

2014

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A Response to Professor Leff’s Tax Planning “Olive Branch” for Marijuana Dealers

*Philip T. Hackney**

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In *Olive v. Commissioner*, the U.S. Tax Court applied § 280E of the Internal Revenue Code (“Code”) promulgated by Congress to enact a public policy penalizing those who sell illegal drugs to deny Olive’s trade or business deductions associated with selling medical marijuana.¹ To solve Olive’s tax problem, Professor Leff proposes Olive form a tax-exempt social welfare organization, hire the unemployed and the unemployable, and train them to sell marijuana.² This would seemingly enable Olive to avoid the strictures of § 280E³ since the Code generally does not impose taxes on tax-

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1. *Olive v. Comm’r*, 139 T.C. 19 (2012).
2. Benjamin Moses Leff, *Tax Planning for Marijuana Dealers*, 99 IOWA L. REV. 523 (2014).
3. *Id.*

exempt social welfare organizations.⁴ Leff unconvincingly supports his case by arguing no public policy doctrine applies to social welfare organizations, and further, that we should look to local law rather than federal in determining social welfare.⁵ But this seems hollow. The Controlled Substances Act (“CSA”) makes illegal the activities of both such a proposed organization and all the individuals who participate in the manufacture or distribution of marijuana within such an organization.⁶ It would be odd indeed if such a criminal organization could obtain significant public benefits via the Code.

While Professor Leff’s efforts to resolve this tax problem are well taken, his proposal is unrealistic and ultimately it does not work.⁷ It is clear, and Leff concedes, that Olive could not operate as a tax exempt charitable organization under § 501(c)(3) because of the “public policy doctrine,” which prohibits a charitable organization from violating any law or established public policy.⁸ What is slightly less clear, however, is Leff’s unique claim that a § 501(c)(4) social welfare organization not only need not concern itself with this same public policy doctrine, but also may ignore federal criminal law and look to local law in defining social welfare.⁹ I contend that the public policy doctrine should apply with equal force to social welfare organizations and charitable organizations, as these organizations are merely kissing cousins without significant structural differences.¹⁰ Furthermore, I contend a federal tax exempt organization may not choose to ignore federal criminal law. Leff’s suggestion that local law, instead of federal law, applies to regulations that direct a social welfare organization to promote the social welfare of the people of the community misunderstands the meaning of the regulation. The purpose of community

4. I.R.C. § 501(a) (2012) provides that organizations described in I.R.C. § 501(c) are exempt from federal income tax.

5. Leff, *supra* note 2; *see also* Bob Jones Univ. v. United States, 461 U.S. 574, 598 (1983).

6. *See* 21 U.S.C. §§ 841, 844 (2012).

7. I confine myself to tax law here. There are substantial criminal law concerns as well as legitimate professional licensing considerations that anyone who chooses to form or operate such an entity should consider before entering into any such transaction. *See* Robert E. Mikos, *A Critical Approach to the Department of Justice’s New Approach to Medical Marijuana*, 22 STAN L. & POL’Y REV. 633, 649 (2011) (discussing the significant issue of whether the individuals of such an enterprise could be prosecuted under the Racketeer Influenced and Corrupt Organization (RICO) statute). I also choose not to engage the substantial problem that any organization that chooses this path would face in convincing the IRS that its operation is not simply an artifice for “carrying on a business with the general public in a manner similar to organizations which are operated for profit.” *See* Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii) (as amended in 1990).

8. Leff, *supra* note 2; *see* Bob Jones Univ. v. United States, 461 U.S. 574, 598 (1983).

9. Leff, *supra* note 2.

10. There is controversy regarding the precise boundaries of the public policy doctrine. *See, e.g.,* Bob Jones Univ., 461 U.S. at 609–10 (Powell, J., concurring) (noting the importance of pluralism in tax-exempt organizations); *see also* Johnny Rex Buckles, *Reforming the Public Policy Doctrine*, 53 U. KAN. L. REV. 397 (2005).

is to direct the organization to be a community movement rather than a private one; it is not intended to allow an organization to define away federal limitations on what is and is not the promotion of social welfare.

