



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Release Number: **201333014**
Release Date: 8/16/2013
Date: May 20, 2013

Contact Person:

Identification Number:

Contact Number:

Employer Identification Number:

Form Required To Be Filed:

Tax Years:

UIL: 501.00-00, 501.03-05, 501.16-00, 521.00-00

Dear :

This is our final determination that you do not qualify for exemption from Federal income tax as an organization described in Internal Revenue Code section 501(c)(16). Recently, we sent you a letter in response to your application that proposed an adverse determination. The letter explained the facts, law and rationale, and gave you 30 days to file a protest. Since we did not receive a protest within the requisite 30 days, the proposed adverse determination is now final.

You must file Federal income tax returns on the form and for the years listed above within 30 days of this letter, unless you request an extension of time to file. File the returns in accordance with their instructions, and do not send them to this office. Failure to file the returns timely may result in a penalty.

We will make this letter and our proposed adverse determination letter available for public inspection under Code section 6110, after deleting certain identifying information. Please read the enclosed Notice 437, Notice of Intention to Disclose, and review the two attached letters that show our proposed deletions. If you disagree with our proposed deletions, follow the instructions in Notice 437. If you agree with our deletions, you do not need to take any further action.

If you have any questions about this letter, please contact the person whose name and telephone number are shown in the heading of this letter. If you have any questions about your Federal income tax status and responsibilities, please contact IRS Customer Service at

1-800-829-1040 or the IRS Customer Service number for businesses, 1-800-829-4933. The IRS Customer Service number for people with hearing impairments is 1-800-829-4059.

Sincerely,

Holly O. Paz
Director, Rulings and Agreements

Enclosure
Notice 437
Redacted Proposed Adverse Determination Letter
Redacted Final Adverse Determination Letter



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Date: March 27, 2013

Contact Person:

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

LEGEND :-

State =

Date1 =

Date2 =

UIL: 501.00-00, 501.03-05,
501.16-00, 521.00-00

Dear :

We have considered your application for recognition of exemption from Federal income tax under § 501(a) of the Internal Revenue Code as an organization described in § 501(c)(16). Based on the information provided, we have concluded that you do not qualify for exemption. The basis for our conclusion is set forth below.

FACTS

You are a State nonprofit cooperative association formed on Date1. However, according to its business website, State has classified your corporate status as "Suspended" since Date2.

You were incorporated by three individuals. Your Articles of Incorporation state that you were "formed for the pleasure, recreation and other non-profit purposes authorized under § 501(c)(16) of the Internal Revenue Code." Your purpose is to form a cooperative that "will facilitate and organize transactions between members who collectively cultivate and possess marijuana for medical purposes." This includes promoting, advocating, and financing "the safe and legal access of medical marijuana for therapeutic and medical purposes as well as research." You will limit access to any marijuana you own or possess to your members who, pursuant to State law, are qualified medical marijuana patients and/or primary caregivers.

Your incorporators are engaged in the production of cannabis and have associated themselves together to form a nonprofit cooperative association. Your incorporators are not organizations exempt from federal income tax under § 521 of the Code, or members of such organizations.

You will have no more than three directors on your board and they will serve four-year terms. The directors must be qualified members to serve on the board. Directors receive compensation for their services and are entitled to reasonable reimbursement for traveling and other expenses.

Any person or entity that is a qualified patient or caregiver, as defined by the State Code, may submit a membership application to become a member of your association. Your Board of Directors may admit or deny membership in its discretion. There is no fee to become a member, but the board may require members to invest funds for effective corporate purposes.

You do not issue stock shares, and while the property interest of each of your members may be unequal, the voting rights are equal with each member having one vote. You measure each member's property rights and interests by the member's total non-refunded contribution of funds, property, or cannabis pro rata to your total retained funds.

