Tax Benefits of Government-Owned Marijuana Stores

*Benjamin M. Leff**

Over a year ago (March 7, 2015), a little store called the Cannabis Corner opened in the small town of North Bonneville, Washington. The Cannabis Corner is the first marijuana store operated by a "public development authority," an independent entity created by a state or local government. Public development authorities are generally exempt from federal income taxes under section 115 of the Internal Revenue Code. For a marijuana business, this exemption is especially valuable because section 280E of the Code currently prevents marijuana businesses from deducting many of the ordinary expenses other businesses regularly deduct, resulting in extremely high federal income taxes.

This Article is the first to address whether independent governmental affiliates that sell marijuana are exempt from federal income tax under section 115 of the Internal Revenue Code. It argues that such entities should easily pass the IRS's current interpretation of the three requirements for tax-exemption under section 115: (i) that exempt income be derived from "the exercise of any essential governmental function"; (ii) that such income "accru[e] to a State or any political subdivision thereof"; and (iii) that the income "not serve private interests[.]" In addition, this Article argues that though selling marijuana is illegal under federal law, that fact is not a bar to exemption under section 115 of the Code the way it is under section 501(c)(3).

Tax exemption for public development authorities that sell marijuana is important because of the non-tax benefits of a marijuana market dominated by government sellers. This Article explores the benefits that might accrue if a state chose to create a regulatory regime for legalizing

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marijuana in which all marijuana selling took place in government-owned stores. The question of whether an independent governmental affiliate is exempt from federal income tax, including section 280E, is especially important to governments contemplating the contours of their legal marijuana markets.

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INTRODUCTION

Over a year ago (March 7, 2015), a little store called the Cannabis Corner opened up in the small town of North Bonneville, Washington, about an hour by car from Portland, Oregon.[1] If you're trying to keep track of the crazy world of federal taxation of marijuana businesses, this little store might interest you, even if you live three thousand miles away, as I do. To my knowledge, it is the first marijuana store to be operated by a "public development authority."[2] A public development authority is an independent entity created by a state or local government. For me, Cannabis Corner's operation by a public development authority is interesting because it means that the business does not have to pay federal income tax on any of its profits. In the marijuana industry, avoiding federal income tax is especially desirable because section 280E of the Internal Revenue Code prevents traffickers of schedule I controlled substances from deducting many of their ordinary and necessary business expenses,[3] and marijuana is still[4] a schedule I controlled substance.[5] Therefore, marijuana stores' federal income taxes are likely to be especially high.[6] The Cannabis Corner has solved the federal income tax problem faced by other marijuana sellers.

1 *See, e.g.*, Todd C. Frankel, *Cornering the Pot Market: After Washington State Made It Legal, a Struggling Town Went into Business*, WASH. POST, Mar. 17, 2015, at A1; Evan Bush, *Here's a First: Tiny Town Will Open Its Own Pot Shop*, SEATTLE TIMES (Mar. 5, 2015, 7:45 PM), http://www.seattletimes.com/seattle-news/heres-a-first-tiny-town-will-open-its-own-pot-shop/; Dan Springer, *First Government-Owned Pot Store Opens in Washington State*, FOX NEWS (Mar. 18, 2015), http://www.foxnews.com/politics/2015/03/18/washington-state-pot-store-brings-revenue-to-local-town.html.

2 In Washington, Public Development Authorities are authorized under RCW 35.21.730. *See generally* Jay Reich, Stacey Cranshaw-Lewis & Deanna Gregory, *Public Development Authorities*, MRSC, http://mrsc.org/getmedia/F0265D7F-F235-4254-B1D1-BED2839DEE8B/PDA-IB516.aspx.

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

4 On August 11, 2016, the Drug Enforcement Administration, which has the authority to re-schedule marijuana, declined to re-schedule it, "reaffirming its conclusion that the drug's therapeutic value has not been proved scientifically and defying a growing clamor to legalize it for the treatment of a variety of conditions." Lenny Bernstein, *U.S. Affirms Its Prohibition on Medical Marijuana*, Wash. Post (Aug. 11, 2016), https://www.washingtonpost.com/news/to-your-health/wp/2016/08/10/u-s-affirms-its-prohibition-on-medical-marijuana/.

5 Marijuana's schedule I status means that it is a violation of federal criminal law to sell it. Unfortunately, the fact that the Cannabis Corner is operated by a governmental affiliate, exempt under section 115 of the Code, does nothing to absolve its employees from federal criminal liability.

6 *See, e.g.*, *Marijuana Business Conference Wrapup: 36 Tips, Lessons & Takeaways for the Cannabis Industry*, MED. MARIJUANA BUS. DAILY (Nov. 15, 2012),

In 2014, I published an article in the Iowa Law Review that argued marijuana sellers could solve their federal tax problem by organizing and operating as nonprofit social welfare organizations, exempt from federal income tax under section 501(c)(4).[7] A number of my colleagues (and presumably the IRS) were unconvinced by my argument that social welfare organizations could run a commercial operation in violation of federal law without disqualifying themselves for tax exemption.[8] The case for governmental affiliates, like the public development authority that operates the Cannabis Corner, is much stronger than the case I made for social welfare organizations.[9] Such government-owned entities are exempt from tax under section 115 of the Code rather than one of the subsections of 501(c). While there is pathetically little binding authority on the matter, it appears that marijuana stores could meet the requirements of section 115 in exactly the same way that state-owned liquor stores do.[10] Under

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http://mjbizdaily.com/marijuana-business-conference-wrapup-36-tips-lessons-take-aways-for-the-cannabis-industry/ ("The federal tax situation is the biggest threat to [state-sanctioned marijuana] businesses and could push the entire industry underground.").

7 Benjamin Moses Leff, *Tax Planning for Marijuana Dealers*, 99 IOWA L. REV. 523, 527 (2014) [hereinafter *Tax Planning*].

8 *See* Philip T. Hackney, *A Response to Professor Leff's Tax Planning 'Olive Branch' for Marijuana Dealers*, 99 IOWA L. REV. BULL. 25, 26 (2014). For a discussion of the IRS's view that an organization that engages in illegal activity cannot qualify as exempt under section 501(c)(4), see Leff, *Tax Planning*, *supra* note 7, at 552-53; *see also* I.R.S. Priv. Ltr. Rul. 2013-33-014 (Aug. 16, 2013) (holding that an organization that facilitates the sale of marijuana is not exempt because "similar to other exemptions and deductions, if a § 501(c)(16) organization commits illegal actions, or encourages others to commit illegal actions, while performing its activities, it will not receive Congress' 'legislative grace' of exemption from federal income tax").

9 Philip Hackney, in his critical response to my article, suggested, "in the spirit of . . . offering a solution," that "the better course of action might be for the state or local government to take that activity [selling marijuana] on itself." Hackney, *supra* note 8, at 35. He argued that state-run marijuana dispensaries would be preferable to private nonprofits because "State and local governments are exempt from tax in most circumstances, and the state can provide more accountability to its community, the federal government, and other states." *Id.*

10 Ellen P. Aprill, *The Integral, the Essential and the Instrumental: Federal Income Tax Treatment of Governmental Affiliates*, 23 J. CORP. L. 803, 816 (1997) [hereinafter *The Integral*] (according to the IRS's "astonishingly liberal" interpretation, "[f]or purposes of section 115, anything that makes or saves the political subdivisions money serves an essential governmental function"); *see also* Ellen P. Aprill, *Excluding the Income of State and Local Governments: The Need for Congressional Action*, 26 GA. L. REV. 421, 429 (1992) [hereinafter *Excluding the Income*] ("The IRS . . . has taken the concept of 'essential governmental function' and expanded it until it encompasses any activity that makes or saves money for a state or local government.").

section 115, income is exempt if it is "derived from . . . the exercise of any essential governmental function" and is "accruing to a State or any political subdivision thereof[.]"[11] According to the IRS, it also must not serve "private interests such as designated individuals, shareholders of organizations, or persons controlled, directly or indirectly, by such private interests."[12] While it seems counter-intuitive to say that selling marijuana is an "essential governmental function," it appears that under current IRS practice, a government-owned marijuana seller could well satisfy all three of the requirements of section 115.

Perhaps more importantly for a marijuana store, there is absolutely no guidance suggesting that the so-called "illegality doctrine" or "public policy doctrine" — which is the impediment to a 501(c)(3) organization (or as some argue, a 501(c)(4) organization) operating a marijuana store — would apply to government affiliates. Indeed, it would be extremely surprising if a court applied such a doctrine to what is effectively state action. In my article of last year, I argued that the federal government should defer to a local community about what advances the community's social welfare. But, when a community's government creates its own entity to advance its local interests (even if the entity violates federal law), the case for inter-jurisdictional deference from the federal government is even stronger.