Additionally, Leff's solution is harmful to the law regarding social welfare organizations, an ill-defined category that is difficult for the Internal Revenue Service ("IRS") to monitor even without Leff's proposal.¹¹ As Leff notes, the IRS and practitioners have long used social welfare to silo nonprofit organizations that are publically beneficial, at least in someone's mind, but not beneficial enough for charitable status.¹² Fitting certain illegal actions into that silo is more of the same. This strategy stretches the law and the resources of our government every time some new organization looks to tax exemption to solve its new "important" problem that is unrelated to tax law. I argue that those who believe marijuana should be legal should expend effort to change federal marijuana policies instead.

In this Essay, I first discuss the requirements of § 501(c)(4) to demonstrate that an organization with a purpose to violate federal criminal law does not fit within its borders. I then consider illegality under the Code along with the public policy doctrine as it applies to tax-exempt organizations. Finally, I consider the implications of this analysis and address whether these implications are supported by the prevailing theories on why we provide tax-exempt status. Thereafter, I conclude that Leff's proposal is unrealistic and should be rejected.

I. SECTION 501(C)(4)'S TAX-EXEMPT STATUS IS INAPPLICABLE TO ORGANIZATIONS THAT PROMOTE ILLICIT ACTIVITY

A thorough analysis of § 501 contradicts Leff's claim that tax-exempt status may apply to social welfare organizations promoting illicit activity. Section 501 provides that "[c]ivic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare" qualify for exemption from federal income tax.¹³ Although there is no legislative history regarding this statutory language,¹⁴ an examination of the

11. Just consider the IRS Tea Party "scandal" as an example of the harm that comes from such an ill-defined Code section made more ill defined by the effort to fit into its ambit whatever organization needs a tax-exempt solution of the day. See TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, INAPPROPRIATE CRITERIA WERE USED TO IDENTIFY TAX-EXEMPT APPLICATIONS FOR REVIEW, (May 14, 2013), available at <http://www.treasury.gov/tigta/auditreports/2013reports/201310053fr.pdf> (discussing the role a lack of guidance played in the IRS's inappropriate target of certain organizations).

12. See, e.g., FRANCES R. HILL & DOUGLAS M. MANCINO, TAXATION OF EXEMPT ORGANIZATIONS ¶ 13.01 (2012).

13. I.R.C. § 501(a), (c)(4)(A) (2006).

14. This provision likely originates from a Chamber of Commerce request to exempt "civic and commercial" organizations. See *Hearings on Tariff Schedules of the Revenue Act of 1913 Before the Subcomm. of the Comm. on Finance*, 63d Cong., 1st Sess. 2001 (1913) (statement of United States

organizations labeled as “civic” associations or organizations at the time of the statutes passage in 1913 suggests the boundaries Congress envisioned. A cursory consideration of the organizations¹⁵ suggests it is highly unlikely Congress intended social welfare organizations could adopt as a purpose the violation of federal or state criminal laws.

Examination of the § 501 regulations supports this conclusion. The regulations provide 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.”¹⁶ Organizations qualifying include homeowner’s associations (as long as the facilities are generally open to the public),¹⁷ health maintenance organizations,¹⁸ cause-related organizations, organizations engaged in community beautification,¹⁹ and organizations involved in providing transportation in a community.²⁰ Notably, there are no readily identifiable social welfare organizations whose purpose involves breaking the law.

Leff tries to pivot off the phrase “people of the community” from the social welfare organization regulations to suggest there might be some ability to judge social welfare from a local perspective and ignore federal criminal law. However, the phrase “people of the community” suggests an idea similar to that played by the charitable class with respect to charitable organizations. This means a social welfare organization must be operated for

Chamber of Commerce). “Commercial” organizations, the Chamber said, are not “selfish,” but perform “civic functions,” and work to improve commerce in the interest of all citizens. The argument follows as such: civic and commercial organizations should not be taxed for the same reason charities should not be taxed—they provide a public benefit in return for exemption.

