

“The Case for Government-Owned Marijuana Stores”

Benjamin Moses Leff

Last spring (3/7/15), 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.” A public development authority is an independent entity created by a state or local government. Why is it interesting that the Cannabis Corner is the first marijuana store to be operated by a public development authority? Because it means that the Cannabis Corner 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,² and marijuana is still a schedule I controlled substance.³ Therefore, federal income taxes of marijuana stores are likely to be especially high.⁴ The Cannabis Corner has solved the federal income tax problem faced by other marijuana sellers.

A year ago, I published an article in the Iowa Law Review that argued that 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).⁵ A number of my colleagues (and presumably the IRS) were unconvinced by my argument that there is no legal impediment to a federally recognized tax-exempt organization running a commercial operation in violation of federal law.⁶ The case for government affiliates, like the public development authority that operates the Cannabis Corner, is much stronger.⁷ Such government-

¹ See, e.g., Mark Nowlin, *Here’s a First: Tiny Town Will Open Its Own Pot Shop*, SEATTLE TIMES (3/5/15); Todd C. Frankel, *Cornering the Pot Market: After Washington State Made it Legal, a Struggling Town Went Into Business*, THE WASHINGTON POST (3/17/2015) at A1.

² See, generally, Edward J. Roche, Jr., *Federal Income Taxation of Medical Marijuana Businesses*, 66 TAX LAW. 429 (2013).

³ In addition, of course, the fact that marijuana is a schedule I controlled substance means that it is a violation of federal criminal law to sell it. Unfortunately, the fact that the Cannabis Corner is operated by a government affiliate, exempt under section 115 of the Code, as discussed in this Article, does nothing to absolve its employees from federal criminal liability.

⁴ See, e.g., *Marijuana Business Conference Wrapup: 36 Tips, Lessons & Takeaways for the Cannabis Industry*, Med. Marijuana Bus. Daily (Nov. 15, 2012), <http://mjbizdaily.com/marijuana-business-conference-wrapup-36-tips-lessons-take-aways-for-the-cannabis-industry/>.

⁵ Benjamin Moses Leff, *Tax Planning for Marijuana Dealers*, 99 IOWA L. REV. 523 (2014).

⁶ See, Philip T. Hackney, *A Response to Professor Leff’s Tax Planning ‘Olive Branch’ for Marijuana Dealers*, 99 IOWA L. REV. BULL. 25 (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, *supra* note 5 at 552-553. See, also, PLR 201333014 (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.”)

⁷ Philip Hackney, in his critical response to my article, suggested “in the spirit of . . . offering a solution” that “a better course of action might be for the state or local government to take that activity [selling marijuana] on itself.” Hackney, *supra* note 6 at 35. He argued that state-run marijuana dispensaries would be preferable to private

owned entities are exempt from tax under section 115 of the Code. 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.⁸ Under section 115, income is exempt if it is “derived from a . . . the exercise of any essential governmental function” and is “accruing to a State or any political subdivision thereof[.]”⁹ 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.”¹⁰ 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 some argue 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.

Finally, the case for government-owned marijuana stores is stronger than just the fact that it solves a federal income tax problem. There are numerous reasons why a state or local government might want to control its newly legalized marijuana market, rather than completely open it up to private businesses. The opening of new legal markets for marijuana may well have adverse social effects, and direct governmental (or quasi-governmental) control of the sale of marijuana may well be the best method to minimize those adverse effects.¹¹ Furthermore, significant problems that are created in attempting to craft an adequate mechanism for taxing marijuana sales at the state level could be solved if government entities ran marijuana stores themselves. This benefit of state ownership could be enjoyed equally by governments who choose to sell marijuana through independent affiliates, like public development authorities.¹²

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.*

⁸ Ellen Aprill, *The Integral, The Essential and the Instrumental: Federal Income Tax Treatment of Governmental Affiliates*, 23 J. CORP. L. 803, 818 (1997)(According to the IRS’s “astonishingly liberal” interpretation, “[f]or purposes of section 115, anything that makes or saves then political subdivisions money serves an essential governmental function.”) *See, also*, Ellen Aprill, *Excluding the Income of State and Local Governments: The Need for Congressional Action*, 26 GA. L. REV. 421, 429 (1992)(“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.”)

⁹ IRC §115(1).

¹⁰ P.L.R. 88-25027 (3/29/1988).

