrain from endorsing candidates or otherwise attempting to influence their election. If it organized as a § 501(c)(4) organization, it would not have to worry about lobbying restrictions and could endorse candidates or attempt to influence elections, so long as that was not its primary activity. Since the organization's primary activity would be related to the operation of its store, that activity would undoubtedly be dominant, and any political activity it conducted would be secondary at most.

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comparable only to other employees who risk very long prison sentences under federal law, or if they may be more comparable to run-of-the-mill retail employees. *See id.* (quoting Treas. Reg. § 53.4958-6(a)) (internal quotation marks omitted). Presumably risk of prison results in higher salaries, but, again, that is a factual question. I leave the answer to that question in the hands of qualified compensation experts.

103. I.R.C. § 501(c)(3) (2006).

104. *See id.* § 501(c)(4).

105. *Id.* § 501(c)(3).

106. *See* Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii) (as amended in 1990) ("The promotion of social welfare does not include direct or indirect participation or intervention in political campaigns on behalf of or in opposition to any candidate for public office. . . . [but a] social welfare organization . . . may qualify under section 501(c)(4) even though it is an *action* organization described in § 1.501(c)(3)-1(c)(3)(ii).").

107. Generally, most § 501(c)(3) organizations are permitted to spend up to 20% of their "exempt purpose expenditures" tax free, and they can spend 30% of such expenditures on lobbying before their tax-exemption could be at risk. *See* I.R.C. §§ 4911(c)(2), 501(h)(2)(B). That would be a substantial amount of money for an organization that was primarily devoted to operating a marijuana store for the purpose of providing job opportunities, job training, and neighborhood economic development.

D. SCOPE OF COMMERCIAL OPERATIONS/COMMERCIALITY DOCTRINE

In addition to the *purposes* requirement, the *no inurement* requirement, and the *political-activity* restrictions, the IRS will also ask a fourth question: Whether the scope of the retail operations is excessive in relation to the organization's tax-exempt purposes and whether the operation, notwithstanding its tax-exempt purpose, is overly "commercial." Thus, even after a proper tax-exempt purpose is identified, tax exemption restricts the ways in which a marijuana seller can operate if it wants to qualify for tax exemption under § 501(c)(4). Nonetheless, these restrictions should not be an absolute bar to exemption if the organization is committed to promoting the community's social welfare.

When approving tax-exempt status for organizations that run a business that trains workers, one key consideration is whether the scope of the business activities are excessive in relation to the tax-exempt purposes. The IRS has held that "[t]he question . . . is whether the organization is conducting its [commercial] operation as an end in itself or as the means by which it accomplishes a charitable purpose other than through the production of income."[108] Therefore, a legitimate job-training program cannot justify exemption for a commercial operation that is not commensurate in scope to the exempt job-training purpose. An organization that ran a grocery store providing job training for a distressed neighborhood's unemployed residents failed to qualify for exemption because the grocery store was "conducted on a scale larger than is reasonably necessary for the performance of the organization's training program."[109] In that case, the training program involved "[a]bout four percent of the store's earnings."[110] On the other hand, organizations that qualified as exempt devoted a greater portion of their resources to job training or employment operations. A toy manufacturing operation was commensurate in scope to its employment operation, largely because the non-management employees were all unskilled trainees.[111] An organization that rehabilitated buildings as a vocational training program qualified

108. Rev. Rul. 73-128, 1973-1 C.B. 222.

109. Rev. Rul. 73-127, 1973-1 C.B. 221.

110. *Id.*

111. Rev. Rul. 73-128, 1973-1 C.B. 222 ("While some individuals hired for the management staff do possess managerial and technical competence, the organization hires these people only to insure the successful operation of the vocational training program. In addition, a substantial number of the management and administrative staff are unskilled trainees."); *see also* I.R.S. Gen. Couns. Mem. 35,074 (Oct. 11, 1972) (addressing the same toy factory seeking exemption, and explaining that the "division that manufactured the dolls had the stated policy of employing only the unskilled and the unemployed or under-employed residents of a particular depressed community[;]" that "it was not [the organization's] policy to retain trained individuals as a permanent cadre but rather to move individuals into career positions with outside employers as soon as practical[;]" and that because of "the constant turnover of employees, the toy division was thought likely to continue to operate at a deficit").

partially because "[a]pproximately 80 percent of the construction work on each home is performed by students."[112]

Generally, the "commerciality doctrine" holds that an organization that conducts activities that are also conducted by for-profit commercial organizations must conduct its operations in a way that is materially different from the for-profit organizations operating in the same market.[113] As one court described it, "if an organization engages in an activity which might be carried on as a trade or business in competition with commercial enterprises, the organization must prove that its primary objective in carrying on the activity is an exempt purpose, and not the production of profits."[114] The test of whether an organization is too commercial may be very similar (or indistinguishable) to the test of whether the commercial operation is commensurate in scope with the tax-exempt purpose.[115] But other factors may also be relevant.[116] For example, in an organization that

112. Rev. Rul. 76-37, 1976-1 CB 149; s*ee also* I.R.S. Gen. Couns. Mem. 36,321 (June 26, 1975) ("[I]t is clear that the organization uses the home construction solely as a means to provide on-the-job training in conjunction with public school vocational training in fundamental construction skills.").

113. *See* Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii) (as amended in 1990) (stating that an organization is not "operated primarily for the promotion of social welfare" if it is "carrying on a business with the general public in a manner similar to organizations which are operated for profit").

114. Greater United Navajo Dev. Enters. v. Comm'r, 74 T.C. 69, 78–79 (1980) (citing B.S.W. Group, Inc. v. Comm'r, 70 T.C. 352, 357 (1978)) (holding that an organization that primarily engages in leasing oil well drilling equipment with no tax-exempt purpose does not qualify under § 501(c)(3) even if it also engages in a small number of activities that are charitable because it provides job training and employment opportunities for residents of the Navajo Reservation), *aff'd*, 672 F.2d 922 (9th Cir. 1981).

115. To complicate matters even further, an organization is permitted to conduct purely commercial activities that are unrelated to its exempt purpose, so long as those commercial operations are not its primary activity. I.R.C. § 511 (2006). But it must pay a tax on the income from those operations. *Id.* Under § 511 of the Code, a tax is imposed on income from an "unrelated trade or business," which means "any trade or business the conduct of which is not substantially related . . . to the exercise or performance by such organization of [the] purpose or function constituting the basis for its exemption under section 501. . . ." *Id.* § 513(a). If an organization that conducted significant exempt activities began to operate a marijuana selling operation as a small part of its overall activities, the marijuana operation may not adversely impact its tax-exempt status even if the IRS held that it was unrelated to the organization's tax-exempt purpose. However, in that case it would owe tax on its income from marijuana sales, and that tax would be calculated *in accordance with § 280E*. The analysis of what constitutes an "unrelated" trade or business is not necessarily identical to the question of what type of activity could advance the tax-exempt purpose of an organization sufficiently to qualify as tax-exempt, but it generally follows the same contours. *See generally* HOPKINS, *supra* note 59, § 24.4. Thus, in order to avoid the impact of § 280E, a tax-exempt marijuana seller must operate its sales activities in such a way that they are directly related to its accomplishment of its tax-exempt purpose.

116. In a recent ruling, the IRS concluded that an organization whose primary activity was running a clinic that sold medical marijuana was not tax-exempt under § 501(c)(3) at least in part because "[i]f it operates like a for-profit, the activities are like a for-profit, if the fees charged are like a for-profit, then it is a for-profit business." I.R.S. Priv. Ltr. Rul. 2010-13-062

provides job training and employment to hard-to-employ workers, the percentage of workers who are needy may be relevant under the commerciality doctrine.

