PROMPT ON THE TAX TREATMENT OF A MARIJUANA BUSINESS

By Douglas A. Kahn* and Howard Bromberg**

Currently, twenty-eight states and the District of Columbia allow the use of marijuana for medical purposes and permit the conduct of a business marketing of marijuana for that purpose. Eight of those states and the District of Columbia permit the recreational use of marijuana. There is reason to believe that more states will decriminalize the marketing of marijuana. However, marijuana is listed in Schedule 1 of the federal Controlled Substances Act of 1970 (CSA) which makes it illegal under federal law to manufacture or distribute marijuana even when it is legal to do so under local state law. In a series of memoranda promulgated by the Justice Department in the period from 2009 to 2014, the Department announced that it would not enforce the CSA prohibition against marijuana if certain requirements are met. Consequently, even the federal government has evidenced some ambivalence as to whether the conduct of a marijuana business for medical use should be illegal.

Section 162(c)(2) of the Internal Revenue Code denies a deduction for a business expense that is illegal under federal or state law. This provision is in accord with a number of administrative and judicial determinations denying deductions for illegal expenses. For example, medical expenses that are illegal under federal or state law are not deductible. So, the IRS has ruled that the cost of purchasing marijuana for medical purposes, even if prescribed by a doctor and legal to purchase under state law, is not deductible because it violates the CSA. The authors have published an article criticizing the denial of a deduction for illegal expenses that otherwise are deductible. However, that is not the central issue with the marijuana business since its expenses typically are legal when conducted in a state that has decriminalized it.

In the absence of a statutory denial, the legal expenses of a business are deductible even if the business itself is illegal. In the 1981 decision of the Tax Court in Edmonson v. Commissioner, the court allowed the deduction of legal expenses of an illegal business. The taxpayer was engaged in the illegal business of selling cocaine and marijuana among other drugs. Congress was displeased with that decision and responded by adding § 280E to the Internal Revenue Code. That provision denies a deduction or credit for the business expenses of a business engaged in trafficking in a controlled substance that is listed in Schedule I or II of the CSA if that business is prohibited by either federal or state law. Marijuana is listed in Schedule I, and so the statute disallows all of the expenses of a

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*Paul G. Kauper Professor of Law Emeritus, University of Michigan.
**Clinical Professor of Law, University of Michigan.
1 See Treas. Reg. § 1.213-1(c)(1)(ii), (2).
4 See Accardo v. Commissioner, 942 F.2d 444 (7th Cir. 1991).
marijuana business. For example, no deduction is allowed for the rent paid for the use of premises, for the wages paid to employees, and for the premiums paid for fire insurance.

It has been suggested that the reason Congress chose this path was to deter advertising of marijuana. If so, the provision is manifestly too broad since it reaches all other ordinary expenses shared by most businesses. Moreover, the authors see no reason to find advertising of purportedly legal businesses objectionable.

The disallowance of deductions for lawful expenses puts those businesses that are engaged in the marijuana business in a very difficult position. The denial of a deduction will greatly impinge on their net profits and may even produce a net loss. They are treated more harshly by the tax law than even illegal businesses are treated. The legal expenses of other illegal businesses are deductible. To postulate an extreme example, a business engaged in assassination for hire can deduct the cost of its bullets and depreciate the cost of its guns: while a lawful marijuana business cannot even deduct its rent or its telephone bill.

Recent cases have demonstrated another consequence of the enforcement of § 280E that some may find objectionable. Since the enforcement of § 280E occurs in the context of civil litigation, the government can use subpoenas to obtain information that could not be obtained in a criminal prosecution. If the government subsequently decides to prosecute the operators of the business, it can then use the information obtained from the subpoena in that criminal case. It would not be surprising if the government were to use § 280E as an excuse to obtain information for a criminal prosecution.

While § 280E denies a deduction for business expenses, it does not prevent the capitalization of capital expenditures. So the capital expenditures of a marijuana business can be included in its cost of goods sold and thereby offset an amount realized on sales and reduce the gain recognized. Contrary to the usual preference to have ordinary deductions rather than capitalized expenditures, the tax treatment of marijuana businesses causes them to capitalize expenditures to the extent it is feasible for them to do so. Those expenditures can reduce its taxable income whereas an expenditure that is characterized as a business expense will have no tax benefit to the taxpayer at all.