To provide capital for your corporate purposes, you may retain funds from your net sales. You classify the total funds that you retain as the "Revolving Fund," and the amounts retained from each member as "Revolving Fund Credits." Revolving Fund Credits are evidence of your indebtedness to each member. You do not plan to pay interest on the credits, but if the board provides for interest, you will not pay more than eight percent per annum.

You may enter into marketing, crop purchase, or other agreements with any member or patron. The agreements may incorporate provisions relating to the harvesting, handling, packing, processing, selling, shipping, delivery, or title transfer of cannabis produced by the member or patron. After delivery, you may receive unqualified power to take title over and process, sell, dispose, or transfer the cannabis.

APPLICABLE LAW

Section 501(a) of the Internal Revenue Code exempts from taxation organizations described in § 501(c).

Section 501(c)(16) of the Code describes corporations organized to finance the ordinary crop operations of its members or other producers. The corporation must be organized by a § 521 farmers' cooperative, or the cooperative's members, and operated in conjunction with the § 521 farmers' cooperative that organized it.

A § 501(c)(16) organization may issue capital stock, but if the stock has a dividend rate, it may not be higher than the greater of the legal rate of interest in its incorporation state or eight percent (8%) per annum on the value of the consideration for which the stock was issued.

If the § 501(c)(16) organization issues stock, the § 521 farmers' cooperative must own substantially all of it. Nonvoting preferred stock may be owned by others, but those stockholders must not participate, directly or indirectly, in the profits of the § 501(c)(16) corporation, on dissolution or otherwise, beyond the fixed dividends.

Section 501(c)(16) organizations may accumulate and maintain a reasonable reserve for any necessary purpose or if required by state law.

Section 521 of the Code exempts farmers' cooperatives from taxation, except as otherwise provided in §§ 1381 – 1383. Farmers' cooperatives include farmers' associations, fruit growers' associations, or like associations organized and operated on a cooperative basis for one of two purposes. The cooperative may organize to market its members' or other producers' products, then return the sales proceeds, less necessary marketing expenses, based on either the quantity or the value of the products furnished by the members or producers ("marketing association"). Alternatively, the farmers'

cooperative may organize to purchase supplies and equipment so its members or others may pay cost rather than retail ("purchasing association").

Treas. Reg. § 1.501(c)(16)-1 states that a corporation organized by a farmers' cooperative, or its members, is tax-exempt if organized for the purpose of financing its members', or other producers', ordinary crop operations. The farmers' cooperative that organizes the financing corporation must be exempt under § 521 and operate the financing corporation in conjunction with itself. Further, the provisions of Treas. Reg. § 1.521-1 relating to a reserve or surplus and to capital stock shall also apply to § 501(c)(16) corporations.

Treas. Reg. § 1.521-1(a)(1) requires the § 521 marketing association to distribute the proceeds of the business proportionally between members and nonmembers. It must also keep permanent records of the business done with both members and nonmembers.

Treas. Reg. § 1.521-1(a)(2) specifies that an association may have capital stock, so long as the stock's dividend rate is not higher than the greater of the legal rate of interest in its incorporation state or 8 percent (8%) per annum on the value of the consideration for which the stock was issued. Additionally, the producers who market their products or purchase their supplies and equipment through the association must own substantially all of the stock of the association.

Treas. Reg. § 1.521-1(a)(3) specifies that accumulation and maintenance of a reserve to either meet state requirements or for any necessary purpose will not destroy the exemption.

Treas. Reg. § 1.521-1(b) expands the description of § 521 purchasing associations, defines the term "supplies and equipment" as it is used in § 521, and states that the provisions in Treas. Reg. § 1.521-1(a) relating to a reserve or surplus and to capital stock applies to purchasing associations. The value of the supplies and equipment purchases for nonmembers may not exceed the value of the supplies and equipment purchased for members, and the total value of the purchases made for nonmembers who are not producers must not exceed 15 percent (15%) of the value of all of the association's purchases.

Treas. Reg. § 1.521-1(e) requires an organization claiming exemption under § 521 to file a Form 1028 with the district director for the internal revenue district where the organization's principal place of business or principal office is located.