But, the case for government-owned marijuana stores is not only stronger because the legal case for federal tax exemption of such entities is stronger. In my last article, I made a fairly weak argument that social welfare organizations running marijuana stores could at least start to redress the harm done to some communities by marijuana prohibition.[13] Government-owned marijuana stores have the potential to do a substantially better job at meeting these policy goals than non-profit marijuana stores.[14] First, cautious proponents of marijuana legalization argue that some states might want to experiment with a legalization regime in which all marijuana-selling takes place in government-owned stores.[15] This government-

[11] I.R.C. § 115(1) (2012).

[12] I.R.S. Priv. Ltr. Rul. 88-25-027 (1988).

[13] *See* Leff, *Tax Planning*, *supra* note 7, at 559-62, 566-68.

[14] For simplicity's sake, I refer to entities that participate in legal marijuana markets as "stores" or "sellers," although there might be reasons for governmental affiliates to participate in marijuana markets in other capacities, like as producers or distributors. The arguments made in this Article may well apply to entities engaged in other aspects of the marijuana industry.

[15] *See, e.g.*, JONATHAN P. CAULKINS ET AL., RAND CORP., CONSIDERING MARIJUANA

monopoly system has numerous public health benefits, since it enables the government to more easily monitor and control the retail marijuana market, as well as directly control the marketing and advertising of marijuana products. For years, many states have experimented with state control of liquor sales, but there are reasons to believe that marijuana may be significantly more suited to a state-controlled market than alcohol, at least for a transitional period.[16] In addition, direct state ownership of the marijuana market also solves the potentially intractable problem of how to tax marijuana at the state level.[17] Finally, a state may want to create a state monopoly on marijuana sales, at least initially, to avoid problems associated with providing licenses to a small number of commercial sellers. Recently, voters in Ohio rejected a marijuana legalization initiative at least partially because even legalization activists thought the initiative unfairly benefited a small number of commercial marijuana producers (the same ones who had funded the initiative).[18] Perhaps counter-intuitively, one of the significant benefits of a true state monopoly is that it avoids the evils of a state-created partial commercial monopoly.[19] These benefits of state ownership could be enjoyed equally by governments who choose to sell marijuana through independent affiliates, like public development authorities. Thus, the question of whether an independent governmental affiliate is exempt from federal income tax, including section 280E, is especially important to governments contemplating the contours of their legal marijuana markets.

This Article is the first to address whether independent governmental affiliates that sell marijuana are exempt from federal income tax under section 115 of the Internal Revenue Code. In Section I, I discuss the three legal requirements for tax exemption under section 115, and how these requirements are likely to apply to a public development authority like the Cannabis Corner.[20] In Section II, I discuss whether a governmental affiliate selling marijuana might

LEGALIZATION: INSIGHTS FOR VERMONT AND OTHER JURISDICTIONS 60-63 (2015) [hereinafter RAND REPORT], http://www.rand.org/content/dam/rand/pubs/research_reports/RR800/RR864/RAND_RR864.pdf; Rosalie Liccardo Pacula et al., *Developing Public Health Regulations for Marijuana: Lessons from Alcohol and Tobacco*, 104 AM. J. PUB. HEALTH 1021, 1023 (2014).

[16] *See infra* text accompanying note 128.

[17] *See infra* text accompanying notes 113–18.

[18] *See infra* text accompanying note 121.

[19] *See infra* text accompanying notes 121 & 122.

[20] *See infra* Part I.

be denied tax-exempt status even if it meets all the section 115 requirements under the so-called "public policy" or "illegality" doctrine.[21] In both of these sections, I argue that it should be relatively easy for a public development authority or other governmental affiliate to sell marijuana exempt from federal taxes. In the final section, I discuss the benefits of recognizing federal tax exemption for governmental affiliates that sell marijuana.[22] In this Article, I am not trying to argue that the current situation — in which marijuana is illegal under federal law and yet subject to a draconian federal tax — is a better system than if the President, or Congress, were to simply de-schedule marijuana, making it legal under federal law and not subject to section 280E.[23] But I am trying to point out that the current tax system, including section 280E coupled with exemption for governmental affiliates under section 115, has the possible benefit of incentivizing governmental sales of marijuana over a purely commercial model.

I. Tax Exemption of a Governmental Entity Under Section 115 of the Code

Tax exemption for governments and governmental entities is notoriously complicated. States and their political subdivisions are exempt from tax either because of the Constitutional doctrine of inter-governmental tax immunity or because of an implied statutory immunity.[24] Entities that are an "integral part" of a state, or political subdivision of a state, are also exempt under the same principles.[25] However, entities that are created by a government but are too independent to qualify as an "integral part" may also produce exempt income, not because of implied immunity, but because of section 115

[21] *See infra* Part II.

[22] *See infra* Part III.

[23] Under 21 U.S.C. § 811 (2012), the Attorney General has the authority to remove ("deschedule") any substance from the controlled substances schedules, after an analysis by the Secretary of Health and Human Services. In 2016, the Drug Enforcement Agency considered re-scheduling marijuana, but ultimately declined to do so. *See supra* note 4.

[24] Aprill, *Excluding the Income*, *supra* note 10, at 421; Aprill, *The Integral*, *supra* note 10, at 804-05 (noting that states and their political subdivisions are exempt from federal income tax because "of an implied statutory immunity. That is, states and their political subsidiaries are exempt because no provision of the Internal Revenue Code taxes them as such.").

[25] Aprill, *The Integral*, *supra* note 10, at 804, 810-14.

of the Code.[26] Section 115 exempts from federal tax "income derived from any public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision thereof, or the District of Columbia."[27] Entities created by or affiliated with state governments may also be exempt under sections 501(c)(3), 501(c)(4), or, in rare occasions, some other subparagraph of section 501(c). As Ellen P. Aprill puts it, "These five categories — political subdivision, integral part of a state or political subdivision, section 115 entity, instrumentality, and section 501(c) organization — form a complicated patchwork."[28]

In the marijuana context, the difference between state entities that are "integral" and those that are "independent" may be important for non-tax reasons. For example, in a recent report commissioned by the Vermont Secretary of Administration on regulatory possibilities should Vermont legalize marijuana, the authors state, "we want to stress at the outset that direct state participation in the supply chain could cause the state to violate federal law."[29] To avoid the direct inter-jurisdictional clash that would be created if "[f]ederal agents could enter state monopoly stores and arrest state employees," the authors propose what they call "near monopoly." In a near monopoly, the marijuana supply chain is controlled not by a government directly, but by "a single, special-purpose entity, call it a public authority" that would operate marijuana stores.[30] The reason an independent public authority is preferable to direct control by a government is that, "in substance, [it] might prove no more offensive to federal interests than

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26 I.R.C. § 115 (2012).

27 *Id.* § 115(1).

28 Aprill, *The Integral*, *supra* note 10, at 805.

29 RAND REPORT, *supra* note 15, at 61 (citing Robert Mikos). The authors also point out, "We say 'seem' because legal considerations concerning federalism are complicated, and courts can surprise." *Id.* The report further points out that this presumptive prohibition on direct state action with regard to marijuana creates what they call "the American federalism dilemma" under which, "[a] state monopoly is the worst option with respect to compliance with [federal criminal law]. . . . Federal agents could enter state monopoly stores and arrest state employees carrying out the option that has — arguably — the best chance to protect public health and reduce harms associated with prohibition (state monopoly)." *Id.* at 72. *See also* ROBERT J. MACCOUN ET AL., STANFORD LAW SCH. LAW & POL'Y LAB, LEGALIZING MARIJUANA IN CALIFORNIA: A REVIEW OF POLICY CONSIDERATIONS 14 (2015), https://law.stanford.edu/publications/legalizing-marijuana-in-california-a-review-of-policy-considerations/ (citing Erwin Chemerinsky, Jolene Forman, Allen Hopper & Sam Kamin, *Cooperative Federalism and Marijuana Regulation*, 62 UCLA L. REV. 74, 106 (2015)); Pacula et al., *supra* note 15, at 1023.

30 RAND REPORT, *supra* note 15, at 63.

a state's actions in a for-profit commercial model . . . ."[31] It would still be possible for the public authority's employees to be arrested by federal agents for selling marijuana, but at least they wouldn't be state employees, and so the state would only be indirectly responsible for this cost of the inter-jurisdictional clash.

