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HARMONIZING FEDERAL TAX LAW AND THE STATE LEGALIZATION OF MARIJUANA

*Daniel Rowe**

I. INTRODUCTION

Prior to 1982, the tax code allowed all businesses—even businesses that engaged in illegal activities—to deduct ordinary and necessary business expenses. This changed with the passage of the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”).¹ This act added section 280E to the Internal Revenue Code (“Code”), which explicitly disallows a tax deduction for any amount paid or incurred in a trade of business that consists of the sale or distribution of controlled substances.² Controlled substances, for purposes of section 280E, are those classified as schedule I or II substances under the federal Controlled Substances Act (“Act”).³ Marijuana and cannabidiol (“CBD”) derived from marijuana are schedule I substances, putting them in the same category as heroin and LSD, and subjecting businesses dealing in marijuana and cannabis-derived products to the deduction disallowance rule of section 280E.⁴

As more states legalize marijuana and cannabis-derived products, both for medical and recreational use,⁵ the punitive tax effect of

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1. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (1982).

2. I.R.C. § 280E (2012).

3. *Id.*

4. See Controlled Substances Act, 21 U.S.C. § 812 (2012).

5. See *State Medical Marijuana Laws*, NAT’L CONFERENCE OF STATE LEGISLATURES (Feb. 1, 2018), <http://www.ncsl.org/research/health/state-medical-marijuana-laws.aspx> (listing 29 states, as well as the District of Columbia, Guam, and Puerto Rico, that have legalized medical or recreational marijuana use as of February 1, 2018). While marijuana has been legalized by states for both medical and recreational purposes, this article more frequently refers to medical marijuana businesses in its analysis, as the majority of state laws currently only provide for legal medical marijuana.

section 280E makes it economically impossible for many marijuana-related businesses to function profitably. By disallowing the deduction of otherwise legitimate business expenditures,⁶ the Code places such businesses in a situation where they are potentially paying federal income tax on their gross receipts despite netting much less in actual income. In addition, because most states conform, at least in part, to the Code,⁷ the inability to deduct ordinary and necessary business expenses for state tax purposes further increases the overall tax burden on marijuana sellers.

This Note explores the disproportionate tax burden on marijuana sellers and the growing tension between current federal tax law and states' legalization of marijuana. This Note recommends the amendment of section 280E to eliminate this burden. It is structured in four parts. Part II discusses the history and legislative intent behind section 280E. It delves into the differing tax treatment for illegal drug traffickers versus that of other illegal activities. Part III describes the effects of section 280E, both intended and unintended, on state-legal marijuana sellers as well as on the overall marijuana industry. It explains how the original intent of section 280E, specifically as it relates to marijuana sellers, has been undermined by the changing public attitude towards marijuana and the rise of legal medical and recreational marijuana facilities. This part also considers the onerous tax regime placed on state-legal marijuana businesses due to their inability to deduct ordinary expenses, and how this regime could be counter-productive to overall tax policy. Part IV describes several alternative solutions to eliminate the reach of section 280E to state-legal marijuana businesses. It concludes with the recommendation to amend section 280E to make it inapplicable to activities that are statutorily legal in the states in which they are conducted.

II. HISTORICAL ANALYSIS OF SECTION 280E

A. *Tax Treatment of Illegal Activities*

In 1981, the United States Tax Court held that Jeffrey Edmonson, a self-employed seller of amphetamines, cocaine, and marijuana, could deduct expenses such as mileage, packaging supplies, and rent

6. I.R.C. § 280E (2012).

7. See Ruth Mason, *Delegating Up: State Conformity with the Federal Tax Base*, 62 DUKE L.J. 1267, 1275 (2013).

for his home office, in determining his taxable income from his drug trafficking business.⁸ Congress, apparently outraged by this result, enacted section 280E to legislatively overrule the case.⁹ The legislative history of TEFRA states:

There is a sharply defined public policy against drug dealing. To allow drug dealers the benefit of business expense deductions at the same time that the U.S. and its citizens are losing billions of dollars per year to such persons is not compelled by the fact that such deductions are allowed to other, legal, enterprises. Such deductions must be disallowed on public policy grounds.¹⁰

Section 280E disallows taxpayers' deductions for expenditures made in connection to their business if their business is that of selling illegal drugs.¹¹ The statute defines illegal drugs as controlled substances (per schedules I and II of the Controlled Substances Act) that are prohibited either by federal law or the law of the state in which the business is conducted.¹² Because marijuana and CBD derived from marijuana plants are Schedule I substances and currently illegal under federal law,¹³ section 280E directly impacts wholesalers and retailers of medical marijuana and CBD products.

The section 280E disallowance of deductions for ordinary and necessary business expenses has a significant adverse effect on the economic feasibility of medical marijuana sellers operating legally under the laws of their home state.¹⁴ Section 280E stands in stark contrast to the Internal Revenue Code's treatment of all other businesses, both legal and illegal, and represents a departure from its generally neutral position regarding the morality of taxpayers' business activities that was intended by its original drafters.¹⁵ In fact, during Senate debates on the original tax bill in 1913, the legislators explicitly rejected the notion of disallowing deductions incurred in

8. *Edmonson v. Comm'r*, 42 T.C.M. (CCH) 1553 (1981).

9. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (1982).

10. S. REP. NO. 97-494, at 309 (1982).

11. I.R.C. § 280E (2012).

12. *Id.*

13. Controlled Substances Act, 21 U.S.C. §§ 801–828 (2012).

14. *See infra* Section III.A.

15. *See* Carrie E. Keller, Comment, *The Implications of I.R.C. 280E in Denying Ordinary and Necessary Business Expense Deductions to Drug Traffickers*, 47 ST. LOUIS U. L.J. 157, 158–59 (2003) (citing *Comm'r v. Tellier*, 383 U.S. 687, 691 (1966)) (“There was an explicit legislative intent that the Code should ignore the underlying source of income for tax purposes.”).

illegal trades or businesses.¹⁶ It was stated during these debates that the purpose of the bill was “not to reform men’s moral characters” but simply “to tax a man’s net income.”¹⁷ As such, section 162 provides that “[t]here shall be allowed as a deduction *all* the ordinary and necessary expenses paid or incurred during the taxable year in carrying on *any* trade or business.”¹⁸

Over time, however, the courts have weighed in on the deductibility of expenses for illegal activities, culminating in the Supreme Court’s development of a public policy exception for the allowance of business deductions.¹⁹ This exception disallowed the deduction of ordinary and necessary business expenses that “frustrate sharply defined national or state policies proscribing particular types of conduct” provided that such policies are “evidenced by some governmental declaration of them.”²⁰ The Court also noted “that a mere violation of the law was not enough ‘frustration’ of public policy to warrant the denial of a deduction.”²¹ Subsequent Supreme Court decisions applied the public policy theory and allowed the deduction of ordinary and necessary expenditures for both an illegal gambling business and the criminal defense of a securities underwriter.²² The Court’s rationale in allowing the deductions in these cases was that the focus of the public policy “analysis must be on the payment of the expense, not the conduct giving rise to it.”²³ Therefore, under the public policy doctrine, only expenditures that are either illegal themselves (e.g. bribes, kickbacks) or represent the payment of a government fine, would be denied deductibility.²⁴ Under this rationale, business expenditures of a medical marijuana seller (advertising, rent, utilities, etc.) which are not inherently illegal payments, would not be disallowed under the public policy doctrine, even though the business enterprise is itself illegal under federal law.

16. *Comm’r v. Tellier*, 383 U.S. 687, 691 (1966).

17. *Id.*

18. I.R.C. § 162(a) (2012) (emphasis added).

19. *Lilly v. Comm’r*, 343 U.S. 90, 96–97 (1952).

20. *Id.*

21. Charles A. Borek, *The Public Policy Doctrine and Tax Logic: The Need for Consistency in Denying Deductions Arising from Illegal Activities*, 22 U. BALT. L. REV. 45, 52 (1992).