¹¹ *See, e.g.*, Rosalie Liccardo Pacula, Beau Kilmer, Alexander Wagenaar, Frank Chaloupka, & Jonathan Caulkins, *Developing Public Health Regulations for Marijuana: Lessons From Alcohol and Tobacco*, 104 AMER. J. OF PUB. HEALTH 1021 (June 2014).

¹² For simplicity’s sake, I refer to entities that participate in legal marijuana markets as “sellers,” although there might reasons for governmental affiliates to participate in marijuana markets in other capacities, like production or distribution. The arguments made in this Article may well apply to entities engaged in other aspects of the marijuana industry.

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 the first section, I discuss the three legal requirements for tax exemption under section 115, and how these three requirements are likely to apply to a public development authority like the Cannabis Corner. In the second section, I discuss whether a government affiliate that sold marijuana might be denied tax-exempt status even if it met all the requirements of section 115 under the so-called “public policy” or “illegality” doctrine. In both 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.

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.¹³ Entities that are an “integral part” of a state or political subdivision of a state are also exempt under the same principles.¹⁴ However, entities that are created by a government, but are too independent to qualify as an “integral part” may also be exempt, not because of implied immunity, but because of section 115 of the Code.¹⁵ Section 115 exempts from federal tax “income derived from any public utility or the exercise of any essential government function and accruing to a State or any political subdivision thereof, or the District of Columbia.”¹⁶ Entities created by or affiliated with state governments may also be exempt under some category of section 501(c). As Ellen 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.”¹⁷

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 if Vermont should legalize marijuana, the authors point out that “we want to stress at the outset that

¹³ Aprill (1992), *supra* note 8 at ____; and Aprill (1997), *supra* note 8 at 804-05 (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.”).

¹⁴ *Id.* I am assuming that a government selling marijuana would rather use an independent “affiliate” rather than a government agency or integral part of the government for a variety of reasons. If a government sells marijuana through an agency of a state or local government or an integral part of such governments, then the federal income tax situation is easy: no federal tax.

¹⁵ 26 U.S.C. §115 (2014), hereinafter IRC §115.

¹⁶ IRC § 115(1).

¹⁷ Aprill (1997), *supra* note 8 at ____.

direct state participation in the supply chain could cause the state to violate federal law.”¹⁸ To avoid the direct inter-jurisdictional clash that would be created if “Federal agents could enter state monopoly stores and arrest state employees,” the authors propose what they call “near monopoly,” in which 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.¹⁹ The reason an independent public authority is preferable to direct control by a government is that “[t]he hope is that those actions, in substance, might prove no more offensive to federal interests than a state’s actions in a for-profit commercial model”²⁰ It would still be possible for the employees of the public authority 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.”²¹ Section 115 of the Code 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” and if it “accru[es] to a State or any political subdivision thereof, or the District of Columbia.”²² The IRS has grafted on to these two requirements another requirement for section 115 organizations: that they be operated such that any “private benefit” that arises out of their operation be “incidental to the public benefit.”²³ The authors of the Report concluded that a public authority that sold 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 government function,’ so income of any public authority, unlike income of a state monopoly, would bear federal income tax[.]”²⁴ This conclusion has strong intuitive appeal, since common sense tells us that selling marijuana is not an essential government function.²⁵ However, it appears that common sense has misled in this case, and this legal conclusion comes from a too-literal reading of section 115.²⁶ This section discusses the application of section 115 to an independent government authority that sells marijuana.

A. Essential Government Function

¹⁸ Rand Report, *supra* note 85 at 61 (citing Robert Mikos). Though they also point out that “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).” Rand Report at 72. *See, also*, The Law and Policy Lab, *supra* note 85 at 14 (citing Erwin Chemerinsky, Jolene Forma, Allen Hopper, & Sam Kamin, *Cooperative Federalism and Marijuana Regulation*, 62 UCLA L. REV. 74, 106 (2015)).

¹⁹ Rand Report, *supra* note 85 at 72.

²⁰ *Id.*

²¹ *Id.*

²² IRC § 115(a)

²³ *See* Aprill at 816 *citing* Rev. Rul. 90-74, 1990-2 C.B. 45.

²⁴ Rand Report at 64.

²⁵ *See* Mark Nowlin, *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.”)

²⁶ The Author would like to thank Pat Oglesby for initially pointing out this issue. (Email correspondence on file with the author).