The Report goes on to observe that one disadvantage of an independent public authority is that, unlike a government, it is potentially subject to federal income tax on its "perhaps-significant profits."[32] Section 115 provides that the income of an independent government affiliate is exempt from federal tax only if it is "derived from . . . the exercise of any essential government function[.]"[33] The authors of the Report conclude that a public authority selling marijuana could not qualify for tax exemption under section 115 because "[i]t might be hard to argue that selling marijuana is the 'exercise of [an] essential governmental function,' so income of any public authority, unlike income of a state monopoly, would bear federal income tax[.]"[34] This conclusion has strong intuitive appeal, since common sense tells us that selling marijuana is not an essential government function.[35] However, it appears that common sense misleads in this case because the conclusion comes from a too-literal reading of section 115.[36] The following section discusses section 115's application to an independent governmental authority that sells marijuana.

A. Essential Government Function

The question of what constitutes an essential governmental function in the context of Section 115 has a long history, well told by Professor Ellen P. Aprill almost twenty-five years ago.[37] As Aprill points out, the essential government function requirement found in section 115 "reflects an early stage of development in the constitutional doctrine of intergovernmental tax immunity."[38] At the time the provision was

31 *Id.*

32 *Id.* at 64.

33 I.R.C. § 115(1) (2012).

34 RAND REPORT, *supra* note 15, at 64.

35 *See* Bush, *supra* note 1 (quoting Skamania County Oregon Sheriff Dave Brown as saying, "I don't think government should be in the business of selling marijuana . . . It's not a fundamental function of government").

36 The Author would like to thank Pat Oglesby for initially pointing out this issue. (Email correspondence on file with the author).

37 *See* Aprill, *Excluding the Income*, *supra* note 10, at 423; Aprill, *The Integral*, *supra* note 10, at 817.

38 Aprill, *Excluding the Income*, *supra* note 10, at 423.

enacted in 1913, the Supreme Court had held that a federal tax on the sale of liquor did not exempt sellers merely because they acted as agents for a State because "whenever a state engages in a business which is of a private nature, that business is not withdrawn from the taxing power of the nation."[39] In other words, states' income is only exempt from federal tax when it comes from the states' sovereign function (such as through taxation) and not when it comes from commercial activities, like liquor sales, even if the purpose of the state monopoly on liquor is to protect the public.

However, this distinction was later abandoned as unworkable by the Supreme Court, which stated, "we reject limitations upon the taxing power of Congress derived from such untenable criteria as 'proprietary' against 'governmental' activities of . . . [g]overnment or activities conducted merely for profit[.]"[40] By abandoning the distinction between proprietary and governmental, the Supreme Court left the "essential government function" test as a sort of orphan of an archaic legal doctrine.

The fact that the Supreme Court has failed to identify those functions of government that are "essential" in the context of inter-governmental tax immunity does not mean that the requirement has been removed from the Code, however. Aprill believes that the "essential governmental function" requirement in section 115 is merely Congress's attempt to codify the distinction between "proprietary" and "sovereign" functions of government described in the old Supreme Court cases.[41] Section 115(1) still says that income is exempt only if it arises from an essential governmental function. So, for example, in 1974 the Tax Court found that a state university was not exempt under section 115 for the gain derived from the liquidation of a corporation that owned hospitals.[42] It applied the old Supreme Court cases distinguishing between proprietary and sovereign functions of government without any mention of the Supreme Court's later disavowal of this approach.[43] In 1979, the Ninth

[39] South Carolina v. United States, 199 U.S. 437, 463 (1905).

[40] *See* New York v. United States, 326 U.S. 572, 583 (1946); *see also* Garcia v. San Antonio Metro. Transit Auth., 469 U.S. 528, 546-47 (1985) ("We therefore now reject, as unsound in principle and unworkable in practice, a rule of state immunity from federal regulation that turns on a judicial appraisal of whether a particular governmental function is 'integral' or 'traditional.' Any such rule leads to inconsistent results at the same time that it disserves principles of democratic self-governance[.]").

[41] *See* Aprill, *Excluding the Income*, *supra* note 10, at 425-26 (citing Flint v. Stone Tracy Co., 220 U.S. 107 (1911); South Carolina v. United States, 199 U.S. at 437).

[42] Troy State Univ. v. Comm'r, 62 T.C. 493, 503 (1974).

[43] *See id.* at 502 (citing South Carolina v. United States, 199 U.S. at 463, and

Circuit managed to avoid the problem entirely by holding that a state-created alcohol seller was not exempt under section 115 because its income did not accrue to the State, which "obviates resolution of" the essential governmental function issue.[44] In 1994, the Sixth Circuit held that a "quasi corporation" of the State of Michigan was an "integral part" of the state and therefore was tax exempt,[45] but a well-reasoned dissent argued that the entity did not qualify as an "integral part" and therefore could only be exempt if it satisfied the criteria of section 115.[46] The dissent went on to conclude that the entity at issue did not so qualify because it provided "a quintessentially private function," giving life (albeit in dissent) to the distinction between proprietary and sovereign functions described in the old Supreme Court cases.[47]

The IRS, however, has apparently taken a different approach than the few courts that have applied the law. In 1935, the IRS issued a General Counsel Memorandum that explained its reasoning for exempting from tax the income of Montana's Liquor Control Board.[48] In its analysis, the IRS treated the Liquor Control Board as if it were the State itself. It argued that income of a State is exempt, not because of the precursor to section 115, but because the Revenue Act only imposes tax on individuals and corporations, and not on States.[49] Here, it implicitly distinguished Supreme Court cases like *South Carolina v. U.S.*, since that case involved a liquor excise tax rather than an income tax. In explaining why a State is exempt from income tax when it earns income directly, the memorandum states,

> It is suggested that Congress, in not taxing the income of States, may well have been motivated by a desire not to limit the activities in which States might otherwise engage. The line between those revenue-producing activities of a State which are 'governmental' and those which are 'proprietary' is one which is in its nature difficult to draw and which has yet been only faintly traced by decisions of the courts. . . . It may be assumed that Congress did not desire in any way to restrict a State's participation in enterprises which might be useful in

extensively quoting *Stone Tracy Co.*, 220 U.S. at 172, but not mentioning New York v. United States, 326 U.S. 572).

[44] *See* City of Bethel v. United States, 594 F.2d 1301, 1303 n.2 (9th Cir. 1979).

[45] *See* Michigan v. United States, 40 F.3d 817, 829 (6th Cir. 1994).

[46] *See id.* at 836 (Guy, J., dissenting).

[47] *Id.* at 834.

[48] I.R.S. Gen. Couns. Mem. 14,407 (1935).

[49] *Id.*

> carrying out those projects desirable from the standpoint of the State Government which, on a broad consideration of the question, may be the function of the sovereign to conduct . . . .[50]

Thus, the IRS ruled that the income produced by the Montana Liquor Control Board was exempt from federal income tax, even if it could be argued that selling liquor is purely proprietary. On the same day, the IRS opined that the operation of liquor stores by the State of Virginia was also exempt from income tax for the same reasons as Montana.[51] Several decades later, the IRS issued rulings that the Oregon Liquor Control Commission[52] and the Montana Liquor Control Board[53] are exempt from federal income tax. In neither case did the IRS even mention the "essential governmental function" test of section 115, which makes sense since in each case, the IRS acted on the assumption that the operation of the Liquor Control Boards constituted direct action by the State itself. Thus, none of these rulings were about section 115's "essential governmental function" requirement (or its precursor) because the IRS found that the States' Liquor Control Boards were not separate entities from the state.[54]

In 1977, however, the IRS did a curious thing. It ruled that the income from an investment fund created by a State was exempt under section 115. In doing so, it commented,

> A comprehensive interpretation of section 115(1) of the Code is set forth in G.C.M. 14,407 [the 1935 guidance about the Montana Liquor Control Board] . . . . It was pointed out that it may be assumed that Congress did not desire in any way to restrict a State's participation in enterprises that might be useful in carrying out those projects desirable from the standpoint of the State government which, on a broad

[50] *Id.*

[51] I.T. 2886, 14-1 C.B. 103 (1935).

[52] Rev. Rul. 71-132, 1971-1 C.B. 29.

[53] Rev. Rul. 71-131, 1971-1 C.B. 28.

[54] Presumably, it would be improper to take the quote from G.C.M. 14,407 to signal that the IRS understood the governmental/proprietary distinction to be unworkable, since it determined on the same day that "when a State or political subdivision engages in the operation of liquor stores it is acting in a proprietary capacity [and so] the compensation of employees [of such liquor stores] is subject to Federal income tax." I.T. 2886, 14-1 C.B. 103 (1935).