If the marijuana store were operated like Homeboy Industries and other CDCs, it should be able to establish that its retail operations are commensurate in scope with its job training, employment, and neighborhood development purposes and that it is not too commercial to be tax-exempt. First, it should primarily employ persons who were either formerly employed in the illegal drug trade, or at risk of becoming employed in the illegal drug trade, in its neighborhood of operation. Second, it should provide those youths with extensive vocational training in the operation of a small business, along with the fundamental skills that are necessary to such operation, including customer service, marketing, bookkeeping, legal compliance, financial planning, etc. Third, it should provide them with counseling and psycho-social rehabilitation where appropriate, especially when they may be suffering from post-traumatic stress disorder, or other stresses. Fourth, it should rarely employ persons that are not from the target distressed group. Fifth, it should use its marijuana selling operations to engage directly with the community, fostering a safe environment conducive to economic development. It should pursue these goals even when they are not directly in the best financial interests of the operation. Finally, its board should always keep in mind, in all of its activities, that its goal is primarily to serve the neighborhood and the poor and disadvantaged youths that it employs, and not to operate an ordinary commercial business in the pursuit of profits. None of these specific suggestions are requirements, and significant variation in both mission and means is possible. But an organization that prioritizes the social welfare of the neighborhood and its people should not be found to be too commercial just because it operates a retail marijuana store as its primary activity.

(Apr. 2, 2010). In addition, court cases can be found that point to other factors supporting the holding that an organization is not exempt because it is too commercial. For example, in 2005 the Eastern District of California held that the fact that an organization "engages in cost-cutting measures," "strives to remain competitive," and pays its executives salaries "targeted . . . to median market levels, making no distinction between salaries paid to executives working at for-profit businesses, and executives working at non-profit entities" all support the holding that the organization is not exempt because it operates in a manner similar to organizations that are operated for profit. Vision Serv. Plan v. United States, No. CIVS041993LKKJFM, 2005 WL 3406321, at *9 (E.D. Cal. 2005), *aff'd*, 265 F. App'x 650 (9th Cir. 2008). It is questionable whether these other factors are good law, but an exempt marijuana seller could attempt to differentiate itself from for-profit sellers in any number of ways.

E. PUBLIC POLICY DOCTRINE

1. Public Policy Doctrine and § 501(c)(3) Organizations

The final impediment to organizing our marijuana seller as a tax-exempt organization is the existence of a common law doctrine generally called the "public policy doctrine." In *Bob Jones University v. Commissioner*, the Supreme Court held that the IRS was within its authority to deny tax-exempt status to universities that had racially discriminatory admissions or dating policies.[117] It could deny them tax exemption not because they failed to have a proper "educational" purpose under § 501(c)(3), but because § 501(c)(3) status requires both that an organization advance educational purposes and also that it meet the common law requirements for charities.[118] The Court held that one of those long-standing common law requirements for charitable trusts was "that the purpose of a charitable trust may not be illegal or violate established public policy."[119] While not illegal, the Court held that having a racially discriminatory policy about admissions or dating was contrary to established public policy, and so the public policy doctrine mandated that Bob Jones have its tax-exempt status revoked.[120]

Finding a violation of a fundamental public policy can be difficult,[121] but determining if the charitable purpose of an organization is illegal is more straightforward. For example, in Revenue Ruling 75-384, the IRS discussed an organization whose "primary activity [was] the sponsoring of protest demonstrations and nonviolent action projects in opposition to war and preparations for war."[122] These events "are violations of local ordinances and breaches of public order."[123] Thus, the organization "induces or encourages the commission of criminal acts by planning and sponsoring such events."[124] There is no question that educating the general public about issues relating to war—even if the perspective is entirely negative—would be a legitimate educational purpose and would qualify the organization for tax-exempt status under § 501(c)(3). Thus, an organization whose primary activity was sponsoring protest demonstrations *that observed all local laws* would qualify for exemption under § 501(c)(3).

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117. Bob Jones Univ. v. Comm'r, 461 U.S. 574, 605 (1983).

118. *Id.* at 585–86.

119. *Id.* at 591; *see also* RESTATEMENT (SECOND) OF TRUSTS § 377 (1959) ("A charitable trust cannot be created for a purpose which is illegal."); HOPKINS, *supra* note 59, § 6.2(a) (discussing the *Bob Jones* holding).

120. *Bob Jones Univ.*, 461 U.S. at 595–96.

121. *See* HOPKINS, *supra* note 59, § 6.2(a) (stating that "[t]he reach of the doctrine has not been extensive," and explaining that a violation of fundamental public policy has rarely been found outside the context of racial discrimination and illegality).

122. Rev. Rul. 75-384, 1975-2 C.B. 204.

123. *Id.*

124. *Id.*

However, the IRS determined that the organization in Revenue Ruling 75-384 could not qualify for tax exemption because its primary activity was illegal. It reasoned that "[a]s a matter of trust law, . . . no trust can be created for a purpose which is illegal. . . . Thus, all charitable trusts (and by implication all charitable organizations, regardless of their form) are subject to the requirement that their purposes may not be illegal or contrary to public policy."[125]

When it comes to marijuana sellers, the IRS has taken the position that the public policy doctrine prevents such an organization from qualifying as exempt under § 501(c)(3). In Private Letter Ruling 2012-24-036, the IRS discussed an application for exemption under § 501(c)(3) by an organization that distributed medical marijuana in a manner legal in its state of residence.[126] The IRS first stated that "[l]ike a trust, a § 501(c)(3) organization cannot be created for a purpose that is illegal."[127] It then went on to observe that "[y]our primary activity, the distribution of cannabis, is illegal. . . . The fact that [your state] legalized distribution of cannabis . . . is not determinative because under federal law, distribution of cannabis is illegal."[128] Thus, the IRS has already taken the position that an organization whose primary purpose is the distribution of marijuana cannot be exempt under § 501(c)(3) because by breaking federal law—even if it complies with all state and local laws—the organization violates the public policy doctrine.

Obviously, the fact that the IRS has taken a position does not make it the law, but its reasoning appears to be sound. The public policy doctrine probably prevents a marijuana seller from qualifying for exemption under § 501(c)(3). But § 501(c)(3) is not the only subsection in § 501. Perhaps an organization that was barred from tax-exempt status under § 501(c)(3) could still be tax-exempt under another subsection, like § 501(c)(4). The relevant question is whether the public policy doctrine applies to § 501(c)(4).

2. Public Policy Doctrine and § 501(c)(4) Organizations

While it seems clear that the public policy doctrine would prevent an organization that sold marijuana from being recognized as exempt under § 501(c)(3), the answer is not nearly as clear with respect to § 501(c)(4).

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125. *Id.* On several other occasions the IRS has determined that organizations whose purposes are illegal cannot qualify for exemption under § 501(c)(3). *See, e.g.*, Mysteryboy, Inc. v. Comm'r, 99 T.C.M. (CCH) 1057, 1068–69 (2010) (holding that an organization that seeks to study and promote sex between adults and children cannot be tax exempt). The most recent organizations to be denied tax-exempt status on account of illegal activities are two organizations that promote polygamy. *See* I.R.S. Priv. Ltr. Rul. 2013-73-025 (Mar. 14, 2013); I.R.S. Priv. Ltr. Rul. 2013-10-047 (Dec. 11, 2012).

126. I.R.S. Priv. Ltr. Rul. 2012-24-036 (June 15, 2012).

127. *Id.*

128. *Id.* at 5–6.

There is no existing guidance from any court addressing the question of whether the public policy doctrine applies to § 501(c)(4) organizations. When a court does address the issue, it may well hold that the doctrine does not apply. The public policy doctrine is derived from the common law of charities, and a § 501(c)(4) organization, *unlike a § 501(c)(3) organization*, is not a charity. Therefore, the common law of charities does not apply to § 501(c)(4) organizations.