15. The American Civic Association’s 1911 convention notes, for instance, state that its attendees came from all parts of the country seeking to achieve “the idea ‘practical,’ in making beautiful and efficient community life.” Am. Civic Ass’n’s Convention, Notes, 2 ART & PROGRESS 117, 117 (1911). It recognized various other kindred civic leagues like “the National Municipal League, the General Federation of Women’s Clubs, the Rochester City Planning Conference, . . . the American Federation of Arts, ‘Boston, 1915,’ and the National Plant, Flower and Fruit Guild.” *Id.* The National Municipal League of the time mentioned by the American Civic Association was described by its secretary, as “an active agency in the betterment of American municipal administration.” Clinton Rogers Woodruff, *The National Municipal League*, 5 PROC. AM. POL. SCI. ASS’N 131, 131 (1908). The League believed it was only through “united action and organization that good citizens can secure the adoption of good laws and the selection of men of trained ability and proved integrity for all municipal positions or prevent the success of incompetent or corrupt candidates for public office.” *Id.* at 132.

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

17. See, e.g., Rev. Rul. 74-99, 1974-1 C.B. 131.

18. *Cf.* Vision Serv. Plan, Inc. v. United States, 265 F. App’x 650 (9th Cir. 2008) (unpublished opinion). See also INTERNAL REVENUE MANUAL 4.76.31.1, available at www.irs.gov/irm/part4/irm_04-076-031.html (setting forth its procedures for determining whether a health maintenance organization qualifies under I.R.C. § 501(a) & (c)(4) (2006)).

19. See, e.g., Rev. Rul. 75-286, 175-2 C.B. 210.

20. See, e.g., Rev. Rul. 78-69, 1978-1 C.B. 156.

more people than a select few. As one court said, such an "organization must be a community movement designed to accomplish community ends."²¹ There is nothing to support Leff's contention that the term "community" within a social welfare context means a particular community may ignore some federal laws in defining social welfare. It merely connotes that there must be a "community" big enough to accept that this organization has a real public purpose.

A social welfare organization must operate "exclusively" to promote social welfare. While this would seem to suggest that any scintilla of a non-social welfare purpose would be deadly to qualification, the Treasury Regulations concerning § 501(c)(4) interpret exclusively to mean "primarily."²² This interpretation, although long-held, is in significant dispute²³ and conflicts with the Supreme Court's interpretation of "exclusively" in *Better Business Bureau of Washington, D.C., Inc. v. United States*, in which the Court analyzed the term in the context of the Social Security Act.²⁴ The Court stated the term "exclusively . . . plainly means that the presence of a single noneducational purpose, if *substantial* in nature, will destroy the exemption regardless of the number or importance of truly educational purposes."²⁵

The Treasury Regulations regarding § 501(c)(3) also interpret exclusively to mean primarily, but state no "more than an insubstantial part of [an organization's] activities" may be in furtherance of a non-exempt purpose.²⁶ Additionally, while the regulations provide an organization cannot operate for the "primary purpose" of running an unrelated trade or business, it again uses the substantial language to modify "primary";²⁷ in the positive, the regulation states an organization can operate "a trade or business as a *substantial* part of its activities, if" that business furthers the organization's exempt purpose.²⁸ This caveat in the § 501(c)(3) regulations seems truer to a likely intent of Congress in using the term "exclusively."²⁹

21. *Erie Endowment v. United States*, 316 F.2d 151, 156 (3d Cir. 1963).

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

23. *See, e.g.*, Letter from Fred Wertheimer, President, Democracy 21, to Douglas H. Shulman, Comm'r, Internal Revenue Serv. (July 27, 2011), *available at* http://www.democracy21.org/uploads/D21_and_CLC_Petition_to_IRS_7_27_2011.pdf (requesting the IRS change its regulation to eliminate the term "primarily" in those regulations and suggesting the standard should be a question of substantiality instead).

24. *Better Bus. Bureau of Wash., D.C., Inc. v. United States*, 326 U.S. 279 (1945).

25. *Id.* at 283 (emphasis added).