22. See *Comm’r v. Sullivan*, 356 U.S. 27 (1958), in which the Court allowed the deduction of rent and wages, and *Comm’r v. Tellier*, 383 U.S. 687 (1966), in which the Court allowed the taxpayer’s deduction of his legal fees paid in the unsuccessful defense of criminal charges related to his securities business.

23. Borek, *supra* note 21, at 54.

24. *Id.* at 55.

Congress codified the public policy doctrine by amending section 162.²⁵ The specific exceptions to deductibility listed in the amended section 162 (e.g. illegal bribes, kickbacks) were intended to be all-inclusive and fully encompass the scope of the public policy doctrine. The legislative history of section 162, as amended by the Tax Reform Act of 1969, states that:

The provision . . . denies deductions for four types of expenditures The provision for the denial of the deduction for payments in these situations which are deemed to violate public policy is intended to be all inclusive. Public policy, in other circumstances, generally is not sufficiently clearly defined to justify the disallowance of deductions.²⁶

Treasury regulations further provide that “[a] deduction for an expense paid or incurred after December 30, 1969, 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.”²⁷ Clearly, the courts, the legislature, and the administrative agencies look to the nature of the payment itself, as opposed to the nature of the business that is making the payment, in determining the deductibility of a business expenditure under section 162. Section 280E represents a glaring departure from this rationale, in that it looks to the nature of the business itself to disallow all ordinary and necessary expenses of medical marijuana sellers (with the exception of cost of goods sold).²⁸

This divergence between section 280E and the treatment of illegal payments under the public policy doctrine and section 162 cannot be overstated. Unlike the language of section 162, section 280E was enacted to specifically target one type of business on the basis of public policy.²⁹ Even if the underlying payments made by a controlled substance trafficker are not illegal in and of themselves, which is the standard applied in *Commissioner v. Sullivan*³⁰ and *Commissioner v.*

25. I.R.C. § 162(c) disallows deduction for any illegal bribes, kickbacks, or other illegal payments that subject the payor to a criminal penalty. I.R.C. § 162(f) disallows deduction for the payment of a fine or penalty to a government for the violation of a law.

26. S. REP. NO. 91-552, at 274 (1969).

27. Treas. Reg. § 1.162-1(a) (as amended in 1993).

28. S. REP. NO. 97-494, at 309 (1982) (stating “[t]o preclude possible challenges on constitutional grounds, the adjustment to gross receipts with respect to effective costs of goods sold is not affected by this provision of the bill”).

29. *Id.*

30. 356 U.S. 27 (1958).

Tellier,³¹ they are nonetheless disallowed because the overall business is illegal in the eyes of the federal government. Section 280E is an anomaly, as the Code and the courts do not subject other illegal businesses to the same unfavorable treatment in disallowing their ordinary business expenditures.³² In theory, any illegal business, including that of an arms trafficker or that of a marijuana trafficker, should be able to deduct their ordinary and necessary business expenses in arriving at net taxable income. In fact, under current federal tax law, even a human trafficker would be allowed to deduct their ordinary and necessary business expenses such as rent and travel under section 162 or the public policy doctrine, but the marijuana trafficker would not be allowed to do so under section 280E. In *Toner v. Commissioner*,³³ an illegal prostitution business was permitted to deduct telephone, rent, insurance, advertising, and other business costs, as there is no provision similar to section 280E targeting prostitution rings.³⁴ Section 280E undermines the function of the federal income tax, which is to tax one's net income.³⁵ Instead, it subjects a specific business type to a potential tax on gross income. This treatment contradicts the public policy doctrine as expressed by the *Sullivan* and *Tellier* courts and codified in section 162, which disallows deductions if the nature of the payment itself is illegal (i.e. bribes) and not on the basis of the underlying business being illegal. As discussed below, marijuana sellers may be able to mitigate the effect of section 280E to some degree through the cost of goods sold exception,³⁶ but the overall impact of section 280E is still profoundly detrimental.

31. 383 U.S. 687 (1966).

32. See *Keller*, *supra* note 15, at 164 (“Even though there are equally strong public policy reasons for prohibiting other illegal activities such as prostitution, gambling, or contract killing, those activities have not been subject to the same unfavorable tax treatment as drug trafficking.”).

33. 60 T.C.M. (CCH) 1016 (1990).

34. *Id.*

35. See *Tellier*, 383 U.S. 687 at 691 (“... the federal income tax is a tax on net income, not a sanction against wrongdoing. That principle has been firmly imbedded in the tax statute from the beginning Income from criminal enterprise is taxed at a rate no higher and no lower than income from more conventional sources.”).

36. See *infra* Section III.B.2., discussing a potential mitigation of the effect of section 280E through the application of UNICAP.

B. *The Scope of Section 280E*

Medical marijuana sellers find themselves in this situation of disallowed business deductions because of section 280E's definition of controlled substances. Expenditures are disallowed when they are incurred in carrying on any trade or business that consists of trafficking in controlled substances.³⁷ However, the scope of section 280E only includes such substances that are listed on schedule I or II of the Controlled Substances Act.³⁸

The Act classifies drugs or other substances into one of five schedules based on various factors such as: 1) the substance's potential for abuse, 2) whether the substance has currently accepted medical use, 3) the level of accepted safety for use of the substance, and 4) the potential for psychological or physical dependence on the substance.³⁹ The determination of a drug or substance's placement within the various schedules is generally made by the Drug Enforcement Administration ("DEA") and the Food and Drug Administration, with Congress also weighing in at times to legislatively add certain substances.⁴⁰ Since the Act's inception, marijuana has been regulated as a schedule I substance, defined as having a high potential for abuse, no currently accepted medical use, and no accepted safety for use under medical supervision.⁴¹ Other substances listed on schedule I include heroin and peyote, while schedule II substances (those deemed to have a currently accepted medical use treatment)⁴² include cocaine, methamphetamine, oxycodone, Adderall, and Ritalin.⁴³ Schedule III substances that fall outside the scope of section 280E include ketamine and anabolic steroids.⁴⁴

Although they may be legal at the state level, as long as they remain schedule I substances, marijuana and its derivative products

37. I.R.C. § 280E (2012).

38. *Id.*

39. Controlled Substances Act, 21 U.S.C. § 812(b) (2012).

40. Edward J. Roche, Jr., *Federal Income Taxation of Medical Marijuana Businesses*, 66 TAX LAWYER 429, 438 (2013).

41. Controlled Substances Act, 21 U.S.C. § 812 sched. 1(c)(10) (2012); *see FDA Regulation of Marijuana: Past Actions, Future Plans* (Apr. 12, 2016), <https://www.fda.gov/downloads/AboutFDA/CentersOffices/OfficeofMedicalProductsandTobacco/CDER/UCM498077.pdf>.

42. Controlled Substances Act, 21 U.S.C. § 812(b)(2) (2012).

43. *Drug Scheduling*, DRUG ENFORCEMENT ADMIN., <https://www.dea.gov/druginfo/ds.shtml> (last visited Feb. 9, 2018).

44. *Id.*

fall within the scope of section 280E as it is currently written.⁴⁵ Thus, marijuana businesses that are operating in total compliance with the laws of their home state will nonetheless face a heavy, if not insurmountable, tax burden by the inability to deduct ordinary and necessary business expenses.

III. EFFECTS OF SECTION 280E ON MARIJUANA BUSINESSES

A. Direct Tax Consequences

The Code clearly states that income from any source, unless specifically excluded by the Code, is included in gross income for U.S. tax purposes.⁴⁶ No distinction is made between income received through legal versus illegal means. The U.S. Supreme Court has noted the “well-established principle . . . that unlawful, as well as lawful, gains are comprehended within the term ‘gross income.’”⁴⁷ Because of the lack of distinction between legal and illegal income, and the explicit language of section 61(a),⁴⁸ any payment received for the sale of marijuana products falls within the scope of the federal income tax, whether the seller’s business is operating legally or illegally. However, taxable income, which is ultimately relevant in determining a business’s tax liability, is defined as gross income minus allowable deductions.⁴⁹ The deductions that a business may take to reduce its gross income down to taxable income depend on legislative grace and are only allowed by clear provision in the law.⁵⁰ One example of such a clear provision, and perhaps the most applicable for most trades or

45. See *Gonzales v. Raich*, 545 U.S. 1 (2005) (holding that Congress’s Commerce Clause authority allows federal law to regulate the legality of the cultivation and sale of marijuana even when the activity is done in compliance with local law); *Olive v. Comm’r*, 139 T.C. 19, 38–39 (2012). In *Olive*, the court rejected the taxpayer’s argument that section 280E did not apply to its business activity, and ultimately denied the medical marijuana dispensary’s expenses under section 280E. *Id.* The taxpayer argued that because its activity was legal under California law, it was not engaged in “illegal trafficking.” *Id.* The court stated that “Congress . . . has set an illegality under Federal law as one trigger to preclude a taxpayer from deducting expenses incurred in a medical marijuana dispensary business. This is true even if the business is legal under State law.” *Id.* at 39.