Given the above considerations, should an exception for marijuana businesses be added to § 280E? Should § 280E itself be repealed?

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“REVERSE AL CAPONE-ISM” AND THE TAX TREATMENT OF MARIJUANA BUSINESSES

Kenneth H. Silverberg*

I. THE FEDERAL TAX LAW IS INTENTIONALLY PUNITIVE

Congress enacted IRC § 280E in 1982 because it was dissatisfied with the Tax Court’s 1981 decision in Edmondson v. Commissioner, T.C. Memo. 1981-623, 42 T.C.M. (CCH) 1533. That decision allowed tax deductions for the legal business expenses incurred by a Minneapolis drug dealer. IRC § 280E denies a deduction or credit for business expenses associated with operating a trade or business consisting of trafficking controlled substances that are listed in Schedule I or Schedule II of the Comprehensive Drug Abuse Prevention and Control Act of 1970 (“CSA”). Marijuana is listed in Schedule I of the CSA.

The Senate Committee Report accompanying the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”) clearly muddled its rationale:

Reasons for Change

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.¹

Despite the syntax lapse, the Committee Report is crystal-clear on what the Senate meant when it adopted § 280E:

Explanation of Provision

All deductions and credits for amounts paid or incurred in the illegal trafficking in drugs listed in the Controlled Substances Act are disallowed.²

Congress stated in 1982 that it was motivated by a strong public policy to punish drug dealers. Although there has been considerable state action liberalizing the treatment of marijuana in recent years, no evidence has been cited to indicate that there has been any change in the federal government’s policy toward drug dealers. Nor has any evidence been cited to indicate that Congress distinguishes marijuana dealers from any other type of drug dealers.³

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* The author is a tax lawyer with Nixon Peabody LLP in Washington, D.C. with strong connections to the University of Michigan. He welcomes the good-humored feedback of readers at ksilverberg@nixonpeabody.com. The use of maize and blue fonts is encouraged.

² Id.
³ DOJ enforcement policy distinguishes marijuana dealers who comply with state law from other drug dealers. This policy is inconsistent with applicable federal laws. See U.S. DEP’T OF JUSTICE, OFFICE OF THE DEPUTY ATTORNEY GENERAL, MEMORANDUM FOR ALL UNITED STATES ATTORNEYS: GUIDANCE.
II. STATE LAW IS ALMOST IRRELEVANT

Regardless of how many state legislatures purport to legalize the manufacture and sale of marijuana, the business of manufacturing and selling marijuana remains illegal under federal law. And the Supremacy Clause of the U.S. Constitution requires inconsistent state laws to defer to federal law:

>This Constitution, and the laws of the United States which shall be made in pursuance thereof; and all treaties made, or which shall be made, under the authority of the United States, shall be the supreme law of the land; and the judges in every state shall be bound thereby, anything in the Constitution or laws of any State to the contrary notwithstanding.4

Proponents of liberalizing marijuana laws simply must acknowledge that there is no marijuana exception to § 280E, and there is no evidence that Congress wants one. Congress clearly intended to impose the financial penalty experienced by those in the marijuana businesses, i.e., that they are in effect obligated to pay federal income tax on their gross income. Section 61(a) does not differentiate between income derived from legal sources and income derived from illegal sources.5

III. KAHN AND BROMBERG ARE ADVOCATES FOR THE COMPLETE REPEAL OF § 280E

In their 2016 Florida Tax Review article6, Professors Kahn and Bromberg argue that § 280E should be repealed because of its flaws as a civil penalty. The principal flaw they discuss stems from their belief that “the punishment should fit the crime” and that § 280E is arbitrary because it contains no protections for the concept of “horizontal equity.”7 They introduce this notion in prompting the current dialog, but they quickly dismiss it, stating that it is not the central focus.

