

The Bankler Report

July 23, 2015

INTRODUCTION

On July 9, 2015, the Court of Appeals (9th Circuit) in California agreed with the Tax Court that business deductions for the legal sale of marijuana are still not deductible on the Federal Income Tax Return (See *Olive v. Commissioner*).

Law

1. Internal Revenue Code Section 280E states that a taxpayer may not deduct any amount for a trade or business where the trade or business (or the activities which comprise the trade or business) consists of trafficking in controlled substances (e.g., controlled substances within the meaning of schedule I—such as marijuana—and II of the Controlled Substances Act), which is prohibited by Federal law.
2. Section 538 of the Consolidated and Further Continuing Appropriations Act, 2015, PL 113-235 (Sec. 538) provides that federal funds cannot be used to prevent states that had made medical marijuana legal at the time of the enactment of that Act in 2014 from implementing their own state laws that authorize the use, distribution, possession, or cultivation of medical marijuana.
3. Internal Revenue Code Section 162(a) provides that a business may deduct from its gross income all the ordinary and necessary expenses paid or incurred during the tax year in carrying on the trade or business.

Prior Court Case

4. In *Californians Helping to Alleviate Med. Problems, Inc.*, (2007) 128 TC 173, the taxpayer, CHAMP, had the primary purpose of providing caregiving services to individuals. Its secondary purpose was providing members with medical marijuana under the California Compassionate Use Act of '96 (CCUA). The IRS disallowed all of CHAMP's deductions under Code Sec. 280E. The Tax Court held that marijuana is a schedule I controlled substance for this purpose, even if it's medical marijuana recommended by a physician as appropriate to benefit the user's health. However, the Tax Court allowed CHAMP to deduct its expenses attributable to its counseling and other caregiving services. The Court rejected the IRS's contentions that CHAMP was engaged in a single business activity (trafficking in marijuana) or that Code Sec. 280E required the denial of all CHAMP's expense deductions.

Current Case (*Olive v. Commissioner*)

5. Martin Olive operates the Vapor Room Herbal Center (Vapor Room), a sole proprietorship medical marijuana dispensary in California, which operated legally under the CCUA. The Vapor Room provides its patrons a place where they can socialize, purchase medical marijuana, and consume it using the Vapor Room's vaporizers. Staff members or patrons sample Vapor Room inventory for free. The Vapor Room offers the following services plus complimentary food to its patrons: discussion of illnesses; counseling on various personal, legal, or political matters related to medical marijuana; and education on how to use the vaporizers and consume medical marijuana responsibly. All these goods and services are provided to patrons at no charge.

6. The IRS sought to disallow all of the Vapor Room's business expenses, based on Code Sec. 280E, for 2004 and 2005. The IRS and the taxpayer agreed that Code Sec. 280E disallows deductions only for the expenses of a business and not for its costs of goods sold.
7. Tax Court disallows deductions. The Tax Court agreed with IRS's disallowance of the taxpayer's business deductions (*Olive*, (2012) 139 TC 19139).
8. The taxpayer argued that Code Sec. 280E applies only to illegal trafficking in a controlled substance and therefore did not apply to the taxpayer's business, which was a legitimate operation under state law. But the Tax Court said it had previously held, in *CHAMP*, that dispensing medical marijuana under CCUA was "trafficking" for Code Sec. 280E purposes.
9. The taxpayer then argued that, like the taxpayer in *CHAMP*, it was in two businesses, marijuana dispensing and caregiving, and that only the expenses related to dispensing marijuana should be disallowed. But the Tax Court said that the taxpayer had a single business—the dispensing of medical marijuana—and provided the caregiving services and other activities as part of that business. Therefore, the Tax Court said, Code Sec. 280E precluded the deduction of any Vapor Room expenses, including those incurred in providing the caregiving services.
10. Ninth Circuit affirms. In the taxpayer's appeal, he made some slight changes to how he argued the case, but the Court rejected all of his arguments and affirmed the Tax Court's holding.

As more states pass laws to legalize marijuana and based on the facts above, more businesses will be confronted with not being able to deduct their business expenses. Losing the ability to deduct expenses can realistically shut down a business. The outcome of the current case (*Olive v. Commissioner*) might have been different if the taxpayer had utilized different pricing options.

As we continually stress to our clients, contact us during the business planning stage so that we can minimize your tax liabilities.