21 U.S.C. § 802(16) defines marijuana as "all parts of the plant *Cannabis sativa* L. whether growing or not; the seeds thereof; the resin extracted from any part of such plant; and every compound, manufacture, salt, derivative, mixture, or preparation of such plant, its seeds or resin."

21 U.S.C. § 812(c), Sch. I(c)(10) lists marijuana as a hallucinogenic substance and includes it on schedule I of the Schedules of Controlled Substances. A schedule I substance is a substance that (1) has a high potential for abuse; (2) has no currently accepted medical use in treatment in the United States; and (3) there is a lack of accepted safety for use of the drug under medical supervision.

21 U.S.C. § 841(a), known as The Controlled Substances Act ("Act"), states that it is illegal for anyone to knowingly or intentionally manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense a controlled substance.

Article VI, Clause 2 of the United States Constitution states that federal laws prevail over conflicting or inconsistent state laws.

United States v. Oakland Cannabis Buyers' Cooperative, 532 U.S. 483, 490 (2001), reiterates that there is only one exception from the Act for cannabis: Government-approved research projects. "It is clear from the text of the Act that Congress has made a determination that marijuana has no medical benefits worthy of an exception." *Id.* at 493.

In *Bob Jones University v. United States*, 461 U.S. 574, 103 S. Ct. 2017 (1983), the Supreme Court held that racially discriminatory education is contrary to public policy, and therefore, the University could not be viewed as providing public benefit within the charitable concept.

In *Ould v. Washington Hospital for Foundlings*, 95 U.S. 303, 311 (1877), the Court noted that "[a] charitable use, where neither law nor public policy forbids, may be applied to almost any thing that tends to promote the well-doing and well-being of social man."

The court in *Weingarden v. Commissioner*, 825 F.2d 1027 (6th Cir. 1987), summarized how courts interpret tax statutes. "The general canon of construction is that statutes imposing a tax are interpreted liberally (in favor of the taxpayer). But provisions granting a deduction or exemption are matters of legislative 'grace' and are construed strictly (in favor of the government)." *Id.* at 1029 (citations omitted).

In *Harding Hospital, Inc. v. United States*, 505 F.2d 1068, 1071 (6th Cir. 1974), the court held that an organization seeking tax-exempt status "bears a heavy burden to prove that it satisfies all the requirements of the exemption statute." The court noted that the "Tax Court has stated consistently that a statute creating an exemption must be strictly construed and any doubt must be resolved in favor of the taxing power." *Id.* (citations removed).

The court in *Green v. Connally*, 330 F. Supp. 1150, 1161-62 (D.C. Cir. 1971), discussed multiple cases that limited tax benefits such as the dependency deduction, the business expense deduction, and the charitable deduction due to violation of federal or state laws. "Before considering the more particular subject of charities, we refer to the 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 . . . illegal." *Id.* at 1161.

In *Mysteryboy Inc. v. Commissioner*, T.C.M. 2010-13 (2010), the Tax Court held that the organization failed the operational test partly because the organization proposed to promote illegal activities.

Rev. Rul. 75-384, 1975-2 C.B. 204, holds that a nonprofit organization, whose purpose was to promote world peace, disarmament, and nonviolent direct action, did not qualify for exemption under §§ 501(c)(3) or (c)(4). The organization's primary activity was to sponsor antiwar protest demonstrations in which it urged demonstrators to violate local ordinances and commit acts of civil disobedience. Citing the law of trusts, the ruling stated that all charitable organizations are subject to the requirement that their purposes cannot be illegal or contrary to public policy. See *Restatement (Second) of Trusts*, § 377 (1959); see also *Restatement (Third) of Trusts*, § 29 (2003). The purpose is illegal if the trust will use the trust property for an object that is in violation of the criminal law, if the trust tends to induce the commission of crime, or if the accomplishment of the purpose is otherwise against public policy. *IV Scott on Trusts* § 377 (3d. ed. 1967); see also *Restatement (Third) of Trusts*, § 29 (2003).

