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A Real Bummer for The Marijuana Industry

By Larry Brant on 10.23.15 | Posted in Business Taxes, Corporate Tax, Individual Income Tax, Tax Laws, Tax Planning, Tax Procedure

As a general rule, in accordance with IRC § 162(a), taxpayers are allowed to deduct, for federal income tax purposes, all of the ordinary and necessary expenses they paid or incurred during the taxable year in carrying on a trade or business. There are, however, numerous exceptions to this general rule. One exception is found in IRC § 280E. It provides:

"No deduction or credit shall be allowed for any payment paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any state in which such trade or business is conducted."

Congress enacted IRC § 280E as part of the Tax Equity and Fiscal Responsibility Act of 1982, in part, to support the government's campaign to curb illegal drug trafficking. Even though several states have now legalized medical and/or recreational marijuana, IRC § 280E may come into play. The sale or distribution of marijuana is still a crime under federal law. The impact of IRC § 280E is to limit the taxpayer's business deductions to the cost of goods sold.

On October 22, 2015, the U.S. Tax Court issued its opinion in *Canna Care, Inc. v. Commissioner*, T.C. Memo 2015-206. In that case, Judge Haines was presented with a California taxpayer that is in the business of selling medical marijuana, an activity that is legal under California law.

The facts of this case are interesting. Bryan and Lanette Davies, facing significant financial setbacks and hefty educational costs for their six (6) children, turned to faith for a solution. After "much prayer," Mr. Davies concluded that God wanted him to start a medical marijuana business. Unfortunately, it does not appear that he consulted with God or a qualified tax advisor about the tax implications of this new business before he and his wife embarked upon the activity.

The good news for the Davies is that their business blossomed. In fact, they employ ten (10) people in the business and have enjoyed financial success. They timely filed state and federal income tax returns, reported income and paid, what they believed, was the proper amount of taxes. The bad news for the Davies is the fact that the IRS did not agree with their computation of the tax liability.

The IRS issued a notice of deficiency. Not able to resolve the matter at IRS appeals, the Davies found themselves in the U.S. Tax Court. The sole issue in the case was whether the taxpayers' business deductions were properly disallowed by the Service under IRC § 280E.

To no avail, the Davies presented numerous arguments as to why marijuana should no longer be a controlled schedule I substance. They also asserted that their new business created employment opportunities for others, cured their family's financial woes, and allowed them to participate in civic and charitable activities.

Judge Haines quickly dismissed the Davies' arguments, concluding the sale of marijuana is prohibited under federal law—marijuana is a schedule I controlled substance. Accordingly, IRC § 280E prevents taxpayers from deducting the expenses incurred in connection with such activity (other than the cost of goods sold).

Faced with a tax assessment exceeding $800,000, the Davies argued that their business does more than sell marijuana. In fact, it sells books, shirts and other items related to medical marijuana. Citing other cases, they argued that their expenses should be apportioned among the various activities (i.e., the sale of medical marijuana and the sale of other items), and that they should be able to deduct the expenses related to the sale of the non-marijuana items.

The court explained that, where a taxpayer is involved in more than one distinct trade or business, it may be able to apportion its ordinary, necessary and reasonable expenses among the different trades or businesses. Unfortunately for the Davies, they could not show that they operated two (2) or more trades or businesses. In this case, the facts indicated that the sale of shirts, books and other items was merely incidental to the sale of medical marijuana. There was not more than one (1) trade or business.

PRACTICE ALERT: Whether more than one (1) trade or business exists is a question of facts and circumstances. Under *CHAMP v. Commissioner*, 128 T.C. 182 (2007), if a taxpayer operates more than one (1) distinct trade or business, it may be allowed to apportion its expenses among the trades or businesses. If only one (1) of the businesses is impacted by IRC § 280E, only the expenses relating thereto should be denied. The key is establishing that more than one (1) trade or business exists, and reasonably be able to apportion the expenses among those trades or businesses. Keeping separate books and records, and accounting for business expenses in a separate manner, is likely the best approach. The more separation and distinction among the businesses the better the chances of showing more than one (1) trade or

business exists. Maintaining separate entities or business names for each activity may be warranted.

The Davies lost the case and are now faced with a hefty tax bill. Unless IRC § 280E is amended, taxpayers involved in the sale of medical and/or recreational marijuana, despite state legalization, will be presented with the same dilemma faced by the Davies in *Canna Care, Inc. v. Commissioner*.

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