46. I.R.C. § 61 (2012).

47. *James v. United States*, 366 U.S. 213, 218 (1961); see *Rutkin v. United States*, 343 U.S. 137 (1952) (noting that “[t]here has been a widespread and settled administrative and judicial recognition of the taxability of unlawful gains of many kinds . . .”).

48. I.R.C. § 61(a)(2) specifically lists “[g]ross income derived from business” as an item includible in gross income under Subtitle A of 26 U.S.C. and §§ 101–40 provide the items specifically excluded from gross income. Nothing in §§ 101–40 provides for the exclusion of receipts from the sale of products made in the course of a trade or business.

49. I.R.C. § 63 (2012).

50. *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934).

businesses, is section 162 which provides that “[t]here shall be *allowed as a deduction* all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . .”⁵¹ Such expenses typically include salaries for personal services rendered, traveling expenses, and rent paid for property used in the trade or business.⁵² So a business, whether legal or illegal, whose only activity was \$100 in gross receipts and \$80 of rent paid for their business office would report taxable income of \$20 in most cases. The exception is when section 280E applies to prohibit the deduction of the ordinary and necessary business expenses, such as rent.⁵³ And section 280E does not apply to any illegal activities other than the trafficking of certain controlled substances.⁵⁴ Thus, in the example above, if the business were that of an illegal arms dealer, it would have taxable income of \$20 but the marijuana seller would have taxable income of \$100. To illustrate further, assume the following facts: Business A is an illegal arms dealer, while Business B is a marijuana dispensary, operating legally under the laws of its home state. Each business has \$1,000,000 of gross sales, \$700,000 of cost of goods sold,⁵⁵ and a variety of other ordinary and necessary expenditures listed below.

51. I.R.C. § 61 (2012) (emphasis added).

52. *Id.*

53. I.R.C. § 280E (2012).

54. *Id.*

55. *See infra* Section III.B. for a detailed discussion of the treatment of cost of goods sold.

**HYPOTHETICAL COMPARISON OF BUSINESS SUBJECT TO
AND NOT SUBJECT TO SECTION 280E**

	Business A Illegal Arms Dealer	Business B Marijuana Retailer
Gross Receipts (Sales)	1,000,000	1,000,000
Cost of Goods Sold (COGS)	<u>(700,000)</u>	<u>(700,000)</u>
Gross Profit	300,000	300,000
Other Deductions:		
Salaries	(200,000)	(200,000)
Utilities	(50,000)	(50,000)
Rent	(100,000)	(100,000)
Advertising	<u>(75,000)</u>	<u>(75,000)</u>
Total Other Deductions	(425,000)	(425,000)
Net Income	(125,000)	(125,000)
Taxable Income/(Loss)	(125,000)	300,000

Due to the operation of section 280E, and its limited application to a specific business (the sale of certain controlled substances), both businesses suffer an economic loss of \$125,000 but the marijuana business has taxable income of \$300,000 because it is unable to deduct its ordinary and necessary business expenses. Assuming a flat federal tax rate of 21%, Business B will owe \$63,000 in federal tax, with no profit from which to pay it. Section 280E's disallowance of deductions for operating expenses that are directly related to the production of income ends up imposing a tax on gross income for marijuana sellers.⁵⁶ Despite the court's reluctance to treat legal and illegal businesses differently for income tax purposes,⁵⁷ Congress has created an egregious disparity in tax treatment for sellers of federally controlled substances as opposed to all other business, including other illegal enterprises.

B. Cost of Goods Sold as a Mitigating Factor for Marijuana Businesses

The extreme tax burden imposed by section 280E is somewhat tempered for certain marijuana businesses by the Code's treatment of cost of goods sold. Businesses in which the production, purchase, or sale of merchandise is an income-producing factor must account for inventory at the beginning and end of their taxable years.⁵⁸ In doing so, they must capitalize, rather than immediately expense, certain costs into inventory.⁵⁹ The taxpayer's cost of goods sold for the year is then determined using the following formula: Beginning Inventory + Capitalized Inventory Costs – Ending Inventory.⁶⁰ Therefore, the amounts capitalized into inventory are ultimately deducted from gross income as cost of goods sold only upon the actual sale of the inventory. Generally, taxpayers would prefer to avoid capitalization of otherwise

56. Treas. Reg. § 1.61-3(a) defines "gross income derived from business" as the total sales, less the costs of goods sold.

57. *See e.g.*, *Comm'r v. Sullivan*, 356 U.S. 27, 29 (1958). In holding that an illegal gambling enterprise could deduct its ordinary and necessary business expenses, the *Sullivan* Court stated that denial of the deductions "would come close to making this type of business taxable on the basis of its gross receipts, while all other businesses would be taxable on the basis of net income. If that choice is to be made, Congress should do it." *Id.*

58. Treas. Reg. § 1.471-1 (1958).

59. Treas. Reg. § 1.471-3 (as amended in 2014).

60. Tony Nitti, *IRS Further Limits Deductions for State-Legal Marijuana Facilities*, FORBES (Jan. 24, 2015, 11:42 PM), <https://www.forbes.com/sites/anthonymitti/2015/01/24/irs-further-limits-deductions-for-state-legal-marijuana-facilities/#1f9bff32a7ab>.

deductible expenditures.⁶¹ It is preferable to receive a deduction from income in the same year as the cash expenditure, rather than potentially waiting until a future year when inventory is sold. But paradoxically for marijuana sellers, the more expenditures that can be capitalized into inventory and eventually deducted as cost of goods sold, the better. Unlike other ordinary and necessary expenses that are nondeductible under section 280E, cost of goods sold is permitted as a reduction of gross income for marijuana businesses. The legislative history of section 280E indicates that cost of goods sold was left unaffected by the law “[t]o preclude possible challenges on constitutional grounds.”⁶² This appears to stem from the fact that gross income specifically excludes the cost of goods sold.⁶³ In fact, cost of goods sold is an adjustment to arrive at gross income, rather than a deduction.⁶⁴ Thus, disallowing a drug trafficker’s cost of goods sold would subject them to tax on an amount greater than their gross income.⁶⁵ Several cases have confirmed the understanding that section 280E does not deny the adjustment to gross income for cost of goods sold.⁶⁶ As a result, the cost of goods sold adjustment is the only saving grace that prevents marijuana businesses from paying tax on 100% of their gross receipts. This produces an incentive for marijuana businesses, unlike most others, to capitalize as many costs as possible into their inventory. This sounds practical in theory, but it can be quite limited in practice.

1. General Mechanics of Inventory Capitalization and the UNICAP Rules, as Applied to Marijuana Businesses

Inventory accounting as proscribed under section 471 and its regulations is applied somewhat differently depending on whether the taxpayer is a reseller or a producer of inventory items. The uniform capitalization rules of Section 263A (“UNICAP”) further complicate the inventory capitalization rules by providing an extensive

61. *Id.*

62. S. REP. NO. 97-494, at 309 (1982).

63. Treas. Reg. § 1.61-3(a) (as amended in 1992).

64. *Id.*

65. See Roche, *supra* note 40, at 443–44 for a discussion of the potential unconstitutionality of such a provision.

66. See *e.g.*, Franklin v. Comm’r, 65 T.C.M (CCH) 2497 (1993) (acknowledging the taxpayer’s entitlement to an adjustment to gross income for cost of goods sold, where the taxpayer was engaged in the sale of controlled substances); McHan v. Comm’r, 91 T.C.M. (CCH) 1069 (2006) (same); Olive v. Comm’r, 139 T.C. 19 (2012) (same).

framework for the required capitalization of certain indirect costs.⁶⁷ As discussed below, section 263A expands the scope of costs that must be included in the cost of inventory, rather than immediately expensed.