The *Restatement (Third) of Trusts*, § 29 (2003) states that an intended trust or trust provision is invalid if its purpose is unlawful, its performance calls for the commission of a criminal or tortious act, or it is contrary to public policy.

ANALYSIS

Based on the information you provided in your application and supporting documentation, we conclude that you are not organized and operated exclusively for exempt purposes under § 501(c)(16) as a crop financing organization.

Section 501(c)(16) Requirements

"[P]rovisions granting . . . [an] exemption are matters of legislative 'grace' and are construed strictly (in favor of the government)." *Weingarden v. Comm'r.*, 825 F.2d at 1029. Organizations exempt under § 521 form crop-financing organizations to provide financing to their member farmers so they may cultivate their crops and livestock. The crop-financing organization may be recognized as exempt under § 501(c)(16) if it proves it is both organized and operated according to the requirements of the statute. See *Harding Hospital v. U.S.*, 505 F.2d at 1071.

A crop-financing organization must be a corporation. § 501(c)(16). The organization must have been organized by either a farmers' cooperative exempt under § 521, or by the members of a farmers' cooperative exempt under § 521. *Id.* The crop-financing organization's purpose must be to finance the ordinary crop operations of its members or other producers, and it must operate in conjunction with the § 521 farmers' cooperative that formed it. *Id.* Finally, Congress stated that the IRS may not deny exemption solely because the crop-financing organization issues capital stock or maintains a reserve. *Id.*; Treas. Reg. § 1.521-1(a).

Although you appear to satisfy the provisions relating to capital stock and a reserve, you do not satisfy the other organizational requirements of § 501(c)(16). State has suspended your corporate status; therefore you do not meet the first organizational requirement of § 501(c)(16). You also have not shown that you were created by a § 521 farmers' cooperative or that your incorporators were members of a § 521 exempt farmers' cooperative, and as such, do not meet the second organizational requirement. Finally, your articles of incorporation state that you were "formed for the pleasure, recreation and other non-profit purposes authorized under § 501(c)(16)." As 'pleasure' and 'recreation' are not exempt purposes listed under § 501(c)(16) or the accompanying regulations, you do not completely satisfy the third organizational requirement. *Id.* Because you do not meet each of the organizational requirements of § 501(c)(16), you are not considered to be organized as a crop-financing organization.

You also fail to satisfy the operational requirements of § 501(c)(16) and the accompanying regulations. See Treas. Reg. § 1.501(c)(16)-1. You cannot operate in conjunction with the § 521 farmers' cooperative that formed you, as you were not formed by a § 521 farmers' cooperative, as defined by the Code and accompanying regulations, or by the members of such a farmers' cooperative.

Illegality

As noted above, exemptions are not a right, but a matter of legislative 'grace.' *Weingarden v. Comm'r.*, 825 F.2d at 1029. Congress grants various organizations exemption from federal income tax. In exchange for this favorable tax treatment, the organization must adhere to certain laws and doctrines. 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. See *Green v. Connally*, 330 F. Supp. at 1161.

The common law of trusts specifies that a charitable trust is invalid if its purpose is unlawful, or if its performance calls for the commission of a criminal or tortious act. See *Restatement (Third) of Trusts*, § 29. Evaluating the same common law, the Supreme Court noted, “[a] charitable use, where neither law nor public policy forbids, may be applied to almost any thing that tends to promote the well-doing and well-being of social man.” *Ould v. Washington Hospital for Foundlings*, 95 U.S. at 311.

The general principle that tax deductions and exemptions are not applicable to activities that are illegal is well established, and the courts and the IRS have consistently applied this general principle to organizations seeking exemption. See *Green v. Connally*, 330 F. Supp. 1150 (D.C. Cir. 1971); *Mysteryboy Inc. v. Comm’r*, T.C. Memo 2010-13 (2010) (organization that encouraged sexual activity with minors with the goal to repeal child pornography and rape laws was not exempt from federal income taxation; activities of the organization violated public policy as reflected in Federal and state laws); Rev. Rul. 75-384, *supra*. Therefore, 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. See *Weingarden v. Comm’r*, 825 F.2d at 1029.