There is one Revenue Ruling in which the IRS held that a specific organization whose primary activity was breaking the law could not be exempt under § 501(c)(4).[129] In addition, the IRS has taken the position in several General Counsel Memoranda or Private Letter Rulings that promoting at least some illegal activities would disqualify an organization from § 501(c)(4) status, since doing so does not promote the general welfare.[130] But, as discussed below, none of these examples involve situations in which there is a conflict between local or national laws, and so, if anything, they support the view that state or local laws should guide social welfare determinations, not federal law.[131]

Very recently, the IRS released a Private Letter Ruling that denied tax-exempt status under § 501(c)(16) to an organization whose purpose was to

129. Rev. Rul. 75-384, 1975-2 C.B. 204. In addition, in *Mysteryboy, Inc.*, the IRS rejection letter concluded that "your organization would not be exempt under either IRC 501(c)(3) or (4)." *Mysteryboy, Inc.*, 99 T.C.M. (CCH) at 1061. But there is no evidence that the organization had applied for tax-exempt status under § 501(c)(4) (it would have had to fill out a different form), and the court made no mention of § 501(c)(4) in its opinion, holding only that the organization could not qualify as exempt under § 501(c)(3). *See id.*

130. *See, e.g.*, I.R.S. Gen. Couns. Mem. 37,173 (June 21, 1977) (reversing its position of denying tax-exempt status to organizations that seek to normalize homosexuality, but cautioning nonetheless that "[i]f an organization directly fostered or promoted homosexual practices, it would not be entitled to exemption [at least in part because] in many jurisdictions, homosexual practices are illegal"); I.R.S. Gen. Couns. Mem. 36,412 (Sept. 11, 1975) (noting that a previous General Counsel Memo from 1957, I.R.S. Gen. Couns. Mem. 30,389 (Nov. 22, 1957), denied § 501(c)(4) status to an organization whose purpose was promoting racial discrimination at least in part because "a substantial portion of the organization's propaganda was concerned with circumvention of existing law"); I.R.S. Gen. Couns. Mem. 36,187 (Mar. 11, 1975) (granting § 501(c)(4) status to an organization advocating for legalizing marijuana, but cautioning that "[b]ecause of the evidence that marijuana use presents a potential threat to society and because possession or use of marijuana is illegal, an organization that advocated or promoted the use of marijuana would be engaging in activities detrimental to the community and could not qualify for exemption under Code § 501(c)(4)"); I.R.S. Gen. Couns. Mem. 35,915 (July 24, 1973) (granting § 501(c)(4) status to an organization serving alcoholic homosexuals, but only because "[t]he organization expressly disavows . . . seeking to alter the community's attitude toward homosexuals" and noting that "[t]he maladaptive and at least potentially offensive nature of homosexual activities is also borne out by the continuing prohibition of substantially all forms of sodomy by the criminal laws of the District of Columbia and all but three of the several states"); I.R.S. Gen. Couns. Mem. 34,696 (Nov. 26, 1971) (denying § 501(c)(4) status to an organization that sought to obtain "complete public acceptance of homosexuals as one type of normal human[] being[]").

131. *See infra* Part II.E.3. Please note that my citation of these memoranda should not be taken as any kind of approval of their reasoning.

"facilitate and organize transactions between members who collectively cultivate and possess marijuana for medical purposes."[132] The organization did not satisfy the requirements of § 501(c)(16), including a requirement that such an organization be formed by a farmers' cooperative and operated in conjunction with it, and this failure is presumably sufficient to prevent the organization from qualifying for tax exemption under § 501(c)(16). However, the IRS went on in the ruling to argue that the organization did not qualify for § 501(c)(16) status because it facilitates the sale of marijuana, which is illegal under federal law.[133] In that ruling the IRS, for the first time, argued explicitly that a general prohibition on tax exemption for organizations that promote illegal activities applies to *all* § 501(c) organizations, as opposed to just those seeking exemption under § 501(c)(3).[134] If the logic of this case is correct, it would presumably apply not just to § 501(c)(16) organizations, but also to § 501(c)(4) organizations. But, for the reasons discussed herein, the IRS's broad statement of the law is not correct. Or, at the very least, as discussed below, there are good reasons for the federal government to consider granting tax-exempt status to § 501(c)(4) organizations promoting or conducting illegal activities when there are fundamental jurisdictional conflicts as there are currently with regards to marijuana.[135]

First, in *Bob Jones* the Supreme Court made very clear that the origin of the public policy doctrine is the common law of charities, and that the common law of charities applies to § 501(c)(3), since that is the tax-exemption category that applies to charities. The Court stated, "[t]he origins of such exemptions [for § 501(c)(3) organizations] lie in the special privileges that have long been extended to charitable trusts."[136] These special privileges are accompanied by a "caveat" that a gift for charitable uses creates a charitable trust "provided the same is consistent with local laws and public policy."[137] The Court nowhere suggests that a § 501(c)(4) organization is a charity or that it is bound by the common law of charities.

The idea that the common law of charitable trusts applies to § 501(c)(3) but not § 501(c)(4) is supported by another line of reasoning advanced in the *Bob Jones* case.[138] The Court pointed out that § 170 of the Code uses the term "charitable contributions" to describe all contributions to organizations described in § 501(c)(3) of the Code.[139] Section 170 is the

132. I.R.S. Priv. Ltr. Rul. 2013-33-014 (May 20, 2013) (internal quotation marks omitted).

133. *Id.*

134. *Id.* ("This general and well-established principle is not limited to exemptions for charitable organizations, but applies to all deductions and exemptions from federal tax.").

135. *See infra* Part III.

136. Bob Jones Univ. v. United States, 461 U.S. 574, 588 (1983).

137. *Id.* (citing Perin v. Carey, 65 U.S. (24 How.) 465, 501 (1860)).

138. *Id.* at 586–92.

139. *Id.*

provision that makes contributions to § 501(c)(3) organizations tax deductible.[140] This deduction provision is different from the exemption provision found in § 501.[141] The exemption provision relieves the organization from paying tax on income that it earns while pursuing its tax-exempt purpose. The deduction provision permits a person making a contribution to a tax-exempt charity to deduct the amount of that contribution from her gross income before calculating her income taxes. The Court pointed out that "[o]n its face, therefore, § 170 reveals that Congress' intention was to provide tax benefits to organizations serving charitable purposes."[142] Thus, the fact that all contributions to § 501(c)(3) organizations are deductible *charitable* contributions according to § 170 suggests that Congress intended that the common law of charities—including the public policy doctrine—should apply to all organizations that are exempt under § 501(c)(3).

But § 501(c)(4) organizations are another matter. Section 501(c)(4) describes organizations "operated exclusively for the promotion of social welfare."[143] The word "charity" or "charitable" appears nowhere in the paragraph.[144] Furthermore, the term "charitable contribution" as used in § 170 *excludes* contributions to organizations that qualify for exemption under § 501(c)(4) rather than § 501(c)(3) of the Code.[145] In fact, it is fair to say that the primary distinction between a § 501(c)(3) organization and a § 501(c)(4) organization is that the § 501(c)(3) organization can receive tax-deductible *charitable* contributions under § 170 while a § 501(c)(4) organization cannot.[146] The Supreme Court has held that organizations that receive the tax subsidies provided in § 501(c)(3) and § 170 are charities, and therefore are subject to the common law of charities, which holds that they may not be organized or operated primarily to conduct activities that are illegal.[147] But § 501(c)(4) organizations are not charities, they cannot receive tax-deductible contributions under § 170, and therefore the common law public policy doctrine simply does not apply to them.