For a marijuana business that strictly buys its product from someone else and resells it to consumers, the amount paid for the product, plus transportation or other direct acquisition costs, should be capitalized into inventory.⁶⁸ Absent section 263A, this would simply include the cost of the marijuana itself. But section 263A expands the scope of costs that must be included in inventory, potentially to the advantage of a business seeking to treat more expenditures as cost of goods sold. In addition to the direct product cost, certain indirect costs that would ordinarily be currently deductible (notwithstanding section 280E) must also be capitalized to the extent they are properly allocable to marijuana acquired for resale.⁶⁹ These may include costs such as rent, insurance, utilities, and labor.⁷⁰

For a marijuana business that produces its product, such as marijuana growers or producers of edibles, tinctures, or other marijuana-derived products, the inventory capitalization rules of section 471 encompass more than just the direct inventory costs. Such producers must use the “full absorption” method of accounting.⁷¹ This method requires them to include both direct and indirect production costs in their cost of inventory.⁷² Direct costs for growers or producers would include the direct material costs such as seeds or the marijuana itself, and direct labor costs for planting, harvesting, mixing, and baking.⁷³ Indirect production costs would include items such as rent, utilities, and depreciation on equipment that is incident to and necessary for the growing or production process.⁷⁴ Similar to resellers, section 263A also applies to producers, causing a portion of other indirect costs such as purchasing, handling, and storage expenses, to be capitalized into inventory.⁷⁵ However, costs associated with marketing, selling, and advertising the taxpayer’s products are

67. I.R.C. § 263A (2012).

68. Treas. Reg. § 1.471-3(b) (as amended in 2014).

69. Treas. Reg. § 1.263A-1 (as amended in 2014).

70. *Id.*

71. Treas. Reg. § 1.471-11 (as amended in 1993).

72. *Id.*

73. *Id.*

74. *Id.*

75. Treas. Reg. § 1.263A-1 (as amended in 2014).

specifically excluded from the scope of section 263A's capitalization requirement.⁷⁶ This means that salespersons' salaries, promotional materials, and other selling costs remain in the ambit of section 280E as nondeductible business expenses. Despite that limitation, it would appear that through the application of sections 471 and 263A, a marijuana business could convert otherwise nondeductible ordinary and necessary business expenses such as rent, utilities, and insurance into capitalized inventory costs.⁷⁷ These costs could then be "deducted" as a reduction of gross income when the inventory is eventually sold. In this context, the onerous capitalization requirements of section 263A, which are generally frowned upon by taxpayers as they delay the timing of deductions, could be advantageous for marijuana businesses as a means of deducting items such as rent and utilities. Section 263A is not required to be used by small retailers (those with average gross receipts under \$25 million) so its provisions will not typically apply to many marijuana sellers.⁷⁸ However, the regulations provide for optional capitalization of indirect costs under section 263A, so small marijuana sellers can choose to apply the provisions even though they are not required to do so.⁷⁹

2. The UNICAP Rules of Section 263A as Potential Mitigation of the Effect of Section 280E

As described above, it is advantageous for marijuana businesses to include as many costs as possible in their cost of goods sold in order to offset gross receipts. Any expenditures falling outside the scope of cost of goods sold are lost to the section 280E limitation. Section 471 clearly requires certain costs to be included in inventory, both for resellers and producers, to the relative delight of marijuana businesses. Such businesses may also be incentivized to liberally apply the provisions of section 263A to capture additional indirect costs into cost of goods sold. There is a catch to this strategy, found within section 263A itself. Section 263A(a)(2)(B) states that "[a]ny cost which . . . could not be taken into account in computing taxable

76. *Id.*

77. See Roche, *supra* note 40, at 443–64 for a thorough discussion and illustration of the application of §§ 471 and 263A and the regulations thereunder in the context of marijuana businesses.

78. I.R.C. § 263A(i) (2012) (applying I.R.C. § 448(c) (West 2018)).

79. Treas. Reg. § 1.263A-1(j)(2)(i) (as amended in 2014).

income for any taxable year shall not be treated as a cost described in this paragraph.” In other words, if a cost would ordinarily be nondeductible for the taxpayer, such as expenses prohibited by section 280E, then it appears that the UNICAP rules of section 263A cannot be used to convert them into “deductible” items by pushing them into cost of goods sold. The language of the statute seems to expressly prohibit a marijuana business from capitalizing ordinary and necessary expenditures such as rent and utilities into their cost of inventory in order to eventually recognize them as cost of goods sold. An example given in the Treasury regulations is that a business meal deduction, which is partially limited by the Code, would remain partially limited in the amount that is able to be capitalized into cost of goods sold under the UNICAP rules.⁸⁰ For example, when a business spends \$100 on a business-related lunch, the deductible amount is \$50.⁸¹ If the lunch expenditure was required to be capitalized into inventory under section 263A, then the inventory amount would be \$50, not the \$100 that was paid.⁸² Likewise, it would seem that if a marijuana business paid \$100 for supplies, and the deduction is limited to \$0 under section 280E, then in applying section 263A the amount that could be capitalized into inventory would also be \$0.

Some legal scholars do not believe that 263A(a)(2)(B) prevents a marijuana business from converting otherwise nondeductible business expenses into “deductible” cost of goods sold.⁸³ Edward J. Roche Jr.’s argument is based on the Code’s distinction between “business expenses” and “cost of goods sold.”⁸⁴ According to Roche, an amount that is required to be included in inventory under the UNICAP rules becomes an inventory cost and ultimately a “cost of goods sold,” which is an adjustment to gross income rather than a deductible business expense.⁸⁵ Since a marijuana business is permitted to reduce its gross income by its cost of goods sold, which the expenditures have become by application of the UNICAP rules, then the business is not actually deducting an otherwise nondeductible expense.⁸⁶ The

80. Treas. Reg. § 1.263A-1(c)(2)(i) (as amended in 2014).

81. I.R.C. § 274(n) limits the allowable deduction for meal and entertainment expenses to 50% of the amount paid.

82. Treas. Reg. § 1.263A-1(c)(2)(i) (as amended in 2014).

83. See Roche, *supra* note 40, at 457.

84. *Id.*

85. *Id.* (applying Treas. Reg. § 1.61-3).

86. *Id.* at 458.

expenditure is not an ordinary and necessary expense subject to disallowance by section 280E, but instead is a cost of inventory and the marijuana business would be simply following the Code and Treasury regulations to properly compute and “deduct” its cost of goods sold.⁸⁷

Roche’s reasoning appears logical and sound, but the Internal Revenue Service completely disagrees with its conclusion.⁸⁸ In a 2015 Chief Counsel Memorandum, the Office of Chief Counsel for the Internal Revenue Service states its official position that, in determining its cost of goods sold, a taxpayer in the business of trafficking in a Schedule I controlled substance must apply the inventory rules under section 471 as they existed at the time section 280E was enacted in 1982.⁸⁹ The UNICAP rules of section 263A did not exist until 1986.⁹⁰ In the Memorandum, the Office of Chief Counsel notes that Congress added the limiting language of section 263A(a)(2)(B) (that an otherwise nondeductible cost should not be considered in determining inventory cost) in 1988 as a retroactive, technical correction to section 263A.⁹¹ The Senate report reveals the legislative intent for this correction to section 263A:

The bill also clarifies that a cost is subject to capitalization under [section 263A] only to the extent it would otherwise be taken into account in computing taxable income for any taxable year. Thus, for example, the portion of a taxpayer’s interest expense that is allocable to personal loans, and hence is disallowed under section 163(h), may not be included in a capital or inventory account and recovered through depreciation or amortization deductions, as a cost of sales, or in any other manner.⁹²

The Memorandum concludes that ordinary and necessary expenses that are nondeductible under section 280E cannot be capitalized into inventory using section 263A, claiming that section 263A is simply a timing provision.⁹³ It determines *when* an expense

87. *Id.*

88. I.R.S. Chief Couns. Mem. 201504011 (Dec. 10, 2014).

89. *Id.* at 1.