26. Treas. Reg. § 1.501(c)(3)-1(c)(1) (as amended in 2008).

27. Treas. Reg. § 1.501(c)(3)-1(e).

28. *Id.* (emphasis added).

29. Some argue that the enactment of the unrelated business income tax prompted a changing of the "exclusively" language, such that the use of the term "primarily" is likely the correct standard. *See, e.g.*, Ellen P. Aprill, *The IRS's Tea Party Tax Row: How 'Exclusively' Became 'Primarily'*, PAC. STANDARD (Jun. 7, 2013), <http://www.psmag.com/politics/the-irss-tea-party->

It is hard to believe Congress meant one thing regarding the word “exclusively” with respect to charitable organizations and another with respect to social welfare organizations. In fact, courts reviewing social welfare as a purpose have generally used the substantial notion of exclusivity. In *Contracting Plumbers* for instance, the Second Circuit, considering whether an organization qualified under § 501(c)(4) stated: “we adhere to the rule that the presence of a single substantial non-exempt purpose precludes exempt status regardless of the number or importance of the exempt purposes.”³⁰ I submit that this continues to be the correct standard, and since illegal actions cannot promote a social welfare purpose, the only real question left is whether Congress intended social welfare organizations to be able to violate federal law if local law conflicted. As noted above, this seems highly suspect.

In conclusion, the difference in purpose between charitable organizations and social welfare organizations is slight.³¹ The biggest difference is that a social welfare organization can engage in some political campaign intervention, while a charitable organization cannot.³² It is hard, though, to find a significant difference between the two that would suggest one could violate the law to some different extent. Should the greater subsidization of a charitable organization really mean a social welfare organization could choose to ignore federal criminal law? I think not.

II. TAXPAYERS MAY NOT USE THE INTERNAL REVENUE CODE TO PROMOTE ILLICIT ACTIVITY

Leff’s proposal is subject to two slightly different public policy doctrines, both of which will likely disallow his suggestion. The courts developed the first public policy doctrine on the idea that the federal tax system has no role in sanctioning criminal activity.³³ Courts often deny business deductions for expenses that contravene “sharply defined” public

tax-row-how-exclusively-became-primarily-59451/. However, Congress did not change the term “exclusively” in either §501(c)(3) or (4). It also maintains the use of the notion of “substantial” adopted by the Court in *Better Business. Better Bus. Bureau of Wash., D.C., Inc.*, 326 U.S. at 283.

30. *Contracting Plumbers Coop. Restoration Corp. v. United States*, 488 F.2d 684, 686 (2d Cir. 1973).

31. A social welfare organization can engage in one-hundred percent lobbying while a charitable organization can engage in no more than a substantial part. I.R.C. § 501(c)(3) (2006). The regulations under §501(c)(3) indicate that “social welfare” qualifies as a charitable purpose. *See id.* There is no “organizational” test that applies to social welfare organizations, while such a test applies to charitable organizations. Both organizations are subjected to § 4958 excess benefit transactions and there is a prohibition on inurement for both, as well as a prohibition on private benefit, and “commercial activity.” Charitable organizations of course may receive deductible charitable contributions, while social welfare organizations may not.

32. I.R.C. § 501(c)(3) expressly prohibits the participation in, or intervention in “any political campaign on behalf of (or in opposition to) any candidate for public office.”

33. *Comm’r v. Tellier*, 383 U.S. 687, 691 (1966); *see also* Edward J. Roche, Jr., *Federal Income Taxation of Medical Marijuana Businesses*, 66 TAX LAW. 429 (2013).

policy.³⁴ "[T]he test of nondeductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction."³⁵ Seeing the merits in this doctrine, Congress codified a similar approach in several areas of the Code. For instance, the Code now prohibits deductions for illegal bribes, kickbacks, or illegal payment under the law, or for any fine paid to a government for violation of the law.³⁶

Both of these public policy doctrines are alive and well. For instance, the Tax Court denied a loss deduction for a man who burned his house down in a grossly negligent manner.³⁷ Congress also continues to use public policy to deny deductions. It in fact enacted § 280E on public policy grounds.³⁸ Accordingly, the public policy doctrine likely affects Leff's proposal—the question, however, is how?