The question of what constitutes an essential governmental function in the context of Section 115 has a long history, well told by Professor Ellen Aprill almost 25 years ago²⁷ (and then again five years later²⁸). 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.”²⁹ At the time the provision was 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.”³⁰ 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. Aprill believes that the “essential governmental function” requirement in section 115 is merely Congresses' attempt to codify the distinction between “proprietary” and “sovereign” functions of government described in these old Supreme Court cases.³¹

However, this distinction was later abandoned as unworkable by the Supreme Court, which stated, “we reject limitations on the taxing power of Congress derived from such untenable criteria as ‘proprietary’ against ‘governmental’ activities of government, or activities conducted merely for profit.”³² By abandoning the distinction between proprietary and governmental, the Supreme Court left the “essential government function” test a sort of orphan of an archaic legal doctrine.

The fact that the Supreme Court has despaired of identifying 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. Section 115 still says that income is exempt only if it arises from an essential governmental function. So, for example, in 1966 the Tax Court found that a state university was not exempt under section 115 from the gain derived from the liquidation of a corporation that owned hospitals.³³ 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.³⁴ In 1979, the Ninth Circuit managed to avoid the problem entirely by holding that a state-created alcohol seller was not

²⁷ See Aprill (1992), *supra* note 8.

²⁸ See Aprill (1997), *supra* note 8.

²⁹ Aprill (1992), *supra* note 8 at 423.

³⁰ *South Carolina v. U.S.*, 199 U.S. 437, 463 (1905).

³¹ Aprill (1992), *supra* note 8 at 425-26 (citing *South Carolina*, et al.).

³² See *New York v. U.S.*, 326 U.S. 572, 583 (1946) (“[W]e reject limitations on the taxing power of Congress derived from such untenable criteria as ‘proprietary’ against ‘governmental’ activities of government, or activities conducted merely for profit”). See, also, *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528 (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[.]”).

³³ *Troy State University*, 62 T.C. 493 (1962).

³⁴ See *id.* (Citing *South Carolina v. U.S.*, 199 U.S. 437, 463 (1905), and extensively quoting *Flint v. Stone Tracy Co.*, 220 U.S. 107, 172 (1911), but not mentioning *New York v. U.S.*, 326 U.S. 572 (1946)).

exempt under section 115 because its income did not accrue to the State, which “obviates resolution of” the essential government function issue.³⁵

The IRS, however, has apparently taken a different approach from that of the few courts to apply 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.³⁶ 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. 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 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 conduct³⁷

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.³⁸ Several decades later, the IRS issued rulings that the Oregon Liquor Control Commission³⁹ and the Montana Liquor Control Board⁴⁰ 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 the “essential governmental function” requirement of section 115 (or its precursor) because the IRS found that the States’ Liquor Control Boards were not separate entities from the state.⁴¹

³⁵ *City of Bethel v. U.S.*, 594 F.2d 1301, note 2 (9th Cir. 1979).

³⁶ G.C.M. 14,407, 1935 XIV-1 C.B. 103 (1935).

³⁷ *Id.* at 106-07.

³⁸ I.T. 2886, 1935 XIV-1 C.B. 103 (1935).

³⁹ Rev. Rul. 71-132, 1971-1 C.B. 29 (1971).

⁴⁰ Rev. Rul. 71-131, 1971-1 C.B. 29 (1971).

⁴¹ Presumably, it would be improper to take the quote from G.C.M. 414,407 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, 1935 XIV-1 C.B. 103 (1935).

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 that,

“[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 consideration of the question, may be the function of the sovereign to conduct.”⁴²

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.”⁴³

Apparently, the IRS has continued to apply this broad view of what constitutes an essential governmental function under section 115, in effect importing the test that the IRS created for governments themselves into the jurisprudence about separate entities created by governments. For example, in Rev. Rul. 90-74, the IRS held that an entity that insured political subdivisions of a state against casualties performed an essential government 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.”⁴⁴ This ruling expresses the IRS’s view that “anything that makes or saves the political subdivisions money serves an essential governmental function.”⁴⁵ 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.⁴⁶

⁴² Rev. Rul. 77-261, 1977-2 C.B. 45, 46 (1977).

⁴³ *Id.* Ellen Aprill has described the application of GCM 14,407 to section 115 entities as “both surprising and wrong.” Aprill (1992), *supra* note ___ at 437.