> consideration of the question, may be the function of the sovereign to conduct.[55]

As discussed above, the IRS's views of Congress's intent described in G.C.M. 14,407 was meant to apply only to States themselves, and not to those separate entities to which section 115 applied. But apparently, at least by 1977, the IRS understood it to apply to section 115 as well, because without any further analysis, it concluded that "[t]he investment of funds by a State or political subdivision in an investment fund of the kind involved in this case constitutes the exercise of an essential governmental function for the purposes of section 115(1) of the Code."[56]

Apparently, the IRS continues to apply this broad view of the section 115 essential governmental function test — in effect, it has imported the test that the IRS created for governments into jurisprudence about separate entities created by governments. For example, in Rev. Rul. 90-74, the IRS held that an entity that insured a state's political subdivisions against casualties performed an essential governmental function because "[p]ooling casualty risks through X instead of purchasing commercial insurance fulfills the obligations of the political subdivisions to protect their financial integrity. . . . Accordingly, X performs an essential governmental function."[57] This ruling expresses the IRS's view that "anything that makes or saves the political subdivisions money serves an essential governmental function."[58] Literally scores of private letter rulings support Professor Aprill's characterization of the IRS's apparently very broad view of what constitutes an essential governmental function. These private letter rulings approve tax-exempt status for organizations that do nothing more "essential" than promoting economic development, among many other things.[59]

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[55] Rev. Rul. 77-261, 1977-2 C.B. 45.

[56] *Id.* Aprill has described the application of G.C.M. 14,407 to section 115 entities as "both surprising and wrong." Aprill, *Excluding the Income*, *supra* note 10, at 437.

[57] Rev. Rul. 90-74, 1990-2 C.B. 34.

[58] Aprill, *The Integral*, *supra* note 10, at 816; *see also* Aprill, *Excluding the Income*, *supra* note 10, at 429 ("The IRS, in contrast, has taken the concept of 'essential governmental function' and expanded it until it encompasses any activity that makes or saves money for a state or local government.").

[59] *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2015-15-016 (Apr. 10, 2015) (ruling that "[p]roviding . . . health and welfare benefits [to retirees of a political subdivision] constitutes the performance of an essential government function within the meaning of IRC §115(1)"); I.R.S. Priv. Ltr. Rul. 2015-09-001 (Feb. 27, 2015) ("Providing for a pooling of resources to procure F supplies and transmission services for municipalities and their residents constitutes the performance of an essential governmental function

Whatever the source of the IRS's broad view of what constitutes an essential governmental function, it makes good sense for the IRS to remove itself from the business of trying to identify which governmental functions are essential and which are not. As Professor Aprill points out, this approach is consistent with the Supreme Court's more modern approach to inter-jurisdictional tax immunity, an approach that arose out of a real frustration with the difficulty of developing a principled mechanism for distinguishing core governmental functions from all the other things that states do.[60] In addition, Congress has had many years to clarify this area of law if it wanted to narrow the circumstances in which a governmentally-created entity could be exempt from tax.[61]

The case that marijuana selling is an essential governmental function, however, is stronger than merely the fact that it makes money for the state. Rather, marijuana use has significant negative health and social costs, and so the state's interest in controlling these negative effects, especially among youth, is strong.[62] Just as it is with liquor sales, it is well within the state's police power to seek to control a market in dangerous substances.[63] Protecting the public from the negative effects of such substances is at the heart of what states do, as

within the meaning of IRC § 115(1)."); I.R.S. Priv. Ltr. Rul. 2013-08-010 (Feb. 22, 2013) (holding that "[p]romoting economic development constitutes the performance of an essential governmental function within the meaning of § 115(1)," and explicitly citing the fact that Rev. Rul. 77-261 "stated that it may be assumed that Congress did not desire in any way to restrict a state's participation in enterprises that might be useful in carrying out projects that are desirable from the standpoint of a state government and which are within the ambit of a sovereign properly to conduct"); I.R.S. Priv. Ltr. Rul. 2003-20-024 (May 16, 2003) (ruling that "[b]y funding the remediation of a contaminated and polluted site, [qualified settlement funds] perform an essential governmental function"); I.R.S. Priv. Ltr. Rul. 2001-16-009 (Apr. 20, 2001) (ruling that a corporation whose purposes include "assisting the City in the financing, acquisition, construction, and operation of a convention center hotel" serves an "essential governmental function"); I.R.S. Priv. Ltr. Rul. 87-53-008 (Oct. 1, 1987) (holding that a pooled insurance fund fulfills an essential governmental function because it provides "coverage at a lower cost than could be obtained commercially").

[60] *See* Aprill, *Excluding the Income*, *supra* note 10, at 429.

[61] *See id.* However, as Aprill also points out, the IRS's approach is unreasonably broad according to the Code's plain language. There is little authoritative support for the IRS's broad reading of "essential governmental function" to mean "any activity that makes or saves money for the state." *See id.*

[62] *See, e.g.*, Pacula et al., *supra* note 15, at 1022 (citing a number of studies showing adverse health effects of marijuana, especially for youths).

[63] *See* LAWRENCE O. GOSTIN & LINDSAY F. WILEY, PUBLIC HEALTH LAW: POWER, DUTY, RESTRAINT 50 (3d. ed. 2016).

is evidenced by criminal laws as well as food and drug safety laws.[64] Governmental control of a market for potentially dangerous substances also has a long history. For example, following Prohibition, almost all of the states controlled alcohol sales either through regulation or state monopoly.[65] In other words, the states have strong governmental interests in citizens' health and safety that warrant state control of marijuana markets. They are not merely making money. Thus, even if the IRS's view of the "essential governmental function" test were narrower than it appears to be, marijuana selling should satisfy the test.[66]

B. Accrue to the Government

What it means for income to be "accruing to" a state or political subdivision under section 115 is as confusing as what it means for the state to be pursuing an "essential governmental function." Again, courts have historically provided a relatively high bar,[67] while the IRS has apparently lowered that bar dramatically in its administrative rulings. According to Aprill, the IRS's view, as expressed in these administrative rulings, is that "[i]ncome accrues to the local governments if those governments have an unrestricted right to receive their proportionate share of the investment fund income."[68]

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64 *See id.* at 4, 8-10.

65 For further discussion on this topic, see PHILIP J. COOK, PAYING THE TAB: THE COSTS AND BENEFITS OF ALCOHOL CONTROL 27-31 (2007), especially Table 2.4 on pages 30-31 showing the seventeen states that created a government monopoly on liquor sales after the repeal of national prohibition; *see also* Harry G. Levine, *The Birth of American Alcohol Control: Prohibition, the Power Elite, and the Problem of Lawlessness*, 12 CONTEMP. DRUG PROBS. 63, 89, 94-95, 100-101 (1985).

66 Aprill's summary of the IRS's approach to section 115 generally has special resonance in the marijuana context: "Understandably hesitant to tax state or local governments without a clear congressional mandate, the IRS has reinterpreted [section 115] to conform to its concept of what the law should be." Aprill, *Excluding the Income*, *supra* note 10, at 429.

67 *See id.* at 440-42. Aprill discusses cases like *Troy State University v. Commissioner*, 62 T.C. 493 (1974), *Omaha Public Power District v. O'Malley*, 232 F.2d 805 (8th Cir. 1956), *cert. denied*, 352 U.S. 837 (1956), and *City of Bethel v. United States*, 594 F.2d 1301 (9th Cir. 1979), *cert. denied*, 444 U.S. 980 (1979), which hold that the state or political subdivision must have a present right (enforceable interest, vested claim) to the entity's income for it to "accrue" within the meaning of the statute. The fact that all the assets of the entity would be distributed to the political subdivision on dissolution is not sufficient under this analysis.

68 *Id.* at 438. Elsewhere, Aprill characterized the IRS's position even more permissively: "Income accrues to the political subdivisions if, upon dissolution, the fund will distribute its assets to its members." *Id.* at 440.

That characterization comes largely from the IRS's last revenue ruling on the subject, which was issued in 1990. In that ruling, the IRS held that income accrued to a state or political subdivision as long as "upon dissolution, [the organization] will distribute its assets to its members."[69]

The IRS's approach has apparently not changed in the twenty-three years since Aprill's first article on the topic. For example, in a private letter ruling issued last year, the IRS concluded that a trust whose purpose was to fund the costs of health and welfare benefits for a state subdivision's retirees and their dependents met the "accruing to" test because "[a]ny assets remaining in [the] Trust after satisfying all benefit obligations may be paid to [the political subdivision] to the extent consistent with IRC § 115."[70] There is no indication in any of the scores of private letter rulings issued in the last several decades that the IRS is applying a more stringent rule pertaining to the "accruing to" test than the one Aprill described: so long as the assets of the entity are paid to the political subdivision or subdivisions upon dissolution or termination, then the "accruing to" test is satisfied. That is, the entity meets the "accruing to" test, so long as it also meets the requirement that it provide no substantial private benefit to any non-governmental entities, as discussed below.[71]

Under the IRS's test, then, it would be very easy for an independent public development authority, like the one that operates the Cannabis Corner, to meet the "accruing to" requirement of section 115. So long as its organizational documents provide that all of its assets revert to the town of North Bonneville upon its dissolution, it would qualify. There would presumably be no requirement that it regularly pay its profits over to the town, or that the town have any right to its profits prior to dissolution. However, it would probably make more sense for North Bonneville to structure the public development authority that operates the Cannabis Corner in such a way as to make the profits from the marijuana store available to the town in an ongoing and predictable way. They could either require profits be transferred according to some regular schedule, or they could structure the

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69 Rev. Rul. 90-74, 1990-2 C.B. 34.