The IRS implicitly recognized that the public policy doctrine does not apply to § 501(c)(4) organizations in its only revenue ruling addressing an organization with illegal purposes seeking tax exemption under

140. *Id.*; *see also* I.R.C. § 170 (2006 & Supp. V 2011).

141. *Bob Jones Univ.*, 461 U.S. at 587 n.10.

142. *Id.* at 587.

143. I.R.C. § 501(c)(4)(A) (2006).

144. *Id.*

145. *See* I.R.C. § 170(c) (2006 & Supp. V 2011) (repeating the list of organizations described in § 501(c)(3) but not those described in § 501(c)(4)).

146. *See* DESIDERIO, *supra* note 84, § 23.01 ("The primary disadvantage of a social welfare organization is that contributors may not deduct contributions if the organization's tax-exempt status derives from IRC Section 501(c)(4).").

147. *Bob Jones Univ.*, 461 U.S. at 586–89.

§ 501(c)(4).[148] In Revenue Ruling 75-384, discussed above,[149] the IRS denied tax-exempt status to an organization whose primary activity was conducting civil disobedience campaigns against war. As discussed above, the IRS held that the organization could not qualify as tax exempt under § 501(c)(3) because of the public policy doctrine. But the organization had actually sought recognition as tax exempt under *either* § 501(c)(3) *or* § 501(c)(4). The IRS started by citing the sections of the Code and Regulations that apply to § 501(c)(3), discussing the public policy doctrine and its origin in charitable trust law, and concluding that the organization could not be exempt under § 501(c)(3). It concluded its public policy analysis by stating, "[a]ccordingly, the organization is not operated exclusively for charitable purposes and does not qualify for exemption from Federal income tax under section 501(c)(3) of the Code."[150]

It then turned its attention to the qualifications for tax exemption under § 501(c)(4), citing the Code and Regulations applicable to that section.[151] Without any mention of the public policy doctrine or the common law of charities, it then concluded in a single two-sentence paragraph:

> Illegal activities, which violate the minimum standards of acceptable conduct necessary to the preservation of an orderly society, are contrary to the common good and the general welfare of the people in a community and thus are not permissible means of promoting the social welfare for purposes of section 501(c)(4) of the Code. Accordingly, the organization in this case is not operated exclusively for the promotion of social welfare and does not qualify for exemption from Federal income tax under section 501(c)(4).[152]

In other words, the organization at issue could not promote social welfare because it plans to engage in "[i]llegal activities, which violate the minimum standards of acceptable conduct necessary to the preservation of an orderly society."[153]

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148. At other times when the IRS has taken the position that promoting specific illegal activities is contrary to social welfare, it has done so without any mention of the public policy doctrine. *See, e.g.*, I.R.S. Gen. Couns. Mem. 36,412 (Sept. 11, 1975) (citing I.R.S. Gen. Couns. Mem. 30,389 (Nov. 22, 1957)) (racial discrimination); I.R.S. Gen. Couns. Mem. 36,187 (Mar. 11, 1975) (marijuana), *revoked in* I.R.S. Gen. Couns. Mem. 37,173 (June 21, 1977); I.R.S. Gen. Couns. Mem. 35,915 (July 24, 1973) (homosexuality), *revoked in* I.R.S. Gen. Couns. Mem. 37,173 (June 21, 1977); I.R.S. Gen. Couns. Mem. 34,696 (Nov. 26, 1971) (homosexuality), *revoked in* I.R.S. Gen. Couns. Mem. 37,173 (June 21, 1977).

149. *See supra* note 122 and accompanying text.

150. Rev. Rul. 75-384, 1975-2 C.B. 204.

151. *Id.*

152. *Id.*

153. *Id.*

The Revenue Ruling is the only discussion in precedential guidance of whether an organization that conducted illegal activities could be exempt under § 501(c)(4).[154] The Ruling makes clear that even the IRS takes the position that the public policy doctrine only applies to § 501(c)(3) organizations, since it discusses that doctrine and its origin in the common law of charities exclusively in the section of the Ruling addressing the claim for § 501(c)(3) status.[155] But it also suggests that the IRS has taken the position that illegal activities violate the minimum standards of acceptable conduct necessary for the preservation of an orderly society, and therefore cannot promote social welfare.

The IRS has suggested this position previously, although never unambiguously. For example, in General Counsel Memorandum 36,187, the IRS granted § 501(c)(4) status to an organization that advocated for the legalization of marijuana. But it expressed some concern "that the organization has engaged in some activity that might reasonably be interpreted as tending to promote the use of marijuana."[156] It went on to explain,"[s]ince such activity may be detrimental to the community, we recommend that a favorable ruling be conditioned on the organization's commitment that its future activities will avoid any promotion of the use of marijuana."[157] The memorandum relies, at least in part, on the fact that "all the states, the District of Columbia, and federal law make the possession or use of marijuana a criminal offense."[158]

In addition, in the 1970s, the IRS either denied tax-exempt status to organizations that had the purpose of "obtaining complete public acceptance of homosexuals as one type of normal human[] beings"[159] or conditioned acceptance on the organization promising not to promote the

154. There is one passing reference to § 501(c)(4) status in a case denying § 501(c)(3) status to an organization because of the public policy doctrine, but the reference provides no guidance on either the law or the IRS's interpretation of the law. *See supra* note 129 and accompanying text.

155. It is worth pointing out that in the last several decades, "[t]he IRS is displaying a greater propensity to import federal tax law principles applicable to tax-exempt charitable organizations to shape the law applicable to exempt social welfare organizations." HOPKINS, *supra* note 59, § 13.4, at 364; *see also id.* § 4.10, at 111–12 (providing as an example the decision in 2005 to apply the commerciality doctrine to § 501(c)(4) organizations); *id.* § 20.11, at 545 (giving as another example of this trend the decision by the IRS in 2004 to apply the private benefit doctrine to § 501(c)(4) organizations). Furthermore, the IRS very recently released a private letter ruling in which it appears to argue that the public policy doctrine applies directly to non-charitable exempt organizations. *See* I.R.S. Priv. Ltr. Rul. 2013-33-014 (Aug. 16, 2013).

156. I.R.S. Gen. Couns. Mem. 36,187 (Mar. 11, 1975).

157. *Id.*

158. *Id.*

159. I.R.S. Gen. Couns. Mem. 34,696, (Nov. 26, 1971), *revoked in* I.R.S. Gen. Couns. Mem. 37,133 (June 21, 1977) (denying § 501(c)(4) status to an organization seeking to educate the public that homosexuality is a propensity "on par with and not different in kind from heterosexuality").

idea that homosexuality was normal.[160] The IRS later retracted its position that an organization that promoted a positive view of homosexuals could not be exempt,[161] but even in that retraction it seemed to claim that an organization could not qualify for exemption under § 501(c)(3) or § 501(c)(4) if it "directly fostered or promoted" illegal activities:

> If an organization directly fostered or promoted homosexual practices, it would not be entitled to exemption in any event; in many jurisdictions, homosexual practices are illegal (and therefore the organization would not qualify under Code § 501(c)(3) or (4) because it promoted illegal acts) and we see no basis, even in jurisdictions where homosexual practices are legal, for the exemption, as charities or social welfare organizations, of organizations whose activities directly promote or encourage sexual practices of any kind.[162]

The second half of the sentence implies that at issue is not just some sort of absolute bar to organizations whose exempt purposes are illegal, as exists under the public policy doctrine, but rather a concern that promoting illegal sexual activities—just like promoting any sexual activities—would not in and of itself constitute a proper tax-exempt purpose. Obviously, that situation should be distinguished from an organization that sold marijuana to provide job training or employment opportunities or to improve a neighborhood in which the social welfare purpose is not simply promoting the illegal activity but improving the conditions of a distressed neighborhood.