90. Section 263A was added to the Code by the Tax Reform Act of 1986, enacted on October 22, 1986. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

91. I.R.S. Chief Couns. Mem. 201504011 (Dec. 10, 2014).

92. S. REP. NO. 100-445, at 104 (1988).

93. I.R.S. Chief Couns. Mem. 201504011 (Dec. 10, 2014).

can be deducted, but cannot change the *character* of any expense from deductible to nondeductible.⁹⁴ The Memorandum notes that, in order to be deductible, an expense must be “ordinary and necessary” within the meaning of section 162 and must satisfy certain timing requirements.⁹⁵ The expense then becomes deductible, unless another Code provision requires it to be deferred, capitalized (e.g. added to inventory), or disallowed completely.⁹⁶ When 263A applies, it converts what would have been a deduction under section 162 into a cost of inventory that is covered through a reduction to gross receipts when the inventory is sold.⁹⁷ But it does not render inoperative section 280E, which would have denied the section 162 expenses in the first place. “Read together, section 280E and the flush language at the end of section 263A(a)(2) prevent a taxpayer trafficking in a . . . controlled substance from obtaining a tax benefit by capitalizing disallowed deductions.”⁹⁸ Allowing this effect would undermine the intent of Congress and would turn section 263A into a vehicle that could transform nondeductible expenses into capitalized inventory costs.⁹⁹ The Chief Counsel Memorandum has no precedential or statutory value, but illuminates the IRS’s position on this matter and provides a compelling argument against a marijuana business’s ability to use section 263A as a means to contravene section 280E and deduct its ordinary and necessary business expenses. Consequently, this does not appear to be a viable strategy for mitigating the detrimental tax effect of section 280E.

C. Separation of Business Activities in the Application of Section 280E

Section 280E’s disallowance of business deductions applies explicitly to expenditures made in connection with the illegal sale of drugs.¹⁰⁰ Therefore, if a marijuana business conducts multiple lines of business, including one that does not involve the sale of marijuana, some of its ordinary and necessary business expenses should be deductible. This separation of activities, if adequately substantiated by

94. *Id.*

95. *Id.* at 5.

96. *Id.*

97. *Id.* at 5–6.

98. *Id.* at 6.

99. *Id.* at 5–6.

100. I.R.C. § 280E (2018).

the taxpayer's books and records, can mitigate the effect of section 280E by keeping some expenses outside of its scope. Two recent Tax Court cases address the issue of multiple business activities, with differing results and takeaways for marijuana businesses.

Californians Helping to Alleviate Medical Problems, Inc. ("CHAMP") was a California corporation providing both medical marijuana and caregiving services to its members, who suffered from AIDS, cancer, multiple sclerosis and other debilitating illnesses.¹⁰¹ While a portion of its business consisted of providing a set amount of medical marijuana to its members, the caregiving services provided by CHAMP were extensive.¹⁰² They included weekly or bi-weekly group support sessions, food for its low-income members, one-on-one counseling, massages, weekend social events, and yoga instructions.¹⁰³ CHAMP essentially broke even, reporting a tax loss of \$239 for 2002.¹⁰⁴ Its gross income consisted entirely of membership fees, which covered both the cost of the marijuana and the cost of the caregiving services.¹⁰⁵ CHAMP reduced its gross income by its cost of goods sold, as well as ordinary and necessary business expenses, including employee salaries, insurance, telephone, and utilities.¹⁰⁶ The Internal Revenue Service disallowed all of CHAMP's business expenses and cost of goods sold, claiming they were connected to the sale of illegal drugs and thus within the scope of section 280E.¹⁰⁷ CHAMP asserted that it was engaged in two trades or businesses: the provision of caregiving services and the supplying of medical marijuana to its members.¹⁰⁸ The Tax Court agreed, noting that "[t]axpayers may be involved in more than one trade or business . . . and whether an activity is a trade or business separate from another . . . is a question of fact."¹⁰⁹

The court rejected the Commissioner's contention that CHAMP's primary business was providing access to marijuana and all of the caregiving activities were merely incidental to that business, finding

101. *Californians Helping to Alleviate Medical Problems, Inc. v. Comm'r, (CHAMP)* 128 T.C. 173, 174 (2007).

102. *Id.* at 175.

103. *Id.*

104. *Id.* at 176.

105. *Id.*

106. *Id.*

107. *Id.* at 177.

108. *Id.* at 180.

109. *Id.* at 183.

the opposite to be true.¹¹⁰ CHAMP did not specifically apportion its membership fee income between the amount charged for the provision of marijuana and the amount charged for the caregiving services, but the court did not believe that fact established that CHAMP operated a single line of business.¹¹¹ Additionally, CHAMP did not separate its business expenses into those related to the marijuana business and those related to the caregiving business.¹¹² The court proceeded to use information available in the record to apportion CHAMP's ordinary and necessary business expenses into the two separate businesses.¹¹³ The apportionment was based on the number of employees and square footage of CHAMP's facilities that were dedicated to each business.¹¹⁴ As a result, a large portion of CHAMP's expenses were attributed to the legal provision of caregiving services, which clearly falls outside the scope of section 280E, and thus fully deductible.¹¹⁵ This taxpayer-favorable precedent was set because CHAMP could convincingly demonstrate that they operated a distinctly separate line of business from the sale of marijuana, and could substantiate its business expenses. A marijuana business that also operates separate legal lines of business would be wise to keep complete records and establish a reasonable, consistently applied allocation methodology, such as square footage, revenue, or employee time devoted to the various activities. But perhaps most crucial is the ability to prove the existence of separate business activities, evidenced by the court's decision in *Olive v. Commissioner*.¹¹⁶

In *Olive*, the taxpayer operated the Vapor Room Herbal Center ("Vapor Room"), retailing medical marijuana pursuant to the California Compassionate Use Act of 1996.¹¹⁷ The Vapor Room was simply a 1,250-square-foot room in a San Francisco neighborhood with games, books, and art supplies for its patrons to use, along with a glass counter containing a cash register and the marijuana inventory.¹¹⁸ The business sold nothing but marijuana and its patrons

110. *Id.* at 184.

111. *Id.* at 184–85.

112. *Id.* at 185.

113. *Id.*

114. *Id.*

115. *Id.*

116. 139 T.C. 19 (2012).

117. *Id.*

118. *Id.* at 21–22.

went there primarily to consume marijuana and socialize.¹¹⁹ The business's revenue came entirely from the sale of marijuana and customers did not specifically pay for any other products or services.¹²⁰ However, Vapor Room staff members educated customers about the responsible use of medical marijuana, and the business hosted regular activities such as yoga classes, chess, and movie screenings for its customers; it also had a program in which customers wrote letters to incarcerated individuals.¹²¹ Upon audit, the IRS denied all of the Vapor Room's substantiated ordinary and necessary business expenses based on section 280E.¹²² The Vapor Room, apparently relying on the *CHAMP* case, argued that it was engaged in caregiving services in addition to selling medical marijuana.¹²³ The court rejected this argument, listing the numerous differences between the Vapor Room's activities and those of *CHAMP*.¹²⁴ The court also stated that “[p]etitioner essentially reads . . . *CHAMP* to hold that a medical marijuana dispensary that allows its customers to consume medical marijuana on its premises . . . is a caregiver if the dispensary also provides the customers with incidental activities, consultation, or advice. Such a reading is wrong.”¹²⁵

The *Olive* court found that in establishing separate business activities, all the facts and circumstances must be considered.¹²⁶ An undertaking must be carried on “with continuity and regularity and the taxpayer’s primary purpose for engaging in the activity must be for income or profit” to be considered a separate business activity under section 162.¹²⁷ The Vapor Room’s services were deemed to be incidental to its primary business of selling marijuana, thus, all of its expenses fell within the scope of section 280E.¹²⁸ In order to take advantage of the *CHAMP* holding, it appears that a marijuana business must clearly establish the existence of separate, independent business activities. Simply providing incidental consulting or social services to marijuana customers is not sufficient. Helpful facts would be revenue

119. *Id.* at 22.