70 I.R.S. Priv. Ltr. Rul. 2015-15-016 (Apr. 10, 2015); *see also* I.R.S. Priv. Ltr. Rul. 2015-16-031 (Apr. 17, 2015) (very similar facts and analysis).

71 *See* Aprill, *Excluding the Income*, *supra* note 10, at 442-43 ("Through its definition of accrue, the IRS has transformed the requirement in section 115 that income 'accrue' to the political subdivision into prohibitions on private inurement and private benefit identical to those applicable to charitable organizations exempt under section 501(c)(3).").

financials such that all funds (other than those required for day-to-day operations) be deposited in a town-controlled fund. Presumably, the development authority's relationship with its creditors and suppliers would have a significant impact on whether it could transmit large quantities of its revenue to the state treasury regularly or if instead it would need to keep significant funds under its own control.[72] In any case, it appears that the IRS's interpretation of the law gives the town wide discretion to structure its financial relationship with its development authorities in the way most conducive to its budgetary needs without fear that their choices will result in taxable income.

C. No Private Benefit

As discussed above, IRS guidance has added a requirement to section 115 that does not appear in the statutory language. In the same 1990 Revenue Ruling that appeared to broaden the definition of "accruing to" so dramatically, the IRS introduced another section 115 requirement: "no private interests participate in or benefit from the operation of [the entity.]"[73] In the ruling, the IRS discussed this "private benefit" requirement in the middle of a paragraph in which it assessed whether the entity performed an essential governmental function. Immediately after the sentence about private benefit, the ruling states, "[a]ccordingly, [the entity] performs an essential governmental function" implying that providing no substantial private benefit is a requirement of meeting the essential governmental function test.[74] At other times, the IRS has simply stated that "even if the income serves a public interest, the requirements of section 115 are not satisfied if the income also serves a private interest that is not incidental to the public interest."[75] Professor Aprill argues that the IRS has substituted a "destination of the funds" test for the traditional

[72] Apparently, there is no agreement regarding the terms by which the Cannabis Corner's profits are available to the town of North Bonneville. However, as of February 23, 2016 at least, the Cannabis Corner has used all of its profits to cover its internal obligations, including rent and repaying its debt burden. *See* E-mail from John Spencer, Partner, Pulse Consulting, to author (Feb. 23, 2016, 12:30 PM) (on file with author).

[73] Rev. Rul. 90-74, *supra* note 69.

[74] *Id.*

[75] I.R.S. Priv. Ltr. Rul. 88-25-027 (June 24, 1988) (holding that a corporation created by a state to administer a college tuition prepayment program is not exempt under section 115 because the individual participants in the prepayment program receive a private benefit that is not incidental to the public purpose).

essential governmental function and accrual tests, approving entities under section 115 so long as they find no substantial private benefit.[76]

While Aprill expresses concern that the new private benefit standard is an *ad hoc* IRS addition to the law and has no statutory authority,[77] there is some validity to using it as a sort of substitute test for the "essential governmental function" and the "accruing to" requirements. By approving under section 115 any entity that does not provide substantial private benefit to anyone other than political subdivisions, the IRS avoids the difficult questions of what is an essential governmental function and what it means for income to accrue to the state. It leaves the maximum amount of discretion to the states and their political subdivisions to conduct their affairs in the way that makes the most sense to them, without completely ceding the field and allowing states to engage in any kind of activity tax-free. If any private person stands to gain from the income generated, then the entity fails either the "essential government function" or the "accruing to" requirements, and the income is not tax free.

The problem is that the parameters of the "private benefit" test are currently horribly indeterminate.[78] In the context of 501(c)(3) organizations, the IRS generally applies both a "private inurement" and a "private benefit" analysis, and the two concepts have legally distinct meanings.[79] Under a private inurement analysis, an

[76] *See* Aprill, *Excluding the Income*, *supra* note 10, at 442.

[77] *See* Aprill, *The Integral*, *supra* note 10, at 817 ("Use of this private benefit standard is questionable. . . . [T]he IRS created out of thin air the . . . prohibition of direct private benefit, that it claims applies under section 115. In applying the principle it invented, the IRS usurped state sovereignty by substituting its own judgment for the judgment of the state as to what is a public purpose."). It is worth noting that this strategy of using the private benefit standard as a substitute for a substantive governmental purpose requirement appears to be popular at the IRS right now. On February 23, 2016, the Treasury promulgated proposed rules for the definition of "political subdivision" in the context of tax-exempt bonds, and included the following provision: "The determination of whether an entity serves a governmental purpose is based on, among other things, . . . whether the entity operates in a manner that provides a significant public benefit *with no more than incidental private benefit*." Definition of Political Subdivision, 81 Fed. Reg. 8870, 8873 (proposed Feb. 23, 2016) (to be codified at 26 C.F.R. pt. 1) (emphasis added). This use of the private benefit standard in the tax-exempt bond context also has no statutory basis.

[78] *See, e.g.*, John D. Colombo, *In Search of Private Benefit*, 58 FLA. L. REV. 1063, 1064 (2006) ("Despite the IRS's broad invocation of private benefit as a policing tool, however (or perhaps *precisely because* of its broad invocation of it), no one really can define the doctrine." (emphasis added)).

[79] *See* BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS § 20.12(a) (11th ed. 2015) ("The private benefit doctrine differs from the private inurement doctrine in

organization is unworthy of tax-exempt status if a private individual, who is in a position to substantially influence the organization, also stands to gain an excessive financial reward from the operation of the organization.[80] Both components must be present for a violation to occur: the individual must be in a position to influence the organization *and* she must receive an excessive benefit.[81] For marijuana stores like the Cannabis Corner, this could function as a genuine restriction. For example, at least one report states that Cannabis Corner's initial start-up capital came from "$260,000 in high-interest loans it borrowed to get the store started."[82] A high-interest loan may or may not be an "excessive benefit" depending on whether the risk-adjusted return is more than could be obtained by unrelated persons in the capital markets.[83] That may be a difficult question to answer. But the public development authority can avoid trouble by making sure it borrows its high-interest loans from someone who is not in a position to influence the organization. In other words, as long as the lender is truly unrelated to the development authority, then there is no risk of violating the private inurement limitation.

The law regarding private *benefit*, however — as opposed to private *inurement* — is much less defined, and there is no similar way for a development authority to both take out high interest loans and ensure that it is not violating the law.[84] This is because courts have supported the IRS's view that an organization could violate the private benefit doctrine even if the benefited person is not an insider in the

two significant respects.").

80 *See* Benjamin M. Leff, *Preventing Private Inurement in Tranched Social Enterprises*, 45 SETON HALL L. REV. 1, 25-27 (2015) [hereinafter *Preventing Private Inurement*]. *See generally* HOPKINS, *supra* note 79, at § 20.1.

81 For some organizations exempt from tax under section 501(c), penalties can be applied in these situations for so-called "excess benefit transactions." *See* I.R.C. § 4958 (2012). But these penalties do not apply to public development authorities or other governmental affiliates, which are exempt from tax under section 115. *See id.* § 4958(e).

82 Frankel, *supra* note 1, at A4. In addition, Frankel reported that store manager Robyn Legun "wanted to offer employees a steep discount" on the store's wares, which could possibly also constitute a private benefit under certain circumstances. "In the end, the board voted to offer the staff marijuana and bongs at a price just above cost." *Id.*

83 *See, e.g.*, Leff, *Preventing Private Inurement*, *supra* note 80, at 33 ("[A] market return is a function of risk, and a comparable rate cannot be identified without an accurate assessment of risk in the venture" (citing Lowry Hosp. Ass'n v. Comm'r, 66 T.C. 850 (1976))).

84 *See, e.g.*, Colombo, *supra* note 78, at 1064.

organization.[85] It is accepted that an organization may provide *incidental* private benefits to private parties. It remains unresolved, however, at what point a benefit ceases to be incidental and instead becomes significant enough to violate the private benefit doctrine.[86] The IRS has consistently insisted that the question of whether private benefits violate the doctrine is both a *qualitative* and a *quantitative* test,[87] so it is not clear whether the benefit has to be excessive, in the sense of an above-market return. Although, the fact that a benefit received by a private party is excessive would undoubtedly be relevant to a private benefit analysis.