A. *THE APPLICATION OF THE PUBLIC POLICY DOCTRINE TO CHARITABLE ORGANIZATIONS*

If the Code is not generally intended as punishment, how should the public policy doctrine apply in the case of organizations exempted from income tax? The predominant view of tax exemption is that it is a subsidy.³⁹ If exemption is a subsidy, by choosing to grant an organization exemption, the federal government is aiding that organization's activities and purposes—clearly, the federal government did not intend for the Code to promote illicit activities.

In *Bob Jones*, the Court held an organization that violates established public policy is not tax exempt under § 501(c)(3).⁴⁰ Bob Jones argued that even though it employed racially discriminatory policies it satisfied the "educational" purpose of § 501(c)(3) and did not need to show it qualified as "charitable" too.⁴¹ It claimed that while the word "charitable" might include a public policy requirement from charitable trust law, no such idea is imbued in the purpose of education.⁴² The Court, believing the plain purpose of the statute could not possibly allow the violation of law or

34. See *Tank Truck Rentals, Inc. v. Comm'r*, 356 U.S. 30, 33 (1958). This typically applied to criminal fines where a court believed the allowance of the deduction worked against state systems of criminal enforcement.

35. *Id.* at 35.

36. I.R.C. § 162(c), (f).

37. *Blackman v. Comm'r*, 88 T.C. 677, 682 (1987).

38. In recommending it, the Senate Finance committee stated: "[t]here is a sharply defined public policy against drug dealing." S. REP. NO. 97-494, vol. 1, at 309 (1982).

39. See generally Philip T. Hackney, *What We Talk About When We Talk About Tax Exemption*, 33 VA. TAX REV. 101 (forthcoming 2014).

40. *Bob Jones Univ. v. United States*, 461 U.S. 574, 591-92 (1983).

41. *Id.* at 585-86.

42. See *id.*

established public policy, looked beyond the plain language of the statute.⁴³ Because tax-exempt organizations must provide a public benefit in return for their tax-advantaged status, the Court held such organizations must not violate public policy.⁴⁴

While Leff is correct that the Court focused upon charitable trust law to justify the public policy doctrine as to charitable organizations, I contend the Court's reasoning is expansive and rests within the broader public policy doctrine discussed above that applies throughout the Code. Speaking at once regarding the concept of "charity" but at the same time speaking to the idea of "tax exemption"—a broader concept—the Court stated Congress had "the intent that entitlement to tax exemption depends on meeting certain common-law standards of charity—namely, that an institution seeking tax-exempt status must serve a public purpose and not be contrary to established public policy."⁴⁵ In a footnote, the Court drew support from the public policy doctrine regarding deductions discussed above.⁴⁶ Recognizing the broad application of the public policy doctrine in the Code by courts and Congress, the Court could have decided *Bob Jones* without resorting to charitable trust law. The requirement that an organization receiving tax exempt-status may not violate established public policy is simply a logical step that comes with the granting of such federal benefits. Tax-exempt organizations should not be allowed to violate fundamental public policy.⁴⁷

Also, *Bob Jones* did not violate criminal law, it violated a significant national moral code prohibiting discrimination on the basis of race. If *Bob Jones* violated criminal laws (other than say, parking tickets), the case likely never would have reached the Supreme Court. Importantly, none of the justices (including the dissent) had trouble with the IRS legitimately denying tax-exempt status to Fagin's School for Educating English Boys because its primary purpose—to teach people to violate the law—is simply not charitable or educational within the meaning of the statute. No one needed charitable trust law to come to such a conclusion—such a notion must be within the statute itself.

43. *Id.* at 586; *see also id.* at 591–92 n.18 ("Fagin's school for educating English boys in the art of picking pockets would be an 'educational' institution under that definition. . . . Surely Congress had no thought of affording such an unthinking, wooden meaning to § 170 and § 501(c)(3) as to provide tax benefits to 'educational' organizations that do not serve a public, charitable purpose.").