⁴⁴ Rev. Rul. 90-74, 1990-2 C.B. 34 (1990)

⁴⁵ Aprill (1997), *supra* note 8 at 816. *See, also*, Aprill (1992), *supra* note 8 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.”)

⁴⁶ For example, see P.L.R. 87-53008 (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”); P.L.R. 2013-08010 (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.”); P.L.R. 2001-16009 (April 23, 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”); P.L.R. 2003-20024 (May 16, 2003)(ruling that “[b]y funding the remediation of a contaminated and polluted site, [qualified settlement funds] perform an essential governmental function); P.L.R. 2015-15016 (April 3, 2015)(ruling that “providing ... health and welfare benefits [to retirees of a political subdivision] constitutes the performance of an essential government function within the

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. In addition, as Professor Aprill points out, 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.⁴⁷ However, as Aprill also points out, the IRS's approach is plausibly broader than is reasonable according to the plain language of the Code. There is little authoritative support for the IRS's broad reading of "essential governmental function" to mean any function that makes or saves money for the state.

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. Just as it is with liquor sales, it is well within the state's police power to seek to control the market in dangerous substances. Protecting the public from the negative effects of such markets is at the heart of what states do. States have been doing that both through regulation and through state monopoly for centuries.⁴⁸ In other words, the states have strong governmental interests that warrant their control of marijuana markets. They are not merely making money. Thus, even if the IRS's view of the "essential governmental function" test was narrower than it appears to be, marijuana selling should satisfy the test.⁴⁹

B. Accrue to the Government

What it means for income to be "accruing to" a state or political subdivision under section 115 is as confused as what it means for the state to be pursuing an "essential governmental function." Again, courts have historically provided a relatively high bar,⁵⁰ 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

meaning of IRC §115(1)"); P.L.R. 2015-16031 (April 17, 2015)(same); P.L.R. 2015-09001 (February 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 within the meaning of §115(1)").

⁴⁷ See Aprill (1992), *supra* note 8 at 429.

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⁴⁹ 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 (1992) *supra* note 8 at 429.

⁵⁰ See Aprill (1992), *supra* note 8 at 440-442, discussing 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.), *cert. denied*, 352 U.S. 837 (1956), and *City of Bethel v. United States*, 594 F.2d 1301 (9th Cir.), *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.

proportionate share of the investment fund income.”⁵¹ 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.”⁵²

The IRS’s approach has apparently not changed in the 23 years since Aprill’s first article on the topic. For example, in a private letter ruling issued this 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.”⁵³ 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.⁵⁴

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 that profits be paid over according to some regular schedule, or they could structure things so 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. 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

⁵¹ Aprill (1992) *supra* note 8 at 438. Elsewhere, she 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.

⁵² Rev. Rul. 90-74, 1990--2 CB 34 (1990).

⁵³ PLR 2015-15016 (4/3/15). *See, also*, PLR 2015-16031 (4/17/15)(very similar facts and analysis).

⁵⁴ *See* Aprill (1992) 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).”

As discussed above, IRS guidance has added an additional requirement to section 115 that does not appear in the statutory language. In the same 1990 Revenue Ruling that apparently broadened the definition of “accruing to” so dramatically, the IRS introduced the notion that another requirement of section 115 is that “no private interests participate in or benefit from the operation of [the entity.]”⁵⁵ In that ruling, the IRS stated this “private benefit” requirement in the middle of its paragraph about whether the entity performs an essential governmental function. Immediately after the sentence about private benefit, the ruling states, “Accordingly, X performs an essential governmental function[,]” implying that providing no substantial private benefit is a requirement of meeting the essential governmental function test.⁵⁶ However, the IRS has also linked private benefit to the question of whether an entity meets the accrual test. At yet 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.”⁵⁷ Professor Aprill argues that the IRS has substituted a “destination of the funds” test for the traditional essential governmental function and accrual tests, approving entities under section 115 so long as they find no substantial private benefit.⁵⁸

While Aprill expresses concern that the new private benefit standard is an *ad hoc* IRS addition to the law and has no statutory authority,⁵⁹ 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 can leave 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 to them 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” requirement of section 115, and the income is not tax free.