Given that selling marijuana is still illegal under federal law, providing substantial start-up capital to a marijuana store presumably poses some significant risk, and if the lenders assumed that risk, then their interest rate might legitimately be quite high. Because of this, it might be hard as a factual matter to determine if an interest rate is excessive, since a relatively high rate may be justified. Even worse, since the private benefit doctrine could be applied even when no excessive benefit is conferred on private parties, there may be even more uncertainty about whether a high-interest loan could constitute an impermissible private benefit. Therefore, the private benefit doctrine may well be a substantial impediment to the operation of public development authorities that finance their operations with private capital.

Because of the uncertainty in the law,[88] a public development authority selling marijuana could take the safest possible route by raising all of its start-up capital from the state, rather than borrowing from private investors, as the Cannabis Corner has done. There are good reasons to think that this situation would be preferable from a

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85 *See* United Cancer Council, Inc. v. Comm'r, 165 F.3d 1173, 1180 (1999) (stating in dicta that "the dissipation of the charity's assets might . . . support a finding that the charity was conferring a private benefit, even if the contracting party did not control, or exercise undue influence over, the charity"); Am. Campaign Acad. v. Comm'r, 92 T.C. 1053, 1069 (1989) (recognizing that the private benefit doctrine applies to "disinterested persons").

86 *See, e.g.*, HOPKINS, *supra* note 79, at § 20.12(a) ("Although tax-exempt charitable organizations may provide benefits to persons in their private capacity, benefits of this nature must — to avoid jeopardizing exempt status — be incidental both quantitatively and qualitatively in relation to the furthering of exempt purposes.").

87 *See, e.g.*, I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991); I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987).

88 As John Colombo has put it: "the problem is that the doctrine currently has no theoretical grounding to set its outer boundaries." Colombo, *supra* note 78, at 1080.

public policy perspective. In other words, in this case, the IRS's concern with the line between a public entity operating for public purposes and a public entity merely providing cover for private persons seeking to make a profit may be at the heart of the difference between a legitimately tax-exempt governmental entity and one that should be taxable. If the organization uses exclusively public funds (rather than investment funds from private investors), then any return on the startup investment would "accrue to" the state or political subdivision, and no "private benefit" — excessive or otherwise — would be available to investors. If the business uses private funds, then there may be some question about both.[89]

In sum, it appears that a public development authority, like the Cannabis Corner, could qualify for tax-exemption under section 115 rather easily. The Cannabis Corner itself may have not taken the most conservative approach when it obtained its start-up capital in the form of high-interest loans from private investors, but it may well have satisfied the requirements of the private inurement and private benefit doctrines anyway, in which case it presumably qualifies. More than that, the requirements of section 115, even though they are much less substantive than the text's plain meaning, provide some important limitations that may well help government-controlled marijuana sellers advance the public good.

II. Application of the Public Policy or Illegality Doctrine

As discussed above, I wrote an article last year that argued that tax-exempt 501(c)(4) organizations could sell marijuana,[90] but some commentators were unpersuaded.[91] Most notably, the IRS continues to argue that the so-called "public policy doctrine" (or illegality doctrine) prevents all 501(c) organizations from being organized or operated for illegal purposes or those that are contrary to a fundamental public policy, which bars marijuana-selling organizations from exemption under any section of 501(c).[92] However, the arguments for denying

[89] On the other hand, the most reasonable interpretation of the law of private benefit would permit a development authority to raise capital from private investors, as long as the return on that investment was no greater than a market return.

[90] *See generally* Leff, *Tax Planning*, *supra* note 7.

[91] *See, e.g.*, Hackney, *supra* note 8, at 26.

[92] *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2013-33-014 (Aug. 16, 2013) (ruling that an organization that facilitated sales of marijuana could not qualify for tax exempt status under § 501(c)(16) of the Code because, among other things, "if a § 501(c)(16) organization commits illegal actions, or encourages others to commit illegal actions, while performing its activities, it will not receive Congress' 'legislative grace' of

exemption under 501(c) for marijuana-selling organizations do not apply to section 115. As far as I know, there is no authority that has ever held that an entity created by a state or political subdivision to advance an essential governmental function should be taxed on its income because the pursuit of the essential governmental function is contrary to federal law or fundamental public policy. More importantly, the logic employed by the IRS in denying tax exemption to private organizations that sell marijuana in violation of federal law — whether that logic is derived from the common law of charities or is founded on the general principle that exemptions be construed narrowly against taxpayers — simply does not apply to organizations created by governments.

In the context of tax-exempt organizations, the public policy doctrine is derived from the law of charitable trusts. Under English common law, "the purpose of a charitable trust may not be illegal or violate established public policy."[93] The IRS has taken the position that an organization that sells marijuana cannot qualify for tax-exempt status under section 501(c)(3) because its activities are illegal under federal law.[94] While the illegality doctrine has almost exclusively been applied to charitable organizations, it has also occasionally been applied to other organizations that are exempt from tax under other sections of 501(c) of the Code.[95] But the IRS has recently issued non-precedential guidance that quite clearly indicates that it believes *all* tax exemptions are subject to the illegality doctrine, and therefore an organization that sells marijuana in violation of federal law cannot qualify for tax exempt status under any section of the Code.[96] Therefore, it is worth discussing in detail why the reasoning of this guidance is wrong. In a section entitled "Illegality," the ruling begins

exemption from federal income tax"). *See generally* Leff, *Tax Planning*, *supra* note 7, at 550-58.

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

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

[95] *See* Leff, *Tax Planning*, *supra* note 7, at 552. Although, it is important to point out that no court has ever expressly held that the public policy or illegality doctrine applies to any classification of tax-exempt organizations other than section 501(c)(3) organizations.

[96] *See* I.R.S. Priv. Ltr. Rul. 2013-33-014 (Aug. 16, 2013). It is important to note that a private letter ruling is not even the official expressed policy of the IRS, and a taxpayer (other than the taxpayer to whom it is directed) cannot cite it as support for her position. *See* I.R.C. § 6110(k)(3) (2012). Nonetheless, because it is the most recent and most explicit discussion of the IRS's views on the application of the illegality doctrine to non-charitable exempt organizations, it is worth discussing in some detail.

by explaining that "exemptions are not a right, but a matter of legislative grace."[97] It then argues,

> "This general and well-established principle is not limited to exemptions for charitable organizations, but applies to all deductions and exemptions from federal tax. Congress did not intend to provide tax deductions and exemptions to activities that are illegal."[98]

The case it cites as authority for this statement is *Green v. Connally*.[99] In *Green v. Connally*, the District Court of the District of Columbia upheld an IRS ruling denying tax-exempt status under section 501(c)(3) to a private school that discriminated on the basis of race. The Supreme Court later decided this issue consistent with *Green* in *Bob Jones University v. Commissioner*.[100] The IRS cites *Green* (a district court case) rather than *Bob Jones* (a Supreme Court case) in this instance because the *Green* court included a discussion of the existence of a general public policy doctrine that applies to all exemptions and deductions under the tax code in addition to the specific public policy doctrine that derives from charitable trust law and therefore applies only to section 501(c)(3) organizations. The Supreme Court did not include a similar discussion in *Bob Jones*.

The *Green* court described a "general and well-established principle that the Congressional intent in providing tax deductions and exemptions is not construed to be applicable to activities that are either illegal or contrary to public policy."[101] The court then went on to cite no less than four Supreme Court opinions for that proposition, each of which discussed the principle that no deduction may be taken by a business if the expenditure that gave rise to the deduction violated some law or fundamental policy.[102] But, as the students in my

97 I.R.S. Priv. Ltr. Rul. 2013-33-014 (Aug. 16, 2013).

98 *Id.*

99 Green v. Connally, 330 F. Supp. 1150 (D.C. Cir. 1971).

100 Bob Jones Univ. v. Comm'r, 461 U.S. 574, 595 (1983).

101 *Green*, 330 F. Supp. at 1161.