Thus, the IRS has on several occasions taken the position that promoting certain activities is contrary to social welfare based at least in part on the fact that such activities are illegal in all or almost all of the states. Very recently, it appears to have taken the position that promoting or engaging in any illegal activities bars an organization from qualifying for exempt status under any subsection of § 501(c).[163] But, if this position is incorrect, and not all illegal activities violate the minimum standards of acceptable conduct in a community or if there are some illegal activities that promote the social welfare of a community, then those activities should not prevent an organization from qualifying under § 501(c)(4). Thus, the appropriate question to ask is: Do the activities conducted by the organization in

160. *See* I.R.S. Gen. Couns. Mem. 35,915 (July 24, 1973) (expressing concern that promoting such views "could reasonably be expected to contribute to the development of a generally unsound attitude toward homosexuality on the part of at least some important segments of the general public").

161. *See* I.R.S. Gen. Couns. Mem. 37,173 (June 21, 1977) ("[W]e are now convinced that those restrictions [conditioning exemption on an agreement not to teach that homosexuality is normal] have little, if any, legal basis, and should no longer be applied.").

162. *Id.*

163. *See* I.R.S. Priv. Ltr. Rul. 2013-33-014 (May 20, 2013).

question promote the social welfare notwithstanding the fact that they are illegal, or not?

In addition, there is support for the view that § 501(c)(4) organizations should be given greater latitude in their activities than § 501(c)(3) organizations. As discussed above, the IRS has explained that § 501(c)(4) is a kind of "catch-all for . . . organizations that resist classification under the other exempting provisions of the Code."[164] But more importantly, there is support for the view that a § 501(c)(4) organization should be permitted to engage in a greater quantity of non-exempt activities than a § 501(c)(3) organization. In Private Letter Ruling 2011-23-047, the IRS explained that:

> 501(c)(4) organization[s] may have more than an incidental amount of . . . non-exempt activities, and still qualify for exemption, as long as those activities are not primary. However, those same activities, if more than insubstantial, will disqualify the organization from tax exemption under section 501(c)(3).[165]

Thus, it is consistent with the general scheme of exemption for an organization that is denied exemption under § 501(c)(3)—in this case because its activities are illegal under federal law—to be granted exemption under § 501(c)(4), since that provision is less exacting. However, a § 501(c)(4) organization still must promote social welfare, and the IRS has taken the position that a social welfare purpose cannot be one that violates the law.[166]

3. Would a § 501(c)(4) Marijuana Seller Promote Social Welfare?

As discussed above, since the public policy doctrine does not apply to § 501(c)(4) organizations, the central question for a nonprofit marijuana seller would be: (1) do its activities promote social welfare? Or, instead (2) do they fail to promote social welfare because they "are contrary to the common good and the general welfare of the people in a community"?[167]

Obviously, one possible approach would be to infer a federal policy from the fact that the federal government has identified marijuana as a Schedule I controlled substance. Under that approach, the federal government has in effect already concluded that sale and use of marijuana is "contrary to the common good and general welfare of the people in a community."[168] That approach is arguably supported by Supreme Court's reasoning in *United States v. Oakland Cannabis Buyers' Cooperative*, in which the Court found that there is no exception to the Controlled Substances Act for

164. *See* Reilly et al., *supra* note 91, at I-3.

165. I.R.S. Priv. Ltr. Rul. 2011-23-047 (June 10, 2011).

166. *See* Rev. Rul. 75-384, 1975-2 C.B. 204; s*ee also* I.R.S. Priv. Ltr. Rul. 2013-33-014 (May 20, 2013).

167. Rev. Rul. 75-384, 1975-2 C.B. 204.

168. *See id.*

state-sanctioned medical marijuana.[169] One could plausibly argue that the Controlled Substances Act states a federal policy about what is or is not beneficial for people and the communities in which they live, and that the IRS need go no further than that in determining whether a marijuana seller could promote the social welfare.

That reasoning, however, negates the possibility that an organization that promoted *any* illegal act could be tax-exempt under § 501(c)(4), and therefore would read out of existence the distinction between charities and non-charities in the application of the public policy doctrine. Reading the public policy doctrine that broadly seems to conflict with the longstanding association of charities with § 501(c)(3) and with the exclusion of § 501(c)(4) organizations from the benefits of deductible charitable contributions under § 170.

Furthermore, the focus of social welfare on local concerns and local beneficiaries suggests at least the possibility that an activity could advance the social welfare of a locality while it was still contrary to some national interest. After all, the IRS has held that an organization created to beautify a *single block* could advance the social welfare of the community.[170] Most importantly, the focus on locality suggests that local policy-makers might disagree with national policy-makers about what activities advance social welfare, and § 501(c)(4) should provide space for local interests to advance their vision of the public good.

If federal law is not the definitive guide to what promotes social welfare, then it seems plausible to look to state law. In legalizing marijuana sales, the states appear to have made a determination about what is in the best interests of their communities. The most recent legalization initiatives suggest that a growing number of voters and legislators are becoming convinced that legalizing and regulating marijuana sales serves the purpose of not only enabling seriously ill people to benefit from marijuana use, but also legalization could serve other social goods.[171] One perceived benefit is that legal marijuana could play a major role in ending the *illegal* sale of marijuana. If that were true, the benefits of using legal marijuana sales to run illegal operations out of business would presumably be largely focused in the neighborhoods that are currently plagued by concentrations of illegal marijuana sales.[172] The argument is that illegal drug sales negatively impact bystanders, who are directly affected by increased levels of violence and whose neighborhoods are prevented from developing economically due to safety concerns. A vibrant illegal drug market also negatively impacts the

169. United States v. Oakland Cannabis Buyers' Coop., 532 U.S. 483, 489–91 (2001).

170. *See* Rev. Rul. 75-286, 1975-2 C.B. 210.

171. *See* sources cited *supra* note 5.

172. This argument about the benefits of substituting a legal, regulated marijuana market for an illegal, unregulated market depends on a number of assumptions, which may or may not be based on correct factual premises. For differing views on the issue, see *supra* note 82.

young people who are driven to take jobs in it—young people who are primarily poor and living in these distressed neighborhoods. Running illegal marijuana sellers out of business could have a significant effect on decreasing the chances that an entrepreneurial young person would find him or herself involved in the illegal drug trade. In other words, the trend among states to legalize marijuana is driven at least partially by a growing belief that permitting the legal sale of marijuana could have the effect of providing relief to the poor, distressed, and underprivileged, lessening neighborhood tensions, combating community deterioration, and combating juvenile delinquency.

In addition, states that have legalized marijuana are pointing to other social benefits. Voters in states that have legalized marijuana have argued that legalization will increase security by permitting police to prioritize more dangerous illegal activity;[173] help keep youths who are tempted to participate in the illegal drug trade out of jail and out of dangerous gangs; help neighborhoods develop; and protect innocent bystanders, often young, who are impacted by the drug trade.[174] The states that have enacted legislation based on these arguments have made policy decisions about what promotes social welfare, and these policy choices are important.

If a state has determined that an activity is in the best interests of its neighborhoods and communities, it is hard to argue that it "violate[s] the minimum standards of acceptable conduct necessary to the preservation of an orderly society."[175] Indeed, the states have made a determination that regulating marijuana sellers is more likely to preserve an orderly society than not doing so. The federal government's decision to continue criminalizing all marijuana selling has significantly less weight as a determination of what conduct is necessary for the preservation of an orderly society, since the states are closer to the communities and neighborhoods they represent and have primary and plenary sovereignty over decisions regarding community order.