I disagree, and suggest that § 280E is indeed the central focus that underlies the current marijuana dialog. I would certainly agree that the practical impact of § 280E is often disproportionate to the severity of the harm caused to third parties by the offense. But that is the yardstick used by criminal law to measure the propriety of a penalty. In the case of a civil-law penalty, including most tax penalties, it is customary for the penalty’s impact to be directly proportional to the offender’s conduct. Most importantly in this instance, it is completely within the offender’s control.

Congress is presumed to have intended to mean what it said – at least until it changes its mind. In this case, Congress clearly and explicitly used the tax law to impose an additional penalty on certain drug offenders, and has never wavered or apologized for the rough justice that ensues.

IV. HOW MARIJUANA COULD BE LEGALIZED

The Constitution contains at least two remedies for those who believe marijuana should be treated differently from other Class 1 drugs. The simplest remedy is to elect senators and representatives who are willing to enact laws that reclassify marijuana. Failing that, the Constitution permits amendments. There is precedent in the laws


4 U.S. CONST. Art. VI, Cl. 2.
7 Id. at 217.
governing the treatment of beverage alcohol – in both the adoption of Prohibition in 1919 by the Eighteenth Amendment and its repeal in 1933 through the Twenty-First Amendment.

It is true that a number of states have made marijuana legal, and our Canadian neighbors seem headed in that direction as this article is being written. However, today’s advocates of legalizing marijuana have been unable to win the only battle that really matters: a potential debate in the U.S. Congress that would result in the removal of marijuana from Schedule I of the CSA. In addition, they seem to have little or no interest in exerting the energy required to amend the Constitution.

I suggest that those advocates who want to create a “marijuana exception” within § 280E are engaging in “reverse Al Capone-ism.” In the 1930’s the FBI became frustrated with its inability to make a case against Al Capone for racketeering, bootlegging, extortion and murder. It turned instead to the income tax law to do indirectly what it was unable to do directly. The FBI put Capone away for tax evasion. So, like J. Edgar Hoover and Elliot Ness, marijuana advocates are now turning to the tax law in hopes of accomplishing indirectly what they have failed to do directly. They want to use the tax law to normalize the economics of the marijuana trade.
Congress enacted § 280E as part of the Tax Equity and Fiscal Responsibility Act of 1982. Section 280E prohibits the deduction of any expenses paid or incurred in carrying on any trade or business if such trade or business consists of trafficking in controlled substances within the meaning of schedule I or II of the Controlled Substances Act of 1970 (CSA) and that trade or business is prohibited by federal law or by the law of a state in which the trade or business is conducted.

Although § 162(c)(2) was in existence prior to 1982, this provision only disallows deductions for illegal business expenses. In other words, a deduction for a business expense is disallowed under § 162(c)(2) if the making of the payment itself is illegal, regardless of whether the underlying business that gave rise to such payment is illegal. Thus, legal expenses of an illegal business continue to be deductible. In Edmondson v. Comm’r, the Tax Court held that ordinary and necessary business expenses, the payment of which were legal, incurred by a taxpayer in the business of selling amphetamines, cocaine, and marijuana were deductible under § 162 of the Code.

In an apparent reaction to Edmondson, Congress enacted § 280E. The legislative history of § 280E makes clear that Congress intended the provision to further the public policy of prohibiting illegal drug dealing:

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 should be disallowed on public policy grounds.

Marijuana is included in Schedule I of the CSA and federal law prohibits the manufacture and distribution of marijuana. Therefore, by reason of § 280E, persons engaged in the business of growing and/or distributing marijuana cannot deduct ordinary and necessary business expenses. According to legislative history, the denial of such deductions is intended to promote a public policy of deterring the manufacture and distribution of marijuana.

In 1996, California became the first state to legalize the use, possession, and cultivation of marijuana for patients who possess a written or oral recommendation from their physician. Today, twenty-eight states and the District of Columbia have legalized the use of marijuana and permit the conduct of a business cultivating and marketing marijuana.

* Counsel, Sidley Austin LLP.
1 Accardo v. Comm’r, 942 F.2d 444 (7th Cir. 1991).
Further, the District of Columbia and eight of those states allow the use of recreational marijuana without the need for a physician’s recommendation.