102 Comm'r v. Tellier, 383 U.S. 687, 694 (1966) (permitting a deduction for cost of hiring a lawyer to represent a broker in his criminal securities fraud case); Tank Truck Rentals, Inc. v. Comm'r, 356 U.S. 30, 33-34 (1958) (denying deduction for fines paid to state); Comm'r v. Sullivan, 356 U.S. 27 (1958) (permitting a deduction for rent and wages paid by proprietors of an illegal gambling operation, even though paying those expenses was a crime under state law); Lilly v. Comm'r, 343 U.S. 90, 96-97 (1952) (permitting a deduction for fees paid by eyeglass makers to doctors for prescribing eyeglasses).

introductory Federal Income Tax class know,[103] subsequent to these four Supreme Court cases, Congress acted in 1969 to codify those situations in which deductions can be denied under the so-called public policy doctrine.[104] The legislative history accompanying the 1969 codification makes it clear that it was intended to be an exclusive list of expenses that failed to qualify on account of public policy. Indeed, the Joint Committee's "Bluebook" stated, "[p]ublic policy, in other circumstances, generally is not sufficiently clearly defined to justify the disallowance of deductions."[105] Furthermore, the Treasury Department issued regulations, binding on the IRS, that state unambiguously, "[a] deduction for an expense . . . which would otherwise be allowable under section 162 shall not be denied on the grounds that allowance of such deduction would frustrate a sharply defined public policy."[106]

In other words, the general, free-standing public policy doctrine discussed in the cases cited in *Green* simply does not exist anymore. It is no longer accurate to state that, "[t]his general and well-established principle is not limited to exemptions for charitable organizations, but applies to all deductions and exemptions from federal tax."[107] The public policy doctrine does still exist with regard to the exemptions and deductions that apply to charitable organizations.[108] But it does not apply in other situations, other than those expressly described in the Code.[109] In other words, there is no public policy or illegality

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103 *See* MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 231 (7th ed. 2013).

104 *See* Tax Reform Act of 1969, Pub. L. No. 91-172, § 902, 83 Stat. 487, 710 (1969).

105 STAFF OF THE J. COMM. ON TAXATION, 91ST CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969, 234 (Comm. Print 1970).

106 26 C.F.R. § 1.162-1(a) (2016).

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

108 *See, e.g.*, Leff, *Tax Planning*, *supra* note 7, at 550-51.

109 Some commentators have pointed out that some courts have held that the "frustration of public policy doctrine" still applies to deny the deduction of business losses under section 165 of the Code if such losses arise out of illegal activities, even in the absence of a statutory warrant for such denial. *See* Douglas A. Kahn & Howard Bromberg, *Provisions Denying a Deduction for Illegal Expenses and Expenses of an Illegal Business Should Be Repealed*, 18 FLA. TAX REV. 207, 209, 212-13, 232 (2016) (discussing Stephens v. Comm'r, 93 T.C. 108 (1989), *rev'd*, 905 F.2d 667 (2d Cir. 1990); Holmes Enters., Inc. v. Comm'r, 69 T.C. 114 (1977)). However, the Second Circuit Court of Appeals made it clear in its reversal of the Tax Court in *Stephens v. Commissioner* that the denial of a deduction for illegal business losses under Section 165 only applies when such losses are equivalent to a fine or penalty, the deduction of which would be statutorily prohibited under Section 162(f). *See* Stephens v. Comm'r, 905 F.2d 667, 672 (2d Cir. 1990) ("We believe that the public policy considerations

doctrine that would prevent the income from an organization that otherwise met the requirements of section 115 from being exempt from federal income tax.

III. BENEFITS OF GOVERNMENT-OWNED MARIJUANA STORES

The previous sections have argued that an independent government authority that operated a marijuana store would be exempt from federal tax. In this section, I argue that permitting such an exemption is sound public policy. The IRS's exempt organizations division is ill equipped to be the front line arbiter in the inter-jurisdictional clash between federal and state marijuana policies. But, perhaps ironically, the existence of section 280E, coupled with an exemption for qualified sellers, could support state efforts to provide responsible access to marijuana without completely unleashing a free commercial market. Last year, I argued that permitting 501(c)(4) organizations to sell marijuana tax-free is not only right under the law, but good policy.[110] But that argument is even stronger when applied to government-owned stores. The introduction of a market for marijuana has significant social risks. Citizens are concerned that the legal sale of marijuana (whether only for medical purposes or more widely) may pose risks to purchasers, especially to underage purchasers.[111] Local governments may be in a better position than for-profit sellers to operate marijuana stores consistent with the public welfare, and several commentators, including some participants in this symposium,[112] have advocated that at least some states should experiment with a government monopoly on marijuana sales.[113]

embodied in Section 162(f) are highly relevant in determining whether the payment . . . was deductible under Section 165."). In other words, there is no support for the IRS's claim that a free-standing public policy doctrine "applies to all deductions and exemptions from federal tax."

110 *See* Leff, *Tax Planning*, *supra* note 7, at 527.

111 *See* Pacula, et al., *supra* note 15, at 1022 ("[W]e have presented the public health perspective favoring certain types of regulations in light of documented harms associated with marijuana use, particularly for youths.").

112 *See generally* Richard J. Bonnie, Professor of Med. and Law, Univ. of Va. Sch. of Law, Keynote Address at the UC Davis Law Review Symposium: Disjointed Regulation, State Efforts to Legalize Marijuana (Jan. 29, 2016). [Ed. Note: An annotated version of this keynote was published as Richard J. Bonnie, Keynote, *The Surprising Collapse of Marijuana Prohibition: What Now?*, 50 UC DAVIS L. REV. 573 (2016).]

113 *See* Pat Oglesby, *States May Be Stuck With Second-Best Marijuana Taxes*, 72 ST. TAX NOTES 539, 539 (2014) [hereinafter *States May Be Stuck*] ("The safest, correctable way to distribute an intoxicant is government monopoly . . . ."); German Lopez, *Big Marijuana*

Recognizing the tax-exempt status of these government-owned stores permits (and even encourages) a state policy of governmental dominance over the marijuana market that arguably advances both state and federal policy objectives.

Furthermore, constructing a viable state tax regime is especially difficult in the case of marijuana, as Pat Oglesby and others have ably pointed out.[114] In all states, marijuana is currently sold on well-established black markets. When a state legalizes marijuana, one of its primary goals is to move the marijuana market from the existing illegal (and untaxed) market to its new legal (and taxed) market.[115] If it sets its taxes too high, especially initially, it runs the risk of preventing the legal market from driving marijuana consumers away from their existing illegal suppliers.[116] On the other hand, economists predict that once a legal supply chain is developed for legal marijuana, the "wholesale" price may fall dramatically.[117] A state may have an interest in preventing this dramatic price drop from affecting the retail price, since low retail prices may drive growth in demand for marijuana. The popularity of legalization among some voters depends

Is Coming — and Even Legalization Supporters Are Worried, VOX (Dec. 2, 2015), http://www.vox.com/policy-and-politics/2015/12/2/9831980/marijuana-legalization-industry-business ("Drug policy experts have long argued that the best approach to legalizing marijuana is a restrained policy — one that limits access to cannabis by, for instance, putting state governments directly in charge . . . .").

114 *See* Pat Oglesby, *Gangs, Ganjapreneurs, or Government: Marijuana Revenue Up for Grabs*, 66 ST. TAX NOTES 255, 255-56 (2012); Pat Oglesby, *Laws to Tax Marijuana (How to Tax It)*, 59 ST. TAX NOTES 251, 258 (2011); Oglesby, *States May Be Stuck*, *supra* note 113, at 541-43; *see also* JONATHAN P. CAULKINS ET AL., MARIJUANA LEGALIZATION: WHAT EVERYONE NEEDS TO KNOW 259 (2d ed. 2016); RAND REPORT, *supra* note 15, at 53; CHRISTOPHER LAW, CTR. FOR NEW REVENUE, LEGALIZED RECREATIONAL MARIJUANA AND BLACK-MARKET CHALLENGE: EARLY LESSONS FOR FUTURE POT LAWS 5-6 (2015), https://newtax.files.wordpress.com/2015/06/legalized-recreational-marijuana-and-the-black-market-challenge.pdf; MACCOUN ET AL., *supra* note 15, at 44-55.

115 *See, e.g.*, Oglesby, *States May Be Stuck*, *supra* note 113, at 539 ("Any marijuana legalization model . . . must use either low prices or enforcement to solve the problem of bootlegging — selling by the illegal sector.").

116 The challenge of setting state taxes low enough that legal retail prices are not too high is exacerbated by the uncertainty of the operation of federal income taxes due to section 280E. The evidence that we have so far from early adopters of legal marijuana regimes is that the existence of state taxes at current levels are not preventing a robust legal marijuana market from developing alongside the established illegal one. *See, e.g.*, Tanya Basu, *Colorado Raised More Tax Revenue from Marijuana than from Alcohol*, TIME (Sept. 16, 2015), http://time.com/4037604/colorado-marijuana-tax-revenue/.

117 *See* Oglesby, *States May Be Stuck*, *supra* note 113, at 539 ("After marijuana is legalized, the costs of producing and selling it will collapse and windfall economic gain will be up for grabs.").

on a belief that legalization will not lead to dramatic growth in demand, since most people still view marijuana as having some adverse medical or social effects.[118] Thus, a state may hope to prevent the retail price of marijuana from falling too dramatically by taxing the sale of marijuana to keep the price stable.

