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Warning for Cannabis-Related Charities (And Others): IRS Applies Legality Doctrine in Denial 201917008

With marijuana use now legal for medicinal purposes in 33 states and fully legal in 10 states (and D.C.), new organizations and programs have been forming to conduct related activities, ranging from medical research and care, to advocacy for further decriminalization nationwide, to educational activities aimed at recreational users. In a recent denial letter (Denial 201917008), the IRS sent a message that these organizations should not expect to easily qualify for tax-exemption under Sections 501(c)(3) or 501(c)(4).

The letter addresses an organization applying for tax-exempt status under Section 501(c)(3), which was formed:

1. "To aid financially disadvantaged patients and patient's families who are affected by the costs of THC and CBD medical treatment by providing financial support to cover costs of living and other expenses that the patients may incur;"
2. "To educate health care providers and the general public about THC and CBD medical treatments;" and
3. "To support and engage in research of THC and CBD medical treatments."

If you delete the words "THC" and "CBD," the activities described would be quintessential 501(c)(3) activities.

Leave those words in, and the IRS finds the organization has illegal purposes because marijuana (the cannabis plant and anything derived from any part of it) is a Schedule 1 controlled substance under federal law – illegal to both possess and sell – and the organization is "advocat(ing) and engag(ing) in activities that contravene federal law" (more on whether that is true below).

Ten or twenty years ago, this ruling would probably not have surprised people, as it would have (somewhat) straightforwardly applied the legality doctrine. As stated in Revenue Ruling 75-384, an organization cannot qualify for exemption under Sections 501(c)(3) or 501(c)(4) if it has an illegal purpose. Until recently, it was uncontroversial to call marijuana use of any kind "illegal."

Now, with the number of medical marijuana patients in the millions and with residents of the entire west coast and the nation's capital able to access marijuana by walking into a dispensary or ordering it on an app, the IRS's unwillingness to reflect practical realities will likely disappoint many charities and advocacy organizations. Until the tension between federal and state law over marijuana is resolved, being unable to obtain federal

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tax-exempt status may be another legal obstacle these organizations are forced to accept.

Some additional comments on the denial letter and its implications:

➤ **Did the organization have illegal purposes/activities?** The statement in the denial letter that the applicant organization “advocate(s) and engage(s) in” illegal activities is a bit of a stretch. The applicant’s activities appear to be structured with the legality doctrine in mind, as it does not distribute THC or CBD and does not require that payments to patients be used for those expenses. All the organization does is screen for financial need and medical use of THC or CBD in making hardship grants and conduct education and research around THC or CBD — none of which is illegal.

The IRS would likely counter that the courts have applied the illegality doctrine to the “promotion” of illegal activity, even if the organization does not conduct the activity. Here, where the non-profit’s directors had a related business selling medical marijuana treatments, it might be difficult to argue that the organization was not trying to promote greater medical marijuana use.

➤ **Is this a dangerous precedent for social services organizations?** The IRS appeared to take the position that, by limiting its charitable class to marijuana users, the organization was promoting marijuana use and thus cannot be tax-exempt. But, if you apply that logic elsewhere, providing some harm reduction services would also violate the legality doctrine. A needle exchange or methadone program is effectively limited to people illegally using opiates — is an organization providing those services disqualified from tax-exemption? What about an organization advocating for the rights of sex workers?

Most practitioners would certainly defend those programs as 501(c)(3) activities and perhaps the IRS would draw a line between activities that seek to relieve the adverse effects of engaging in illegal behavior and activities focused on increasing the rate of that behavior. But, there’s reason to be skeptical that the IRS will artfully draw that line. So, organizations applying to the IRS that are planning to engage in harm reduction activities should frame them carefully.

➤ **How much did the IRS care about private benefit?** Interestingly, the IRS found that, even without the marijuana angle, the organization still would not have qualified for tax-exemption because it provided excess benefit to its directors by virtue of their for-profit medical marijuana business operating under a similar name. With minimal facts or explanation regarding how the non-profit and for-profit interacted, it’s hard to say whether the IRS’s decision on this issue was justified. It is possible to imagine the non-profit operating in a manner that steered patients to the business, which should disqualify the non-profit from tax-exempt status. However, it is also possible to have a tandem structure like this, with a for-profit and a 501(c)(3) operating in related fields, as long as certain limitations are observed (e.g. the non-profit should not tie its payments in any way to whether the recipients are customers of the for-profit, and customers of the for-profit should not constitute too high a proportion of the persons aided by the nonprofit).

The ruling does not spend significant time on this issue and the IRS may not have raised it if the marijuana issue did not raise the application’s profile. Still, this ruling reminds charities that it’s important to properly structure for-profit and non-profit relationships to obtain and maintain tax-exempt status.