Finally, if states have made a determination that legal marijuana is potentially beneficial to a community, and the federal government has made a determination that legal marijuana is harmful to a community, *municipalities, localities, and neighborhoods* may have their own views on the matter.[176] These views may be expressed in local zoning laws and

173. *See* WASHINGTON VOTER GUIDE, *supra* note 5, at 31 ("Treating adult marijuana use as a crime . . . ties up police, courts, and jail space. We should focus our scarce public safety dollars on real public safety threats.").

174. *See id.* ("Marijuana prohibition has made our communities less safe. . . . [W]e need to take the marijuana profits out of the hands of violent organized crime.").

175. Rev. Rul. 75-384, 1975-2 C.B. 204.

176. Many municipalities have passed ordinances to prevent marijuana from being sold in their jurisdiction, causing conflict between state and local governments. *See generally* Salkin & Kansler, *supra* note 24 (discussing conflict between states and localities over marijuana policy); Steve Elliot, *Judge*

regulations, but they may also be expressed through participation in local organizations. Surely, these *local* determinations of what potentially promotes social welfare should be given significant deference in making determinations about what type of organization promotes social welfare.[177] Thus, an IRS determination about whether an organization promotes social welfare arguably should discount federal law (contrary to the public policy doctrine) and should instead look to state law, local law, and civic engagement. Thus, the IRS should only recognize a social welfare organization that sells marijuana when state and local indications align in support of legal marijuana sales.

As discussed above,[178] in Revenue Ruling 75-384 the IRS determined that an organization that conducted civil disobedience to protest war could not be a § 501(c)(4) organization because it engaged in conduct that violated the minimum standards of acceptable conduct necessary for the preservation of an orderly society.[179] Without conceding that the IRS was right in that determination, it is possible to distinguish that organization from a community economic development corporation that operates a marijuana store. In the case of the organization conducting civil disobedience campaigns, such campaigns would violate *local* laws, and therefore would violate norms established by both state and local communities. The organization was created to purposely provoke local law enforcement by engaging in conduct that those authorities perceived to be a breach of the peace and therefore a threat to the preservation of an orderly society. [180]

The same could not be said about a nonprofit marijuana seller in a state and locality in which marijuana is legal. Indeed, the opposite is the case. A

Tosses L.A. Pot Dispensary Moratorium, NEWS JUNKIE POST (Dec. 11, 2010, 12:39 PM), http://newsjunkiepost.com/2010/12/11/judge-tosses-l-a-pot-dispensary-moratorium/; Scott Gacek, *MA: Peabody Bans Medical Marijuana Dispensaries*, DAILY CHRONIC (Jan. 25, 2013), http://www.thedailychronic.net/2013/15048/ma-peabody-bans-medical-marijuana-dispensaries/.

177. *See, e.g.*, Kamin, *supra* note 6, at 162–65 (discussing tension between states and localities and the "federalism" issues caused by this type of intergovernmental conflict). The IRS's evaluation of whether a marijuana seller promotes social welfare could well take into account the views of the local government as well as other community stakeholders or leaders in the impacted neighborhood. Indeed, that would be the purpose of selling marijuana from a community economic development organization—to ensure community participation.

178. *See supra* text accompanying notes 116, 149–54.

179. *See* Rev. Rul. 75-384, 1975-2 C.B. 204.

180. Again, without in any way accepting the reasoning of cases like I.R.S. Gen. Couns. Mem. 34,696 (Nov. 26, 1971) (homosexuality), *revoked in* I.R.S. Gen. Couns. Mem. 37,173 (June 21, 1977), I.R.S. Gen. Couns. Mem. 36,187 (Mar. 11, 1975) (marijuana), or I.R.S. Priv. Ltr. Rul. 2013-23-025 (June 7, 2013) (polygamy), those situations can be distinguished since the "bad" act that the organizations promoted, or were cautioned not to promote, was illegal in their state or locality, and not just at the national level. Indeed, in each of those cases, it was pointed out that there was consensus (or almost complete consensus in the case of sodomy laws) among the states and the federal government about the proscribed activity. Such is obviously not the case today with respect to marijuana use (or homosexuality, obviously).

nonprofit marijuana seller is organized and operated specifically to *preserve* the order of the society in which it operates. It seeks to combat illegal, unregulated marijuana selling and make opportunities for the neighborhoods and youth formerly impacted by it. In each case, the state in which it would operate had legalized its operations and thereby determined that such operations do not breach the peace or violate community norms. In addition, because the organization would be community-based, its existence would reflect a community determination that its operations promoted rather than impeded social order and social welfare. In this situation, it is only the federal government who views the activities as destructive, and it is not at all clear that it does so because they violate the minimum standards necessary for the preservation of an orderly society. If the question is what promotes the social welfare, then the local community and state authorities presumably are better guides than federal law.

As discussed above, an organization should be able to qualify as promoting social welfare if it: (1) ran a state-sanctioned marijuana business in such a way as to drive illegal marijuana sales out of business in a neighborhood previously plagued by the illegal marijuana trade; (2) employed and provided job-skills training for youths who were previously blocked from employment because of the operations of the illegal marijuana trade; and (3) was operated by a community-based organization that operated the business for the purpose of advancing the interests of its poor and distressed neighborhood, and not just making money for someone. The fact that marijuana is still illegal under federal law should not determine whether an organization qualifies for tax-exemption under § 501(c)(4). Rather, the IRS should independently apply the criteria for tax-exemption by determining whether the activities performed by the organization promote social welfare. Only if such activities "violate the minimum standards of acceptable conduct necessary for the preservation of an orderly society [and] are contrary to the common good and general welfare of the people in a community"[181] should the IRS deny § 501(c)(4) status.

4. Social Welfare and Illegality

Of course, even if the IRS were to accept the argument made above and accept the § 501(c)(4) status of social welfare organizations that sold marijuana contrary to federal law, the illegality of these organizations' activities would be problematic. Obviously, it might be hard to find people to work at such organizations since the workers could be subject to criminal prosecution for the violation of federal law. Scholars and commentators have identified other impediments to operation of for-profit-marijuana businesses that would apply with equal force to § 501(c)(4) social welfare organization. It is difficult or impossible for marijuana sellers to open bank

181. Rev. Rul. 75-384, 1975-2 C.B. 204.

accounts,[182] it may be difficult for them to rent retail space,[183] their contracts may be unenforceable,[184] and their lawyers may be subject to legal prosecution or censure for ethical violations.[185]

In addition, there are some issues that would be unique to a nonprofit social welfare organization. First, a § 501(c)(4) organization would have to be some type of *entity*, a nonprofit corporation being the most common choice. Most states have nonprofit corporation statutes, and most of these statutes specify that a nonprofit corporation can be formed for any *lawful* purpose, presumably excluding illegal purposes.[186] It is not at all clear that these statutory provisions would bar nonprofit incorporation of marijuana sellers, however, since the purpose—promotion of social welfare—is legal, even if one of the primary activities that advance that purpose—selling marijuana—is not. If nonprofit incorporation was problematic in a state, an organization could operate as an unincorporated nonprofit association, which does not have the same express limitation on permissible purposes.[187]

If one were to contemplate selling marijuana, one should not minimize the impact of the fact that doing so is illegal under federal law. Even if the federal government pursues a policy of restraint with respect to criminal enforcement, the impediments to state-sanctioned marijuana selling caused by federal illegality are great. But, if one were to attempt to sell marijuana notwithstanding these impediments, it is plausible that operating as a tax-exempt § 501(c)(4) social welfare organization would at least relieve the seller of the burden of federal taxation under § 280E.

III. FEDERALISM AND MARIJUANA POLICY

The previous Part argues that current law plausibly permits marijuana sellers to avoid the impact of § 280E by operating as tax-exempt social welfare organizations. If that is true, federal tax law creates a strong incentive for marijuana sellers to do just that. This incentive may well be no more than a historical oddity: an unintended consequence of the confluence of the creation of a type of tax-exempt organization that is unaffected by the public policy doctrine and the placement in the tax code

182. *See, e.g.*, Jose Pagliery, *Legal Marijuana's All-Cash Business and Secret Banking*, CNNMONEY (April 29, 2013, 3:56 PM), http://money.cnn.com/2013/04/29/ smallbusiness/ marijuana-cash/.