It is difficult to design a state tax system that could accurately identify the right level of taxation — low enough to ensure that the regulated market can compete with the black market but high enough to discourage growth in demand as prices fall. It is even more difficult because changes to the wholesale price of marijuana are likely to be dramatic, and are unusually hard to predict. Designing a state tax system that is sufficiently dynamic to take into account such changes as they occur is arguably impossible.[119] But, if a state simply set the price of marijuana, which it would do if its legalization regime created a state monopoly on marijuana sales, it would be extremely easy to react quickly to changes in the wholesale cost of marijuana to keep prices at an optimal level to meet the state's multiple regulatory purposes.

Perhaps ironically, one benefit of a state monopoly on marijuana sales is that it would reduce the chance that there would be a private (but state supported) monopoly (or oligopoly) on marijuana sales. Voters in Ohio recently rejected a legalization initiative because it "would have created an oligopoly on marijuana production for a small handful of the initiative's wealthy donors."[120] While the Ohio Initiative was an extreme case, marijuana legalization advocates and public health experts alike have expressed concern about the effects of big businesses entering the marijuana market,[121] and some believe that strict licensing regimes potentially create governmentally-supported windfall profits for politically-connected sellers.[122] A state monopoly

118 *See, e.g.*, WILLIAM A. GALSTON & E.J. DIONNE, BROOKINGS INST., THE NEW POLITICS OF MARIJUANA LEGALIZATION: WHY OPINION IS CHANGING 3 (2013), https://www.brookings.edu/research/the-new-politics-of-marijuana-legalization-why-opinion-is-changing/ ("Many of those who favor legalization do so despite believing that marijuana is harmful or reporting that they feel uncomfortable with its use.").

119 There may even be constitutional issues. *See* Nima H. Mohebbi, Samuel T. Greenberg & Ian S. Speir, *Crafting a Constitutional Marijuana Tax*, 69 TAX LAW. 214, 215 (2015).

120 Christopher Ingraham, *Why Ohio Voted Against Legal Marijuana — and What It Means for the Future of the Pot Debate*, WASH. POST (Nov. 4, 2015), http://www.washingtonpost.com/news/wonk/wp/2015/11/03/ohio-rejected-legalizing-marijuana-what-that-means-for-the-future-of-pot/.

121 *See, e.g.*, Lopez, *supra* note 113.

122 *See, e.g.*, RAND REPORT, *supra* note 15, at 96 ("Like any licensing plan, any quota system transfers scarcity rents from the state to quota owners.").

prevents such windfall profits. In the case of a monopoly operated by a public development authority or authorities, the IRS's rules against "private benefit"[123] supplement any existing protections against private excess profits from selling marijuana.

One objection I have heard to the operation of marijuana stores by state development authorities (that also applies to high taxes on marijuana) is that some voters are skeptical that new revenue raised from a legal marijuana industry would be wasted by state or local governments. An even stronger argument has been made that there are significant adverse effects when governments come to rely on revenue from so-called "sin" taxes.[124] In other contexts, states' claims about the uses of "earmarked" government revenue to address social or health issues have turned out to be empty promises.[125] High marijuana taxes have also been criticized for being "regressive," meaning that poorer people pay a higher percentage of them, relative to their income, than richer people.[126] This is true even if there is no difference in the amount of marijuana consumed by poorer or richer people, since an identical tax on the same amount of cost is borne more heavily by a poorer person than a richer one simply because the same tax makes up a larger proportion of a poorer person's income.

A governmental marijuana monopoly would function something like high marijuana taxes, since it would enable the state or local government to "sop up" potential profits as the cost of marijuana production falls. One solution to both of these problems would be for a state that legalized marijuana under a government-monopoly system to distribute all or some of the profits from the operation of the marijuana industry to the citizens of that state or locality. Creating a public development authority to operate the government monopoly

[123] *See supra* text accompanying note 73.

[124] Andrew J. Haile, *Sin Taxes: When the State Becomes the Sinner*, 82 TEMP. L. REV. 1041, 1043 (2009) ("[R]eliance on sin taxes comes with a troubling ethical issue: when a state becomes dependent on sin tax revenues to finance essential governmental programs and services, the state creates a conflict of interest between the protection of its citizens' health and the need for continued sales of harmful products.").

[125] *See, e.g.*, GOSTIN & WILEY, *supra* note 63, at 263 ("[The Master Settlement Agreement] offered a missed opportunity for investment in smoking prevention. Unfortunately, the states have used the discretionary funds primarily for general education, social programs, tax relief, and other political priorities. States are spending less than two cents of every dollar in tobacco revenue from the MSA and tobacco taxes to fight tobacco use. Meanwhile, for every dollar spent by states to reduce tobacco use, the industry spends eighteen dollars to market tobacco products.").

[126] Haile, *supra* note 124, at 1050-51.

would make it easier to mandate the terms of a profit distribution system, since the same legislation that created the authority could also stipulate the mechanism by which its profits are distributed to the people. Because of the requirement that the profits "accrue to" the state or political subdivision, it would probably be unwise to distribute *all* of the profits, but a substantial percentage would no doubt be permissible. And the class of distribution recipients could be defined broadly enough that the "private benefit" doctrine would not apply. For example, each citizen of the jurisdiction could receive an equal distribution (which would mitigate the regressivity of the tax). Or, profits could be distributed progressively, with a larger distribution being made to poorer citizens. Or, profits could be distributed as "reparations" primarily to people in communities that were most adversely affected by marijuana prohibition policies and the war on drugs. Under any of these systems, the concerns that marijuana taxes are regressive or will be used inefficiently by the government are unwarranted.

CONCLUSION

At first blush, the idea that government-owned marijuana sellers could be exempt from federal tax because they advance an "essential governmental function" seems like the perfect test of Professor Ellen Aprill's claim that "[u]nder [the IRS's section 115 policy] governments could conduct tax-free any kind of enterprise for any reason."[127] But the case for government-controlled marijuana sellers is actually much stronger than it initially appears. If the federal government is looking for a way to avoid the kind of inter-jurisdictional conflict that is currently being caused by the contradictory state and federal laws about marijuana,[128] a federal tax incentive for local governments to control their own retail marijuana markets may be extremely beneficial. Recognizing the tax-exempt status of independent public development authorities that sell marijuana, when combined with the harsh tax treatment of commercial marijuana sellers under IRC §280E, creates exactly such an incentive. And it is already the law.

From the state perspective, it may also appear that directly operating an industry that is illegal under federal law, even if operated through independent public authorities, will provoke inter-jurisdictional conflict. However, if a state monopoly on marijuana sales is the most

127 Aprill, *Excluding the Income*, *supra* note 10, at 439.

128 *See, e.g.*, Erwin Chemerinsky, Jolene Forman, Allen Hopper & Sam Kamin, *Cooperative Federalism and Marijuana Regulation*, 62 UCLA L. REV. 74, 77 (2015).

responsible way to operate a legal marijuana industry, even if only for a transitional period, then it is a means for navigating the inter-jurisdictional conflict in a way that is the *least* destructive to national interests.

One place where a state monopoly may be especially well suited is my home of Washington, D.C. We legalized recreational marijuana by initiative in 2015, but Congress blocked us from implementing a regulatory system by placing a rider on our budget, preventing the D.C. government from spending any money to implement the legalization law.[129] Because we have so many close neighbors that have not legalized recreational marijuana (Virginia, Maryland, and federal land), it is especially important for our transition to legalization take place in a controlled manner. A D.C. governmental monopoly on marijuana sales would be the easiest mechanism to ensure this level of control. In this city, where African-American communities were so hard hit by the negative effects of decades of marijuana prohibition,[130] it might make sense to treat the distribution of governmental marijuana profits as reparations for those decades of harm. For D.C. to lead the nation in both sane marijuana legalization policy and reparative racial justice would be especially fitting.

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[129] *See* Aaron C. Davis, *Budget Bill Outlaws Pot Sales in D.C. for 2 Years*, WASH. POST (June 11, 2015), https://www.washingtonpost.com/local/dc-politics/house-budget-bill-would-outlaw-marijuana-sales-in-dc-for-two-years/2015/06/11/ffd763ae-1051-11e5-adec-e82f8395c032_story.html.

[130] *See generally*, DONALD BRAMAN, DOING TIME ON THE OUTSIDE: INCARCERATION AND FAMILY LIFE IN URBAN AMERICA (2004) (providing information about the dramatically adverse and wide-ranging impacts of high levels of incarceration on families in DC, only some of which are due to marijuana prohibition).