120. *Id.*

121. *Id.* at 23–24.

122. *Id.* at 28.

123. *Id.* at 39.

124. *Id.* at 40.

125. *Id.*

126. *Id.*

127. *Id.* at 41.

128. *Id.* at 42–43.

specifically attributable to other goods or services, employees' time spent on activities other than the sale of marijuana, and separate physical space devoted to other activities.

Although the *CHAMP* and *Olive* cases establish a precedent for separating expenses into those subject to section 280E and those subject only to section 162, the cases provide little solace to taxpayers who are unable to adequately substantiate all of their expenses because they are operating primarily on a cash basis. Currently, many marijuana businesses, although legal in their home state, are still operating on an all-cash basis because they are unable to obtain commercial banking services.¹²⁹ Further, *CHAMP* and *Olive* do not alter the impact of section 280E on marijuana businesses, but simply provide a mitigating factor to those business that provide substantial services or products in addition to the sale of marijuana.

D. Growth of the Legal Marijuana Industry

Section 280E was passed into law in 1982, with its stated purpose being to support the “sharply defined public policy against drug dealing.”¹³⁰ Around this time, President Reagan was announcing a war on drugs, declaring illicit drugs to be a threat to national security.¹³¹ Since 1982, there has been a dramatic shift in the status of marijuana in the United States in terms of its legalization, public opinion, medicinal use, and growth as an industry.¹³² The drafters of Section 280E likely did not anticipate the current growth of state legalized and regulated medical marijuana businesses, or intend to capture such businesses in its defense of the anti-drug-dealing public policy.

California became the first state to legalize marijuana for medical purposes in 1996 when its voters approved Proposition 215 and its legislature enacted the Compassionate Use Act of 1996.¹³³ Since that time, twenty-eight other states, as well as the District of Columbia,

129. Jeffrey Gramlich & Kimberly Houser, *Marijuana Business and Sec. 280E: Potential Pitfalls for Clients and Advisers*, 46 TAX ADVISER 524, 528 (2015).

130. S. REP. NO. 97-494, at 309 (1982).

131. See Andrew Glass, *Reagan declares 'War on Drugs,' October 14, 1982*, POLITICO (Oct. 10, 2010, 4:44 AM), <https://www.politico.com/story/2010/10/reagan-declares-war-on-drugs-october-14-1982-043552>; see also Ronald Reagan, Remarks Announcing Federal Initiatives Against Drug Trafficking and Organized Crime, RONALD REGAN PRESIDENTIAL LIBR. AND MUSEUM (Oct. 14, 1982), <https://www.reaganlibrary.gov/research/speeches/101482c>.

132. For a brief overview of these societal shifts, see *infra* notes 139–141 and accompanying text.

133. CAL. HEALTH & SAFETY CODE § 11362.5 (West 2017).

Guam, and Puerto Rico, have enacted similar laws to legalize medical marijuana.¹³⁴ Additionally, eighteen other states have approved measures to allow for the use of high-CBD products for medical reasons.¹³⁵ In 2007, New Mexico became the first state to regulate large medical marijuana dispensaries, with other states soon following suit.¹³⁶ As Nikola Vujcic observes, by establishing comprehensive regulatory systems for licensing marijuana businesses, states have demonstrated their intent to distinguish between “drug dealers acting outside the scope of decriminalized conduct” and businesses operating legally under state-approved conditions.¹³⁷ The states have essentially “carved out a distinct legal niche from what is otherwise an illegal market.”¹³⁸

Just as the states’ position on marijuana has evolved since 1982, so has public opinion and the enforcement position of the federal government. According to the Congressional Research Service, the percentage of adults that support legalization of marijuana (for any purpose) has increased from 12% in 1969 to 60% in 2016.¹³⁹ In terms of medical marijuana, a 2010 research poll found that 73% of people support legalizing “the sale and use of marijuana for medical purposes if it is prescribed by a doctor.”¹⁴⁰ Overall support for the legalization of marijuana has more than doubled since 1995 according to Gallup polls, and a majority of the population believe that the federal government should not enforce federal prohibition laws in states where marijuana has been legalized.¹⁴¹

In fact, the federal government has acknowledged a distinction in the level of federal law enforcement for marijuana businesses operating in compliance with comprehensive state regulations versus those that are not. In a 2013 memorandum to United States Attorneys, then deputy Attorney General James Cole outlined the Department of

134. See *State Medical Marijuana Laws*, NAT’L CONF. OF ST. LEGISLATURES (Jan. 23, 2019), <http://www.ncsl.org/research/health/state-medical-marijuana-laws.aspx>.

135. *Id.*

136. See Nikola Vujcic, Note, *Section 280E of the Internal Revenue Code and Medical Marijuana Dispensaries: An Interpretation Based on Statutory Purpose*, 84 GEO. WASH. L. REV. 249, 262 (2016).

137. *Id.*

138. *Id.*

139. LISA N. SACCO ET AL., CONG. RESEARCH SERV., R44782, THE MARIJUANA POLICY GAP AND THE PATH FORWARD (2017).

140. News Release, The Pew Research Ctr., Modest Rise in Percentage Favoring General Legalization (Apr. 1, 2010), available at <http://www.people-press.org/files/legacy-pdf/602.pdf>.

141. SACCO, *supra* note 139.

Justice's priorities regarding marijuana enforcement under the Controlled Substances Act.¹⁴² Cole's memorandum listed eight specific concerns of law enforcement, including: preventing the distribution of marijuana to minors; preventing marijuana revenue from going to criminal enterprises, cartels, and gangs; preventing state-authorized marijuana activity from being used as a cover to traffic other illegal drugs or activity; preventing the use of violence or firearms in the marijuana industry; preventing intoxicated driving, and; preventing marijuana growing on public property.¹⁴³ Outside of those priorities, the federal government will tend to defer to state and local agencies to handle marijuana activity through their own laws.¹⁴⁴ In assessing a marijuana business's threat to the eight enumerated federal priorities, the memorandum notes that "both the existence of a strong and effective state regulatory system, and an operation's compliance with such a system, may allay" any such threats.¹⁴⁵ Thus a state-regulated marijuana business, regardless of whether it is strictly serving seriously ill medical patients or it is operating as a large-scale, for-profit commercial enterprise, may be given prosecutorial deference by the Department of Justice on the basis of its compliance with a "strong and effective state regulatory system."¹⁴⁶

As marijuana becomes more readily available to medical patients through state legalization, its use and acceptance as a legitimate medical treatment is growing. For example, recent studies have shown CBD to be a potential anticancer drug, and a potential treatment for anxiety disorders and Alzheimer's symptoms.¹⁴⁷ A minor originally from Texas (which as of 2017 has not legalized medical marijuana use) recently filed a lawsuit against the Attorney General, the Department of Justice, and the Drug Enforcement Agency over access to medical marijuana for treatment of her epilepsy.¹⁴⁸ In another

142. Memorandum from James M. Cole, Deputy Attorney Gen., to U.S. Attorneys (Aug. 29, 2013), available at <https://www.justice.gov/iso/opa/resources/3052013829132756857467.pdf>.

143. *Id.* at 1–2.

144. *Id.* at 2.

145. *Id.*

146. *Id.*

147. See, e.g., Paola Massi et al., *Cannabidiol as Potential Anticancer Drug*, 75 BRIT. J. CLINICAL PHARMACOLOGY 303 (2012); Esther M. Blessing et al., *Cannabidiol as a Potential Treatment for Anxiety Disorders*, 12 NEUROTHERAPEUTICS 825 (2015); David Cheng et al., *Long-term Cannabidiol Treatment Prevents the Development of Social Recognition Memory Deficits in Alzheimer's Disease Transgenic Mice*, 42 J. ALZHEIMER'S DISEASE 1383 (2014).