183. *See* Michael N. Widener, *Medicinal Cannabis Entrepreneurs As Commercial Tenants: Assessment and Treatment*, 46 REAL PROP., TR. & EST. L.J. 377, 382–83 (2011).

184. *See* Hammer v. Today's Health Care II, No. CV2011-051350 (Ariz. Super. Ct. 2012).

185. *See* Kamin & Wald, *supra* note 13, at 892–95 (2013).

186. For example, the Model Nonprofit Corporation Act stipulates that "[e]very nonprofit corporation has the purpose of engaging in any lawful activity unless a more limited purpose is set forth in the articles of incorporation." MODEL NONPROFIT CORP. ACT § 3.01(a) (2008).

187. The Revised Uniform Unincorporated Nonprofit Association Act has no express requirement that an unincorporated association have a legal purpose. *See* REVISED UNIF. UNINCORPORATED NONPROFIT ASS'N ACT § 2(8) (2008).

of a penalty for selling marijuana. But it is possible that the incentive created in such a strange manner is good policy. This Part explores that question: Does a tax incentive encouraging marijuana selling by social welfare organizations solve certain federalism issues better than other federal laws addressing the marijuana issue?

The conflict between state and federal laws governing the marijuana industry presents a stark example of inter-jurisdictional conflict. The federal government has criminalized all sale and use of marijuana; a number of states have legalized marijuana for medical purposes; and, as of this year, Washington and Colorado have legalized marijuana for any purpose. This conflict creates a potentially extreme federalism problem.[188] Robert Mikos describes a "war" between the federal government and some states over marijuana policy.[189] The most predictable outcome of the war would be a victory for the federal government, given that the Constitution permits the federal government to preempt state law when acting within its authority, and the Supreme Court has held that regulating marijuana is within the federal government's authority.[190]

However, Mikos argues that "the states—and not the federal government—have already won the war over medical marijuana,"[191] largely because states have continued to legalize marijuana and public opinion is strongly behind them.[192] If the President wanted to use force to fight the war, he could direct the Department of Justice to criminally prosecute marijuana users or sellers to the full extent of federal law, presumably resulting in significant prison sentences for people who are behaving in ways sanctioned by their state governments. While there are practical constraints on the federal government's ability to prosecute marijuana sellers,[193] it

188. For example, Michael O'Hear complains that federal-state conflicts over drug policy "threaten the integrity of national drug policies, generate unnecessary public confusion, and present a risk of real injustice to individuals caught in the middle." Michael M. O'Hear, *Federalism and Drug Control*, 57 VAND. L. REV. 783, 787 (2004).

189. *See* Mikos, *When States Relax*, *supra* note 6, at 3.

190. *See* Gonzales v. Raich, 545 U.S. 1, 22 (2005). Commentators have noted that, "the problem of federal preemption of state law lies in its eliminating the advantages of regulatory overlap. Preemption is 'jurispathic,' erasing the benefits of concurrent legal regimes." ROBERT A. SCHAPIRO, POLYPHONIC FEDERALISM: TOWARD THE PROTECTION OF FUNDAMENTAL RIGHTS 114 (2009).

191. Mikos, *When States Relax*, *supra* note 6, at 3.

192. A recent Pew research poll found that 52% of Americans favored marijuana legalization, and 72% reported that the costs of enforcing marijuana prohibitions exceed the value to society. PEW RESEARCH CTR., supra note 27, at 2–3. More to the point, "60% say that the federal government should not enforce federal laws prohibiting the use of marijuana in states where it is legal." *Id.* at 3.

193. *See, e.g.*, Mikos, *When States Relax*, *supra* note 6, at 19 ("Though the [Controlled Substances Act] certainly threatens harsh sanctions, the federal government does not have the resources to impose them frequently enough to make a meaningful impact on proscribe behavior.").

presumably could deter a lot of individual actors if it vigorously enforced the criminal law. Instead, the President appears to have tactically retreated from this inter-jurisdictional conflict, at least with respect to criminal enforcement of federal drug laws against state-sanctioned marijuana sellers.[194]As discussed above, the IRS has not participated in this retreat, and its current policy appears to be vigorous enforcement of § 280E against state-sanctioned marijuana sellers. I argue that § 280E enforcement, coupled with recognition of tax-exempt status for properly operated marijuana sellers, provides the federal government with a superior resolution to its "war" with the states. Using tax law to channel marijuana sellers into social welfare organizations is better policy than either returning to a policy of enforcing criminal penalties against state-sanctioned marijuana sellers or a policy of benign neglect of state-sanctioned marijuana sellers.[195]

The use of federal tax law to channel marijuana sellers into social welfare organizations is superior policy because it encourages "multi-jurisdictional" federalism. Multiple scholars of federalism have pointed out that a dualist model of federalism, in which the goal is to allocate authority between or balance the interests of only two parties—a state government and the national government—is too limited.[196] Instead, it is important to recognize that localities may have inter-jurisdictional conflicts with their states, and the principles of federalism may apply with equal force to these sub-national, inter-jurisdictional conflicts, even if localities are not truly sovereign.[197] In the marijuana context, conflicts between states that have liberalized marijuana laws and localities seeking to restrict or prohibit marijuana sales have become common.[198] Therefore, in assessing the merits

194. *See* sources cited *supra* note 13.

195. I do not argue that this approach is superior to the federal government getting out of the marijuana control business altogether. If Congress were tempted to de-list marijuana as a Schedule I Controlled Substance, thereby officially removing the absolute federal ban on marijuana sales and use, that may well be the best option of all. Consideration of re-scheduling marijuana under the Controlled Substances Act is beyond the scope of this Article. However, for a discussion of Congress's and the Attorney General and Drug Enforcement Agency's past refusals to re-schedule marijuana, see Mikos, *Medical Marijuana*, *supra* note 6, at 1434. If the IRS were to get out of the marijuana control business entirely, either through congressional or administrative action, that would reduce the inter-jurisdictional conflict that exists under current law. *See supra* note 29.

196. *See, e.g.*, SCHAPIRO, *supra* note 190, at 79 ("To ensure real opportunities for citizen participation, decisions must be made in counties, towns, or cities. The central government, just as well as the states, could allocate decisions to localities. If the ultimate goal is meaningful local participation, then it would seem that constitutional protection of localism, rather than federalism, would be the most direct path." (footnote omitted)).

197. *See, e.g.*, Roderick M. Hills, Jr., *Dissecting the State: The Use of Federal Law to Free State and Local Officials from State Legislatures' Control*, 97 MICH. L. REV. 1201 (1999); Kamin, *supra* note 6; O'Hear, *supra* note 188.

198. *See* Kamin, *supra* note 6, at 152–57 (discussing the enforcement of federal law in states that allow medicinal use of marijuana); Salkin & Kansler, *supra* note 24, at 3 (discussing the

of any particular approach that the federal government could take to the question of how to influence national marijuana policy, it makes sense to take into account not just policy made at state level, but the interests of local stakeholders in each locality as well.

How could this "multi-jurisdictional" federalism be advanced by an IRS policy of channeling marijuana sellers into nonprofit social welfare organizations? First, as discussed above, nonprofit social welfare organizations are more likely than for-profit operations to advance the interests of localities because of their commitment to social welfare purposes. To qualify as a social welfare organization, an organization would have to provide job training and employment opportunities for hard-to-employ members of the community. Providing these jobs has the potential to reduce the negative effects of illegal drug markets and thereby positively impact the neighborhood in which the organization operates.