44. *Id.* at 592.

45. *Id.* at 575.

46. *Id.* at 591 n.17 (discussing "the presumption against congressional intent to encourage violation of declared public policy" (internal quotation marks omitted) (quoting *Tank Truck Rentals, Inc. v. Comm'r*, 356 U.S. 30, 35 (1958))).

47. *Cf. supra* notes 7–10 (discussing the controversy regarding applying the idea of "fundamental public policy").

B. *TAX EXEMPT ENTITIES MAY NOT USE ILLEGAL ACTIVITIES TO PROMOTE THEIR EXEMPT PURPOSE*

Leff's claim that social welfare organizations may take illegal actions to support their tax-exempt purpose is simply inaccurate. As a preliminary matter, the IRS holds social welfare organizations may not violate the law.⁴⁸ The IRS explains that "[i]llegal 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."⁴⁹

Leff suggests, however, that this holding is not necessarily controlling because the IRS apparently has a different policy for social welfare organizations than charitable organizations.⁵⁰ This argument is unpersuasive because the IRS found the same quantum of illegal activity meant this organization was not operated exclusively for an exempt purpose as either a charitable or a social welfare organization. Although certain illegal actions, like violations of local pollution regulations, may not deny an organization exempt status, other illegal activities, like robbing banks, will immediately result in an organization's loss of exempt status.⁵¹

The question then arises as to whether promoting illegal marijuana sales and/or consumption is sufficiently "illegal" to result in the loss of exempt status. The following two judicial opinions indicate the answer is clearly yes.

In *United States v. Omaha Live Stock Traders Exchange*, the Eighth Circuit determined a livestock trading exchange organization could qualify as a business league under § 501(c)(6) even though it engaged in illegal trade practices; the organization otherwise qualified, and the illegal practices did no harm to business practices.⁵² The later clarified antitrust violations of business leagues only become problematic when the practice is: (1) judicially determined to violate the law; (2) a principal practice or one of a number of principal practices; (3) harmful to general business; and (4) imputable to the members of the organization.⁵³ This simply implements the idea that the tax-exemption question is whether the legal violation is too great in quantity and quality that it overshadows the exempt activity.

48. Rev. Rul. 75-384, 1975-2 C.B. 204; *see also* Jean Wright & Jay H. Rotz, *Illegality and Public Policy Considerations*, in EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION (CPE) TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 1994 (1993), available at www.irs.gov/pub/irs-tege/eotopicL94.pdf.

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

50. Leff, *supra* note 2.

51. I.R.S. Gen. Couns. Mem. 34,631, at *12-13 (Oct. 4, 1971).

52. *United States v. Omaha Live Stock Traders Exch.*, 366 F.2d 749, 751-53 (8th Cir. 1966).

53. I.R.S. Gen. Couns. Mem. 37,111 (May 4, 1977).

The U.S. Tax Court adopted a similar line of reasoning in determining that an organization qualified as a social club under § 501(c)(7) even though it engaged in illegal gambling.⁵⁴ There were a couple of mollifying factors though—all the clubs in the area engaged in such gambling activity under the knowledge of the law, and revenues from the activity made up a small portion of the revenues of the club in the relevant years (twenty-two percent and thirteen percent).⁵⁵ Following this case, the IRS ruled a social club deriving revenue from illegal gambling devices still qualified as exempt as a social club under § 501(c)(7).⁵⁶ Troublingly, the IRS found gambling devices promoted pleasure and recreation.⁵⁷ While the court case seems justifiable under my above analysis, the related IRS ruling seems incorrect and of questionable merit. It is very odd for the federal government to assist an organization in explicit violation of state or local statutes.⁵⁸

The IRS position today, as evidenced by a recent private letter ruling, seems to be that illegality does not foster any exempt purpose. As Leff notes, the IRS ruled a cooperative with a primary purpose of the cultivation of marijuana for sale could not qualify as exempt under § 501(c)(16).⁵⁹ Because the sale of marijuana is illegal under federal law—and federal law prevails over state law—the IRS found the organization did not qualify for exemption. It based its holding on the principle that tax deductions and exemptions are not available to those who violate the law.