The problem is that the parameters of the “private benefit” test are currently horribly indeterminate. First of all, it is likely that the IRS really means to apply both a “private inurement” and a “private benefit” analysis to section 115 organizations. Under a private inurement analysis, an organization is unworthy of tax-exempt status if some private individual who is in a position to substantially influence the organization also stands to gain some excessive financial reward from the operation of the organization.⁶⁰ 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.⁶¹ For marijuana stores like the Cannabis Corner, this could

⁵⁵ Rev. Rul. 90-74, *supra* note 52.

⁵⁶ *Id.*

⁵⁷ PLR 88-25027 (Mar. 29, 1988)(holding that a corporation created by a state to administer a college tuition prepayment program is not exempt under §115 because the individual participants in the prepayment program receive a private benefit that is not incidental to the public purpose).

⁵⁸ See Aprill (1992) at 442.

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⁶⁰ See, e.g., Benjamin M. Leff, *Preventing Private Inurement in Tranche Social Enterprises*, 45 SET. HALL L. REV. 1, 25-27 (2015).

⁶¹ For organizations exempt from tax under section 501(c) of the Code, penalties can be applied in these situations for so-called “excess benefit transactions.” See IRC §4958. But these penalties do not apply to public development authorities or other governmental affiliates, which are exempt from tax under section 115.

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."⁶² 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. That may be a difficult question to answer. But the public development authority can avoid risk of trouble by making sure that 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 well-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.⁶³ An organization could violate the private benefit doctrine even if the benefited person is not an insider in the organization.⁶⁴ Given the fact 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. Since the private benefit doctrine prohibits tax-exempt organizations formed for private purposes, and there is no way to avoid the application of the doctrine by simply obtaining start-up capital from unrelated parties, the private benefit doctrine may well be a substantial impediment to the operation of public development authorities that finance their operations with private capital.

Given the uncertainty in the law, 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. Instead of obtaining start-up costs in the form of high-interest loans from private investors, it could use funds from the general treasury to start its marijuana-selling operation. There are good reasons to think that this situation would be preferable from a 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. If it uses private funds, then there may be some question about whether all the profits accrue to the government or not.⁶⁵

⁶² Todd C. Frankel, *Cornering the Pot Market: After Washington State Made it Legal, a Struggling Town Went Into Business*, THE WASHINGTON POST (3/17/2015) A1, 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.*

⁶³ See, e.g., John D. Colombo, In Search of Private Benefit, 58 Fla. L. Rev. 1063, 1064 (2006).

⁶⁴ See *United Cancer Council, Inc. v. Comm'r*, 165 F3d 1173, 1180 (1999) ("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.")

⁶⁵ 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.

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 plain meaning of their words implies, provide some important limitations that may well help government-controlled marijuana sellers to 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,⁶⁶ but some commentators were unpersuaded.⁶⁷ 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).⁶⁸ However, the arguments for denying 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 are 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.”⁶⁹ 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.⁷⁰ 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.⁷¹ But the IRS has recently issued non-precedential guidance that makes the case quite clearly that it believes that *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

⁶⁶ See Leff, *supra* note 5.

⁶⁷ See Hackney, *supra* note 6.

⁶⁸ See, e.g., I.R.S. Priv. Ltr. Rul. 2013-33-014 (May 20, 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’s ‘legislative grace’ of exemption from federal income tax.”). See, generally, Leff, *supra* note 5 at 550-558.

⁶⁹ *Bob Jones University v. Comm’r*, 461 U.S. 574, 605 (1983).

⁷⁰ See Priv. Ltr. Rul. 2012-24036 (June 15, 2012).

⁷¹ See Leff, *supra* note 5 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.

under any section of the Code.⁷² Therefore, it is worth discussing in detail why the reasoning of this guidance is wrong. In a section entitled “Illegality,” the ruling begins by explaining that “exemptions are not a right, but a matter of legislative grace.” It then argues that,

“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.”

The case it cites as authority for this statement is *Green v. Connally*.⁷³ 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*.⁷⁴ The IRS is citing *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.”⁷⁵ 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.⁷⁶ But, as the students in my introductory Federal Income Tax class know,⁷⁷ 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.⁷⁸ The legislative history accompanying the 1969 codification makes it clear that the codification was intended to be an exclusive list of expenses that failed to qualify on account of public policy, since the Joint Committee’s “Bluebook” stated, “[p]ublic policy, in other

⁷² I.R.S. Priv. Ltr. Rul. 2013-33-014 (May 20, 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. 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.