Popular support for the legalization of marijuana has steadily grown since § 280E was originally enacted in 1982. According to a Gallup poll conducted in 1969, 12% of Americans thought marijuana use should be legal. From the late 1970s through the mid-1990s, approximately 25% of Americans thought marijuana use should be legal. The percentage of respondents who favored making use of the drug legal exceeded 30% by 2000 and 40% by 2009. While support for marijuana legalization has vacillated a bit over the past six years, it has averaged 48% from 2010 through 2012 and has averaged above 56% ever since. Today, 58% of respondents say marijuana use should be legal in the United States.4

Although the use, possession and cultivation of marijuana continues to be illegal under federal law, U.S. Department of Justice (DOJ) Deputy Attorney General James M. Cole issued a memorandum (the “Cole Memo”) on August 29, 2013 providing guidance to federal prosecutors regarding enforcement of federal marijuana law in states where marijuana has been decriminalized.5 The Cole Memo guidance applies to all of the DOJ’s federal enforcement activity, including civil enforcement and criminal investigations and prosecution, concerning marijuana in all states.

The Cole Memo lists eight areas that are a priority focus for the federal government’s enforcement of marijuana policy, including preventing the distribution of marijuana to minors and preventing the use of marijuana while operating a vehicle. In states where marijuana is decriminalized and where laws are passed to protect the federal government’s areas of priority focus, the Cole Memo provides that the DOJ should allow state law enforcement and regulatory bodies to be the primary means of addressing marijuana-related activities.6 Therefore, pursuant to the Cole Memo, a state that has legalized marijuana and has adequate regulations addressing marijuana growth, distribution, and use should expect that the federal government will not interfere with marijuana-related businesses operating within its borders.

On February 14, 2014, the Department of the Treasury’s Financial Crimes Enforcement Network (FinCEN) issued guidance clarifying expectations for financial institutions seeking to provide services to marijuana-related businesses.7 The FinCEN guidance clarifies how financial institutions can provide services to marijuana-related businesses consistent with their obligations under federal law. The FinCEN guidance repeats the priority focus areas of the Cole Memo and requires banks to conduct additional diligence on any marijuana-related customers to assess whether one of the priority focus areas of the Cole Memo is implicated. Although the FinCEN guidance does not give banks immunity for servicing customers in the marijuana industry, the memo is intended to give banks confidence that they will not be punished if they provide services to legitimate

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6 Id.

marijuana businesses in states where such businesses are legal, despite the fact that such
businesses remain illicit under federal law.\textsuperscript{8}

In 1982, Congress enacted § 280E on public policy grounds to deter those engaged
in the manufacture and distribution of illegal drugs. At the time of its enactment, marijuana
was illegal in every state and the majority of the public disapproved of marijuana
legalization. However, public policy with respect to the manufacture and distribution of
marijuana has evolved. Today, twenty-eight states and the District of Columbia have
legalized the use of marijuana and permit businesses to cultivate and market marijuana.
Further, a majority of the public now consistently favors the legalization of marijuana.
Through memorandums and other guidance, the federal government has openly recognized
this shift in public perception and acquiesced to the manufacture and distribution of
marijuana where such business activity is legal under state law.

The public policy purpose behind § 280E of deterring the manufacture and
distribution of illegal drugs no longer seems valid or sustainable with respect to the
manufacture and distribution of marijuana in states where such business activity is legal.
Therefore, in consideration of the evolution in public policy concerning marijuana use and
cultivation, § 280E should be amended to provide an exception to the general disallowance
of deductions for persons engaged in the business of manufacturing or distributing
marijuana in a manner that is consistent with applicable state law.\textsuperscript{9}

\textsuperscript{8}Serge Kovaleski, \textit{U.S. Issues Marijuana Guidelines for Banks}, \textit{N.Y. TIMES} (Feb. 14, 2014),

\textsuperscript{9}While an exception should be made under § 280E as described above, the author believes the
more practical solution is to remove marijuana from Schedule I and II of the CSA through the CSA’s
rulemaking process.