But perhaps as importantly, while I have argued that an intention to violate *federal* law should not prevent an organization from qualifying for tax-exempt status under § 501(c)(4), I have also argued that an intention to violate *state* or *local* laws should. Remember, the one piece of guidance from the IRS on the relationship between illegal activities and § 501(c)(4) status involved an organization whose intention was to violate *local* laws and ordinances by engaging in civil disobedience. The IRS argued that an organization that intended to disrupt the peace of a community could not advance the social welfare of that community because it intended to engage in activities that "violate the minimum standards of acceptable conduct necessary to the preservation of an orderly society."[199] The IRS could make clear that this "minimum standards of acceptable conduct" standard is based on *local* standards, and could thereby refuse to recognize the tax-exempt status of a social welfare organization that intended to sell marijuana contrary to local law. If that was the IRS's standard then it would be using federal law to intervene in marijuana policy, *but only when state laws and local laws were in harmony*. In effect, the tax law would incentivize marijuana sales in communities that permitted such sales, and dis-incentivize such sales in communities that objected to them. This type of "multi-jurisdictional" approach to a key federalism issue could mitigate inter-jurisdictional conflict, and would arm localities in their struggle for control over marijuana policy.

Finally, the fact that federal tax law regulates certain aspects of the governance of social welfare organizations potentially adds another level of regulation to marijuana sellers. Federal law requires transparency in the finances of social welfare organizations by requiring public access to their

tensions between state law and local zoning laws with respect to those states that allow the use of medicinal marijuana).

199. Rev. Rul. 75-384, 1975-2 C.B. 204.

annual tax filings (called Form 990). These forms contain important information identifying those responsible for social welfare organizations and providing an organization's financial profile, including the compensation of the five highest paid employees. Requiring public access to this information could beneficially impact the role of marijuana sellers in a community by requiring transparency and the accountability that may go with it.

The substantive restrictions of § 501(c)(4) may also be beneficial in advancing federal interests or in assisting states or localities in pursuing their goals. As discussed above, nonprofit social welfare organizations are prohibited from distributing profits to investors,[200] which effectively bars them from raising equity capital. A ban on raising equity capital effectively slows the growth of an organization. Without significant assets to leverage for debt financing, an organization can only raise so much capital from friendly sources, and so must start small. It may be able to gradually expand operations as it builds up reserves and acquires property to serve as collateral, but this will take time. Thus, by creating a financial incentive for marijuana sellers to operate as nonprofit social welfare organizations, federal tax law slows the explosion of marijuana businesses without completely stopping them.[201] This soft solution to the inter-jurisdictional conflict between states, localities and the federal government may be superior to a hard one. Rather than threatening to put people in jail when they obey their state laws, the federal government can pursue a policy of caution and permit the states' marijuana liberalization experiments to proceed, but slowly and with some federal oversight.

Furthermore, there is at minimum a plausible argument that at least one prominent justification for the existence of § 501(c)(4) is to create the regulatory space for organizations that promote the welfare of local communities, even if the organization is not quite charitable enough to be granted § 501(c)(3) status. There is a line of rulings from the 1970s in which the IRS argued that § 501(c)(4) status is appropriate for organizations that advance local interests, even if such interests are too

200. *See supra* Part II.

201. Of course, any policy that impedes the state-sanctioned sale of marijuana (for example, by slowing the growth of the state-sanctioned industry) increases the likelihood that marijuana buyers will continue to obtain their marijuana from non-state-sanctioned sources. To the degree to which buyers have an adequate substitute for state-sanctioned marijuana in illegal marijuana, state-sanctioned sellers will compete at a disadvantage due to regulatory constraints that illegal sellers effectively avoid. To discourage illegal marijuana sales, states and localities would have to maintain *or increase* their prosecution of illegal sellers to justify the costs imposed on state-sanctioned sellers. This kind of increased prosecution is exactly what voters hope to eliminate by liberalizing marijuana laws—getting this balance exactly right will be a significant regulatory challenge.

limited or local to justify § 501(c)(3) status.[202] There is no reason to believe that this line of reasoning is not presently good law.[203] Thus, it may well be that using § 501(c)(4) to mitigate inter-jurisdictional conflict by leveraging the power of very local community organizations—even when such organizations do not rise to the level of "charitable"—is exactly what § 501(c)(4) is for, even if no one could have predicted the particular statutory scheme that makes marijuana such an intractable problem.

The benefit of using § 501(c)(4) to solve the problem caused by § 280E is that it turns federal tax law into a tool to incentivize the use of community-based nonprofit organizations as the dominant or exclusive state-sanctioned sellers of marijuana. Under the proposed solution, *only* organizations that primarily seek to benefit the communities in which they operate would be granted tax-exempt status, and only those organizations would avoid the impact of § 280E. Such organizations would then be subject not only to state regulation as marijuana sellers, but also to federal regulation as tax-exempt nonprofits. That way, the federal tax laws would be employed to promote coherence between state and local views on social welfare. Marijuana would only be sold when doing so served the goals of both the state and the locality, thus using federal law to advance intergovernmental harmony between the state and the local levels.

CONCLUSION

In the final analysis, the idea that marijuana sellers could avoid the impact of § 280E by operating as social welfare organizations may seem to some readers like nothing more than a "tax loophole" too clever by half. But I do not think it is. Rather, it is a way to at least partially avoid the federalism problems created by inconsistent federal and state laws regarding marijuana sales. If the Department of Justice is willing to refrain from enforcing criminal statutes against state-sanctioned marijuana sellers, the IRS can play a role in cabining such activities in forms that promote their responsible operation.

Currently, the IRS's enforcement of § 280E dramatically raises the cost of legitimacy for a marijuana seller. Black-market operators avoid paying taxes by hiding their operations and avoiding detection by the authorities. State-sanctioned operators do not have that luxury, and the IRS is currently punishing them with an unsustainable income-tax regime. Ironically, the tax burden imposed by § 280E makes it virtually impossible for states or localities to levy their own sales or excise taxes on marijuana. The federal tax

202. *See, e.g.*, Rev. Rul. 75-286, 1975-2 C.B. 210; Rev. Rul. 75-386, 1975-2 C.B. 211; Reilly, et al., *supra* note 91.

203. For a recent example that supports this reasoning, see I.R.S. Priv. Ltr. Rul. 2011-23-047 (Mar. 18, 2011). Thanks to Daniel Halperin for alerting me to this private letter ruling.

makes the price of legitimate operations so high that there is potentially no money left over to pay other taxes.

But if marijuana sellers operated as § 501(c)(4) organizations, the benefits would be numerous. Sellers that were operated solely to enrich their owners without any community involvement might be driven out of business by § 280E. On the other hand, the federal income tax would not affect sellers that were community-based, that sought primarily to provide relief to the poor, distressed, or underprivileged, to lessen neighborhood tensions, and to combat community deterioration and juvenile delinquency. These organizations would have a leg up, not only over the illegal and black-market operators, but over regular for-profit operators as well. They might flourish. The IRS would be serving not to frustrate the policy goals enunciated by states when they legalized marijuana sales, but to support those goals.

It is unlikely that the IRS will approve an application for § 501(c)(4) status from a marijuana seller who applied. Even though the law permits it, it is uncharted legal terrain, and the IRS is not required to go out on a limb for a § 501(c)(4) applicant—especially in the current political environment. However, such political considerations are irrelevant to the question of whether recognizing the tax-exempt status of a properly operated marijuana-selling social welfare organization is legal. If the IRS denies a properly operated organization's application, a court can decide that. But more importantly, interjurisdictional conflicts between the federal government, states, and localities are likely to recur, and creative solutions may be necessary to mitigate the harmful effects of such conflicts.