148. Daniel Politi, *A 12-Year-Old Girl with Epilepsy is Suing Jeff Sessions Over Medical Marijuana*, SLATE (Nov. 12, 2017 6:18 PM), http://www.slate.com/blogs/the_slatest/2017/11/12

example of the growing acceptance of marijuana as an effective medical treatment, the American Legion recently petitioned the federal government to enable more research into the use of marijuana in treating post-traumatic stress disorder.¹⁴⁹

The actual and potential medical uses for marijuana, along with the evolution of public opinion and federal law enforcement's priorities concerning marijuana, may account in large part for the massive economic growth of the marijuana industry. The legal marijuana industry is estimated to have grown 74% from 2013 to 2014—from a \$1.5 billion to \$2.7 billion industry—making it the fastest growing industry in the United States.¹⁵⁰ With the expected legalization of medical and recreational marijuana in additional states, the industry is expected to continue this exponential growth.¹⁵¹ A recent study projects a compound annual growth rate of 17% for the legal marijuana industry, with medical marijuana sales going from \$4.7 billion in 2016 to \$13.3 billion in 2020 and recreational sales going from \$2.6 billion to \$11.2 billion over the same period.¹⁵² This study also predicts that the industry growth will create more than 250,000 new jobs by 2020.¹⁵³ Additionally, the CBD market is estimated to grow by 700% from 2016 to 2020 to become a \$2.1

/a_12_year_old_girl_with_epilepsy_is_suing_jeff_sessions_over_medical_marijuana.html. After five years of seizures and doctors' recommendation of brain surgery, the minor decided to first try medical marijuana. *Id.* The marijuana treatment provided her immediate relief from her seizures, and she has gone more than two years seizure-free without any other seizure medication, according to her complaint. *See* Complaint at 11–12, *Washington v. Sessions*, 2018 WL 1114758 (S.D.N.Y., Feb. 26, 2018) (No. 1:17-cv-05625).

149. Reggie Ugwu, *Veterans Groups Push for Medical Marijuana to Treat PTSD*, NEW YORK TIMES (Nov. 3, 2017), <https://www.nytimes.com/2017/11/03/us/medical-marijuana-veterans.html?r=0>.

150. Matt Ferner, *Legal Marijuana is the Fastest-Growing Industry in the U.S.: Report*, HUFFINGTON POST (Jan. 26, 2015, 12:00 AM), https://www.huffingtonpost.com/2015/01/26/marijuana-industry-fastest-growing_n_6540166.html (referencing an industry report by The ArcView Group, a marijuana industry investment and research firm).

151. *Id.*

152. Debra Borhardt, *Marijuana Industry Projected to Create More Jobs than Manufacturing by 2020*, FORBES (Feb. 22, 2017, 10:51 AM), <https://www.forbes.com/sites/debraborhardt/2017/02/22/marijuana-industry-projected-to-create-more-jobs-than-manufacturing-by-2020/#7fe78bfa3fa9> (referencing a report by New Frontier Data); *see* Jennifer Kaplan, *U.S. Cannabis Industry Expected to Maintain Growth Despite Trump*, BLOOMBERG (Mar. 23, 2017 8:54 AM), <https://www.bloomberg.com/news/articles/2017-03-23/u-s-cannabis-industry-expected-to-maintain-growth-despite-trump>.

153. Debra Borhardt, *Marijuana Industry Projected to Create More Jobs than Manufacturing by 2020*, FORBES (Feb. 22, 2017, 10:51 AM), <https://www.forbes.com/sites/debraborhardt/2017/02/22/marijuana-industry-projected-to-create-more-jobs-than-manufacturing-by-2020/#7fe78bfa3fa9>.

billion market.¹⁵⁴ There is legitimate concern that current federal tax policy, specifically the application of section 280E to marijuana businesses, could stifle this growth and force otherwise legitimate businesses to operate underground. Keller suggests that section 280E might work against the public policy goals of reducing drug-related crime, stopping the flow of drugs at borders, and reducing sources of supply by denying ordinary and necessary deductions to state-regulated, legal businesses.¹⁵⁵ This is because the inability to deduct selling and overhead costs, including rent and employee salaries, would create a higher demand for small-time dealers that do not have such costs.¹⁵⁶ The small-time dealer can “deduct” their inventory, which is their primary and perhaps only significant cost, and pay tax on the net amount. The high tax burden faced by larger, regulated businesses that have substantial selling and overhead costs such as quality control and testing costs, could make their businesses unsustainable. They might attempt to skirt the regulations to reduce nondeductible costs, or lose their business entirely to the small-time, unregulated drug dealers. According to experts in the marijuana industry, federal tax law, rather than criminal law, is perceived as the biggest threat to the development of the legal marijuana industry, and has the potential to drive the industry underground.¹⁵⁷ Additionally, the inability of legal marijuana businesses to stay in business because of the onerous tax burden could undermine public policy preferences for safe, regulated marijuana and affordable access to medicine.¹⁵⁸ Forcing state-legal marijuana sellers out of business or driving them underground will ultimately reduce federal tax revenue. It will also discourage businesses from hiring and expanding due to the inability to deduct payroll and rent, and may stifle legal economic growth

154. Debra Borhardt, *The Cannabis Market that Could Grow 700% by 2020*, FORBES (Dec. 12, 2016, 12:52 PM), <https://www.forbes.com/sites/debraborhardt/2016/12/12/the-cannabis-market-that-could-grow-700-by-2020/#236d3c54be1e>.

155. Keller *supra* note 15, at 173–74.

156. *Id.* at 174.

157. Benjamin Moses Leff, *Tax Planning for Marijuana Dealers*, 99 IOWA L. REV. 523, 525 (2014).

158. See Matthai Kuruvila, *Oakland Sues Feds Over Pot Dispensary*, SF GATE (Oct. 10, 2012, 10:51 PM), <https://www.sfgate.com/bayarea/article/Oakland-sues-feds-over-pot-dispensary-3937839.php> (quoting the San Francisco City Attorney as stating: “If the federal government is successful with shutting down these businesses we have licensed and are complying with regulations and taxes, we will shift people into the black market That will endanger their lives because they may not have safe, affordable access to medicine”).

without lessening the overall demand for marijuana.¹⁵⁹

IV. CONGRESS SHOULD AMEND SECTION 280E TO EXEMPT CERTAIN ACTIVITIES RELATED TO STATE-LEGALIZED MARIJUANA SALES

The state-legalized marijuana industry is growing, with the potential to add hundreds of thousands of jobs, provide a boost to the U.S. economy, and become a significant source of federal tax revenue. The current application of section 280E is problematic. It potentially undermines this growth, represses tax revenue, and contravenes public policy by diverting marijuana activity away from state-legal, regulated businesses to underground drug dealers who are less likely to even report and pay tax on their income.¹⁶⁰

Section 280E stands contrary to both common law and legislative treatment of all other illegal businesses for tax purposes. The cost of goods sold and separate activity exceptions to section 280E mitigate its punitive effect to some degree, but also create an inefficient and unclear tax system where businesses expend resources on accountants and lawyers to creatively apportion costs, without certainty that the allocations will be respected without IRS challenge or ultimately upheld despite costly tax litigation. Further, the authors of section 280E appear to have been intent on preventing the proliferation of dangerous illegal drugs.¹⁶¹ There is reasonable question as to whether section 280E is even an effective means for that end.¹⁶² In any event, Congress did not foresee the rise of a state sanctioned and well-regulated marijuana industry when it enacted section 280E.¹⁶³ The section currently undermines the safety and regulatory efforts of the states by driving sellers underground to avoid the punitive and often unsustainable economic effect of the inability to deduct business expenses in computing their taxable income.¹⁶⁴ The significant change in marijuana's public acceptance, its recognition for medicinal uses, and its contribution to the U.S. economy over the last two decades provide reason to reexamine the effectiveness of section 280E in achieving Congress's intent when applied to the current and future

159. Sam Kamin, *The Limits of Marijuana Legalization in the States*, 99 IOWA L. REV. BULL. 39, 43 (2014).

160. See Keller *supra* note 15, at 174.

161. S. REP. NO. 97-494, at 309 (1982).

162. Keller *supra* note 15, at 177-78.

163. See Vujcic *supra* note 136, at 276-77.

164. See Leff *supra* note 157, at 525.

marijuana industry. For the reasons stated above, action should be taken to remove legitimate marijuana businesses from the punitive web of section 280E.