III. PROFESSOR LEFF'S OLIVE BRANCH FAILS BECAUSE IT DIRECTLY AND SUBSTANTIALLY CONFLICTS WITH CONTROLLING FEDERAL LAW

Leff's suggested course of action contradicts the decision by all three branches of the federal government that marijuana should be illegal. Congress enacted legislation to make marijuana illegal, and on public policy reasons, Congress denies marijuana dealers trade or business deductions under the Code. Federal law bans people who use illicit drugs from: serving in a certain roles associated with public transportation,⁶⁰ receiving federal housing assistance,⁶¹ and possessing firearms.⁶² The Court has found the criminalization of marijuana to be constitutional.⁶³ The Department of

54. *Aviation Country Club, Inc. v. Comm'r*, 21 T.C. 807, 815-17 (1954). *acq.*, 1954-2 C.B. 3.

55. *Aviation Country Club, Inc.*, 21 T.C. at 813-15.

56. Rev. Rul. 69-68, 1969-1 C.B. 153.

57. *Cf. Augusta Golf Ass'n, Inc. v. United States*, 338 F. Supp. 272, 275 (S.D. Ga. 1971).

58. Congress enacted I.R.C. § 501(i) in 1976 to make explicit that social clubs may not discriminate in their written organization documents on the basis of race, color, or religion. This legislation of course predates the *Bob Jones* opinion.

59. I.R.S. Priv. Ltr. Rul. 2013-33-014 (May 20, 2013); Leff, *supra* note 2.

60. 49 U.S.C. § 5331 (2006 & Supp. V 2011).

61. 42 U.S.C. § 13661 (2006 & Supp. V 2011).

62. 18 U.S.C. § 922(g)(3) (2012).

63. *See, e.g., Gonzales v. Raich*, 545 U.S. 1 (2005); *United States v. Oakland Cannabis Buyers' Coop.*, 532 U.S. 483 (2001).

Justice ("DOJ") states in considering enforcement regarding marijuana it takes into consideration that "marijuana is a dangerous drug and that the illegal distribution and sale of marijuana is a serious crime that provides a significant source of revenue to large-scale criminal enterprises, gangs, and cartels."⁶⁴ Engaging in the distribution of such a drug that is a clear public policy problem at a federal level cannot possibly promote social welfare.

The attempt to stretch the idea of community in the idea of social welfare to allow a community to ignore certain federal laws also fails; the idea of community focuses on whether there is a big enough group to make an activity a public one. Thus, nothing suggests a tax-exempt social welfare organization could take up as a purpose the sale of marijuana. Considering the gravity of such an offense, any adoption of such a purpose should also automatically rise to the level of a substantial purpose and deny such an organization social welfare status. This analysis is no different than would apply to a charitable organization, whether called the public policy doctrine or the illegality doctrine.

In the spirit of not just offering criticism, but also offering a solution, I recommend considering that in the case of conflict with criminal law at the state and federal level, the better course of action might be for the state or local government to take that activity on itself. Admittedly, others have already pointed out that the state itself is not allowed to violate the CSA.⁶⁵ However it would seem in the case of medical marijuana, instead of placing the battle between relatively unaccountable private entities and the federal government, the state, through its traditional function of operating hospitals and clinics, should open up medical marijuana clinics or provide medical marijuana services through state hospitals. State and local governments are exempt from tax in most circumstances,⁶⁶ and the state can provide more accountability to its community, the federal government, and other states. This is a much better solution than trying to expand an abused section of the Code. Such a solution would also be more consistent with accomplishing the objectives of the DOJ that it described in its recent memo regarding enforcement of marijuana laws in states that have legalized medical marijuana.⁶⁷

64. See Memorandum from James M. Cole, Deputy Attorney Gen., U.S. Dep't of Justice, to all U.S. Attorneys 1 (Aug. 29, 2013), available at www.justice.gov/iso/opa/resources/3052013829132756857467.pdf.

