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Another Blow to the Marijuana Industry: 9th Circuit Holds That Business Expenses Are Not Deductible

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Under Section 162(a) of the Internal Revenue Code, a business can deduct from its gross income "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." According to the United States Court of Appeals for the Ninth Circuit, however, this deduction is not extended to marijuana related businesses. *Olive v. Commissioner of Internal Revenue,* No. 13-70510 (9th Cir. July 9, 2015).

In 2012, the United States Tax Court assessed penalties and interest against Vapor Room Herbal Center, a California medical marijuana dispensary owned by Martin Olive, for its deduction of $654,071 as business expenses on its 2004 and 2005 income tax returns. Although IRC Section 162(a) allows businesses to deduct "ordinary and necessary expenses," IRC Section 280E prohibits a business from deducting for any "trade or business [that] consists of trafficking in controlled substances ... prohibited by Federal law." Citing Section 280E, the Tax Court held that operating a medical marijuana dispensary constituted trafficking in controlled substances in violation of federal law, even though it was legal under California law.

Olive appealed the Tax Court's decision to the Ninth Circuit Court of Appeals. His first claim was that for a "trade or business" to "consist of trafficking in controlled substances," the business must consist solely of trafficking in controlled substances. Olive argued that in addition to dispensing medical marijuana, the Vapor Room also offered free caregiving services such as yoga, massage therapy, discussion of illnesses, counselling on various personal, legal or political matters related to medical marijuana and education on how to consume medical marijuana responsibly. The Ninth Circuit agreed with the Tax Court that the Vapor Room's only "trade or business" was the sale of marijuana. It noted that the test for determining if an activity is "trade or business" is whether the activity was entered into with the intent of making a profit. As the Vapor Room's other services were offered for free, the only activity that could raise a profit was the sale of marijuana.

Olive's second claim was that IRC Section 280E should not apply to him because it was enacted before medical marijuana dispensaries existed, therefore Congress could not have intended for medical marijuana dispensaries to fall within the category of "items not deductible." The Ninth Circuit stated that this

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argument had no bearing on its analysis.

Olive's last claim was that Section 538 of the Consolidated and Further Continuing Appropriations Act 2015, PL 113-235 prohibits the IRS from defending his appeal as it provides that federal funds may not be used to prevent states that at the time of the Act had legalized medical marijuana, from implementing their state laws authorizing the use, distribution, possession or cultivation of medical marijuana. The Ninth Circuit held that Section 538 does not apply because the IRS is not preventing California from implementing its laws that authorize the use, distribution, possession or cultivation of marijuana. Instead, the IRS is simply enforcing a tax, which does not prevent people from using, distributing, possessing or cultivating marijuana in California.

This ruling is an obvious and a troubling set-back for the marijuana business community. It is just another example of how the inconsistencies between federal and state laws can be challenging for marijuana users, growers, processors and regulators. This problem could be resolved by revising the Internal Revenue Code to provide a further exception under 280E to allow state-sanctioned marijuana enterprises. Until then, marijuana business owners should caution taking business deductions or - alternately, consider whether other business activities are entered into with the intent of making a profit for the business.

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