There are several possible means for eliminating the harm of section 280E for marijuana sellers. One option is for the federal government to reschedule marijuana and marijuana-derived products so they are no longer Schedule I or II controlled substances, and thus outside the scope of section 280E. The Drug Enforcement Agency has rejected recent petitions to reschedule marijuana, although Congress also has the ability to reschedule.¹⁶⁵ There has been legislation introduced in both houses of Congress to either reschedule marijuana or amend the Controlled Substances Act to exempt from criminality persons operating in compliance with state laws.¹⁶⁶ However, rescheduling or amending the Controlled Substances Act would have broader implications beyond just the application of section 280E and thus is outside the scope of this Note.

A less direct option is for the Supreme Court to adopt a purposive interpretation of section 280E. Nikola Vujcic proposes that the Court should “give greater significance to the purpose of section 280E rather than limiting its analysis to a strict reading of the statutory text.” He expects that an analysis that includes legislative intent and purpose would result in a holding that section 280E was not meant to encompass state-sanctioned businesses and therefore should not apply to them.¹⁶⁷ However such a holding is not guaranteed, and requires marijuana businesses to wait for the litigation process to work its way up to and through the Supreme Court.

The IRS has declined to administratively interpret section 280E as inapplicable to medical marijuana businesses. IRS Chief Counsel has stated that they lack the authority to publish such guidance, insisting that this would require congressional amendment to the

165. SACCO, *supra* note 139.

166. *See, e.g.*, Respect State Marijuana Laws Act of 2017, H.R. 975, 115th Cong. (2017) (amending the CSA “to provide that the Act’s regulatory controls and administrative, civil, and criminal penalties do not apply to a person who produces, possesses, distributes, dispenses, administers, or delivers marijuana in compliance with state laws”); Compassionate Access, Research Expansion, and Respect States Act of 2015, S. 683, 114th Cong. (2015) (amending the CSA in a similar manner and rescheduling marijuana from Schedule I to Schedule II); States’ Medical Marijuana Patient Protection Act, H.R. 689, 113th Cong. (2013) (requiring the DEA to recommend listing marijuana as other than a Schedule I or Schedule II substance).

167. Vujcic *supra* note 136, at 253.

Internal Revenue Code or the Controlled Substances Act.¹⁶⁸ Similarly, the Tax Court has also signaled that marijuana businesses will only be able to deduct their ordinary and necessary expenses by way of congressional amendment.¹⁶⁹

Carrie Keller has recommended omitting section 280E from the Internal Revenue Code entirely.¹⁷⁰ She argues that section 280E contradicts the intent of the original Code drafters, is outdated, and is ineffective (and possibly harmful) in the government's battle against illegal drug sale and use.¹⁷¹ Her arguments are persuasive, but her proposal would affect sellers of other substances in addition to marijuana, such as heroin and methamphetamine, currently Schedule I and Schedule II substances, respectively.¹⁷² The non-tax implications of this proposal are beyond the scope of this Note, but given the lack of compelling evidence that the public and legislators favor legalizing drugs such as heroin and methamphetamine, this proposal seems like an unlikely solution to the dilemma of state-legalized marijuana businesses.

The most direct solution, with a higher likelihood of successful passage than a complete repeal of section 280E, is congressional amendment of the statute. Congress should amend section 280E to exempt activities that are legal in the state in which they are carried on. Roche points out that this can be done by simply replacing the word "or" with "and" so that the statute reads ". . . which is prohibited by Federal law *and* the law of any State in which such trade or business is conducted"¹⁷³ This would encapsulate both medical and recreational use marijuana depending on the home state's laws regarding each. If Congress did not want to yield complete power to the states to influence federal tax law, it could simply except marijuana from the definition of controlled substances directly within the statute. However, yielding some power to the states on this matter would follow the Department of Justice's precedent¹⁷⁴ and would

168. Joel S. Newman, *Deductions on a Higher Plane: Medical Marijuana Business Expenses*, LEXIS FED. TAX J. Q., September 2013, Wake Forest Univ. Legal Studies Paper No. 2333969, available at SSRN: <https://ssrn.com/abstract=2333969>.

169. Vujcic *supra* note 136, at 252.

170. See Keller *supra* note 15, at 168.

171. *Id.* at 168–78.

172. See Controlled Substances Act, 21 U.S.C. § 812 (2012).

173. See Roche, *supra* note 40, at 482 (emphasis added).

174. Memorandum from James M. Cole, Deputy Attorney Gen., to U.S. Attorneys (Aug. 29, 2013), <https://www.justice.gov/iso/opa/resources/3052013829132756857467.pdf>.

acknowledge that state-legalized marijuana, regulated to mitigate the concerns of the federal law enforcement and distinguishable from an underground heavy drug trade, was not the intended target in the enactment of section 280E.¹⁷⁵

There have been repeated attempts by legislators to amend section 280E in favor of marijuana sellers with no action taken to date by the House of Representatives or the Senate.¹⁷⁶ But with the steady change in public opinion on legalized marijuana, the increase in state regulations, and the projected growth in marijuana industry jobs, Congress may be more likely to pass such an amendment in the near future. As marijuana business are able to expand and are encouraged to operate legitimately rather than underground, the likelihood, completeness, and accuracy of their tax compliance should improve. The federal government would likely realize much more tax revenue by amending section 280E in favor of legalized marijuana sellers than by keeping the status quo due to more accurate and forthcoming tax reporting by growing businesses.

An amendment to section 280E to exempt marijuana businesses also promotes a fairer and more efficient tax system. As discussed above, the potential cost of goods sold and separate activities manipulations create inefficiencies in the compliance process for both taxpayers and the IRS. A bright-line exemption removes uncertainty and the incentive to use gray areas of the law to deduct business expenses. Such an amendment would not completely address the unusually punitive effect of section 280E relative to the tax code's treatment of other illegal businesses, but it would move the Code a step closer to reducing the effect with a pragmatic approach to state-legal marijuana businesses. Perhaps a step that is tolerable by Congress, particularly considering the perceived ineffectiveness of section 280E to curb the supply and demand for illegal drugs. Amending section 280E to exempt marijuana businesses, rather than repealing it outright, would enhance the likelihood of congressional approval. The government can still suggest that it is penalizing certain

175. If this were the case, Congress could specify that only state-compliant businesses would be exempt from section 280E, as provided in all of the legislation referenced in *infra* note 176, to avoid benefitting underground drug dealers.

176. *See, e.g.*, H.R. 2240, 113th Cong. (2013) (amending section 280E to allow deductions and credits relating to expenditures in connection with marijuana sales conducted in compliance with State law); H.R. 1855, 114th Cong. (2015) (same); S. 987, 114th Cong. (2015) (same); H.R. 1810, 115th Cong. (2017) (same); S. 777, 115th Cong. (2017) (same).

drug dealers without harming legal, state-licensed businesses.

V. CONCLUSION

Section 280E is a highly punitive tax statute, unlike any other provision in the current Code, in that it directly calls out a specific type of business and treats that business differently than any other, both legal and illegal. When the section was enacted, Congress could not foresee the current state of the marijuana industry and the prevalence of legalization measures by the states. The result is a current tax system that places an egregious burden on legitimate businesses, stifling their growth and feasibility while also limiting tax efficiency, fairness, and potential revenue collection. The current divergence in state and federal law regarding the legality of marijuana businesses has exacerbated this dilemma, with the potential to undermine both the state and federal governments' interests in regulating marijuana sales, reduce safe access for marijuana patients, and slow beneficial economic growth. The most direct and practical solution, in terms of simplicity and the likelihood of legislative passage, is a congressional amendment to section 280E that exempts state regulated marijuana businesses from the statute.