65. Mikos, *supra* note 7, at 659.

66. Because of space in this Essay, I do not discuss the tax status of state and local government entities. See, however, a good discussion of the tax status of such entities in Ellen P. Aprill, *Excluding the Income of State and Local Governments: The Need for Congressional Action*, 26 GA. L. REV. 421 (1992).

67. See Memorandum from James M. Cole, *supra* note 64.

IV. IMPLICATIONS OF THEORIES OF RATIONALE FOR EXEMPTION

It is worth considering the prevailing rationales for exemption to check my foregoing analysis. Two prominent theories suggest tax exemption can help solve inefficiencies of government failure⁶⁸ and market failure.⁶⁹ Government failure arises because government typically only provides the public goods needed by the median voter—i.e., representatives can be expected to provide what the median voter wants rather than what the voters on either extreme want. Therefore, some significant set of citizens is denied an optimal amount of public goods. Nonprofits can provide some of those desired public goods. Market failure arises as a result of free rider problems and asymmetrical information. Nonprofits provide a more trustworthy organization than for-profit businesses to provide services and goods associated with market failure. We subsidize the nonprofit sector because of the necessary challenges with such organizations raising enough capital to provide the optimal amount of these services.

So, does a market failure or government failure exist in the sale of medical marijuana? If there is no market failure, there is no reason to believe there is a government failure. Government failure should only arise in association with public goods, and the lack of a market failure is a big indicator that there is no public good involved. Given that many organizations are willing to sell medical marijuana in a for-profit manner when the product is illegal, it is hard to conclude market failure exists. This makes a claim of government failure highly dubious. Thus, neither of the two prominent theories regarding tax exemption supports tax exemption in the case of the illegal sale of marijuana.

Finally, in considering why we provide exemption, we should also ask upon what basis we would tax nonprofit corporate entities in the first place.⁷⁰ Our rationale for imposing a tax should have implications for why we might decide not to tax. There appear to be two primary reasons we might tax nonprofit entities: (1) to tax shareholders and (2) to regulate corporate managers. It is hard to find how the organization that Leff wants to establish might involve shareholders. However, I contend that setting clean boundaries for tax-exempt organizations, such as prohibiting them from violating the law, makes the question of whether there are shareholders much easier to determine. It is an administratively useful tool in this endeavor. Those who would violate the law will likely not be acting in

68. Burton A. Weisbrod, *Toward a Theory of the Voluntary Nonprofit Sector in a Three-Sector Economy*, in *THE ECONOMICS OF NONPROFIT INSTITUTIONS: STUDIES IN STRUCTURE AND POLICY* 21–26 (Susan Rose-Ackerman ed., 1986).

69. Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 *YALE L.J.* 54, 67–68 (1981).

70. Hackney, *supra* note 39.

a public capacity—i.e., such individuals are more likely to control the organization to deliver its surplus to private interests rather than public.

Analyzing the question from the perspective that the tax is a regulatory device—i.e., we should apply a separate tax on entities where there is a separation of ownership and control, in order to take some of the power away from the corporate managers—also suggests there should be a tax on an organization engaged in illegal activities. Particularly considering the fact that Congress has chosen to regulate sales of marijuana via the Code through § 280E, it would seem entirely appropriate to utilize a tax in the corporate context as well as a regulatory device to regulate managers who plan to violate local, state, or federal law.

V. CONCLUSION

Professor Leff's efforts at solving this tax challenge and conflict between federal and state law are noble, but run headlong into creating more problems by his effort to pigeonhole the latest problem of the country into a tax-exempt entity. These efforts cause harm to tax-exempt law by stretching its bounds too far. Although there is almost no legislative history suggesting what Congress might have meant by a civic league promoting social welfare, there is certainly no evidence that it intended such organizations to be able to violate federal law. Everything indicates Congress generally saw these organizations as receiving a subsidy in exchange for doing something that provided a public benefit. It makes no sense to say Congress would intend to provide such a subsidy to an organization specifically intending to violate a federal law that is relatively long-held and supported by precedent. Sorry Olive, but Professor Leff's "branch" cannot save you this time.