Your activities violate this general principle. Your primary activity, facilitating and organizing transactions between members who cultivate and possess cannabis, is illegal under Federal law. You enter into agreements that give you title to the cannabis grown by your members. Once you obtain title, you process, sell, and otherwise dispose of it as you decide. Federal law does not recognize any health benefits of cannabis and classifies it as a controlled substance. 21 U.S.C. § 812. Federal law prohibits the manufacture, distribution, possession, or dispensing of a controlled substance. 21 U.S.C. § 841(a). Congress has “made a determination that marijuana has no medical benefits worthy of an exception” to the general rule that the manufacture and distribution of cannabis is illegal. *Oakland Cannabis Buyers’ Coop.*, 532 U.S. at 493.

Federal law always prevails over conflicting or inconsistent state law. See U.S. Const. art. VI, cl. 2. Current federal law prohibits the use of cannabis except in limited circumstances; those limited circumstances do not include the use of cannabis for medicinal purposes. See *Oakland Cannabis Buyers’ Coop.*, 532 U.S. at 493-94. The fact that State legalized distribution of cannabis to a limited extent is not determinative because distribution of cannabis is illegal under federal law.

You operate in a manner that promotes activities that federal law prohibits, “violate[s] public policy as reflected in those laws, and tends to promote illegal activities.” *Mysteryboy Inc. v. Comm’r*, T.C.M. 2010-13, 19. Because you advocate and engage in activities that contravene federal law, you failed to prove that you satisfy the requirements of § 501(c)(16) and the related regulations. See *Harding Hospital, Inc.*, 505 F.2d at 1071.

CONCLUSION

Based on the facts and information submitted, you are not currently a legal corporation and you were not organized by a § 521 exempt farmers’ cooperative, or by the members of such a cooperative. Therefore, you cannot operate in conjunction with such a cooperative and are not described in § 501(c)(16) of the Code. Additionally, your primary purpose of facilitating and organizing transactions involving cannabis not only violates federal law and public policy, but also promotes illegal activities.

Accordingly, you do not qualify for exemption as an organization described in § 501(c)(16) of the Code and you must file federal income tax returns.

You have the right to file a protest if you believe this determination is incorrect. To protest, you must submit a statement of your views and fully explain your reasoning. You must submit the statement, signed by one of your officers, within 30 days from the date of this letter. We will consider your statement and decide if the information affects our determination.

Your protest statement should be accompanied by the following declaration:

Under penalties of perjury, I declare that I have examined this protest statement, including accompanying documents, and, to the best of my knowledge and belief, the statement contains all the relevant facts, and such facts are true, correct, and complete.

You also have a right to request a conference to discuss your protest. This request should be made when you file your protest statement. An attorney, certified public accountant, or an individual enrolled to practice before the Internal Revenue Service may represent you. If you want representation during the conference procedures, you must file a proper power of attorney, Form 2848, *Power of Attorney and Declaration of Representative*, if you have not already done so. For more information about representation, see Publication 947, *Practice before the IRS and Power of Attorney*. All forms and publications mentioned in this letter can be found at www.irs.gov, Forms and Publications.

If you do not intend to protest this determination, you do not need to take any further action. If we do not hear from you within 30 days, we will issue a final adverse determination letter. That letter will provide information about filing tax returns and other matters.

Please send your protest statement, Form 2848, and any supporting documents to this address:

Internal Revenue Service

Washington, DC 20224

You may also fax your statement using the fax number shown in the heading of this letter. If you fax your statement, please call the person identified in the heading of this letter to confirm that she received your fax.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Holly Paz
Director, Rulings and Agreements