⁷³ 330 F.Supp. 1150, 1161 (D.C. Cir. 1971).

⁷⁴ 461 U.S. 574 (1983).

⁷⁵ *Green*, at 1161.

⁷⁶ The cases were *Commissioner 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. Commissioner*, 356 U.S. 30, 33-34 (1958)(denying deduction for fines paid to state); *Commissioner v. Sullivan*, 356 U.S. 27, 78 (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); and *Lilly v. Commissioner*, 343 U.S. 90, 96-97 (1952)(permitting a deduction for fees paid by eyeglass makers to doctors for prescribing eyeglasses).

⁷⁷ See Michael J. Graetz & Deborah H. Schenk, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES (7th Ed. 2013) at 231.

⁷⁸ See Tax Reform Act of 1969.

circumstances, generally is not sufficiently clearly defined to justify the disallowance of deductions.”⁷⁹ Furthermore, the Treasury Department issued regulations, binding on the IRS, that state unambiguously that, “[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.”⁸⁰ In other words, the general, free-standing public policy doctrine discussed in the cases cited in *Green* simply does not exist anymore.⁸¹ It is no longer accurate to state that, “This general and well-established principle is not limited to exemptions for charitable organizations, but applies to all deductions and exemptions from federal tax.”⁸² The public policy or illegality doctrine exists with regard to the exemption and deduction that applies to charitable organizations,⁸³ but it does not apply in other situations, obviously other than those expressly described in the Code.⁸⁴ In other words, there is no public policy or illegality doctrine that would prevent the income from an organization that otherwise met the requirements of section 115 from being exempt from federal income tax.

Thus, there is no authority to deny a government-owned marijuana store tax exemption because selling marijuana is illegal under federal law. But, more than that, permitting the exemption is sound public policy. The IRS's exempt organizations division is ill equipped to serve as the front line in the inter-jurisdictional clash between federal and state marijuana policies. 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. But those arguments are 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. Local governments may be in a better position than for-profit sellers to operate marijuana stores consistent with the public welfare. 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 has been ably pointed out by Pat Oglesby, among others.⁸⁵ 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. If it sets its taxes too high, especially initially, it runs the risk

⁷⁹ Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1969, 91st Cong., 1st Sess. 233-35 (1969).

⁸⁰ Treas. Reg. §1.162-1(a).

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⁸² PLR 2013-33014 at 5.

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⁸⁵ See, e.g., Jonathan P. Caulkins, et al., *MARIJUANA LEGALIZATION: WHAT EVERYONE NEEDS TO KNOW* (Oxford 2012); Jonathan P. Caulkins, Beau Kilmer, Mark A. R. Kleinman, Robert J. MacCoun, Gregory Midgette, Pat Oglesby, Rosalie Liccardo Pacula, Peter H. Reuter, *Considering Marijuana Legalization: Insights for Vermont and Other Jurisdictions*, RAND CORPORATION RESEARCH REPORT (2015)(hereinafter “Rand Report”); Christopher Law, *Legalized Recreational Marijuana and Black-Market Challenge: Early Lessons for Future Pot Laws*, Center for New Revenue (June 15, 2015)(available at <https://newtax.files.wordpress.com/2015/06/legalized-recreational-marijuana-and-the-black-market-challenge.pdf>); R.J. McCoun et al., The Law and Policy Lab, Stanford Law School, *Legalizing Marijuana in California: A Review of Policy Considerations* (2015).

of preventing the legal market from driving marijuana consumers away from their existing illegal suppliers.⁸⁶ On the other hand, economists predict that once a legal supply chain is developed for legal marijuana, the “wholesale” price may fall dramatically. A state may have an interest in preventing this dramatic fall in price from affecting the retail price, since low retail prices may drive growth in demand for marijuana. The popularity of legalization among some voters depends 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. 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. 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.

III. 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.”⁸⁷ 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 clash that is currently being caused by the contradictory state and federal laws about marijuana,⁸⁸ 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.

⁸⁶ 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), available at <http://time.com/4037604/colorado-marijuana-tax-revenue/>.

⁸⁷ Aprill (1992) *supra* note 8 at 439.

⁸⁸ *See, e.g.,* Erwin Chermerski, Jolene Forman, Allen Hopper, & Sam Kamin, *Cooperative Federalism and Marijuana Regulation*, 62 UCLA L. REV. 74 (2015).