MODERNIZING U.S. TAX CODE SECTION 280E: HOW AN OUTDATED "WAR ON DRUGS" TAX LAW IS FAILING THE UNITED STATES LEGAL CANNABIS INDUSTRY AND WHAT CONGRESS CAN DO TO FIX IT

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ABSTRACT

Historically, the Internal Revenue Code ("Code") and U.S. courts applied a taxpayer-friendly approach to determine the deductibility of business expenses. As long as the taxpayer paid taxes, the Code and U.S. courts allowed her to deduct certain business expenses, even if the source of her income was illegal. But, with the rise of President Richard Nixon's "War on Drugs" and the enforcement of "no tolerance" drug policies in the 1970s, Congress restricted the taxpayer-friendly approach. In 1981, Congress enacted Section 280E, which forbids businesses who traffic Schedule I or II substances from deducting ordinary business expenses when filing their federal taxes. Today, with thirty-three states and the District of Columbia allowing the sale of medical or adult-use cannabis—defying the plant's Schedule I status—state-legal cannabis business owners must pay taxes on gross receipts, instead of net income. Section 280E does not satisfy any War on Drugs policy goals and cripples the development of the legal cannabis industry. To remedy these shortcomings, Congress must reform Section 280E by enacting the STATES Act.

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I. INTRODUCTION

Section 280E of the Internal Revenue Code is described as "a dagger at the throat of the [United States] legal cannabis industry."[1] Representative Earl Blumenauer (D-OR) told the New York Times that Section 280E affects "thousands of [cannabis] businesses, and it's doubling, tripling, quadrupling their taxes . . . . It just cripples them."[2] Historically, the Internal Revenue Code ("Code") and U.S. courts applied a taxpayer-friendly approach to determine the deductibility of business expenses. In determining deductibility, the legality of the income source was irrelevant.[3] As long as the taxpayer paid taxes, the Code and U.S. courts allowed her to deduct certain business expenses, even if the source of the income was illegal.[4] But, with the rise of President Richard Nixon's "War on Drugs" and the enforcement of "no tolerance" drug policies in the 1970s, Congress restricted their taxpayer-friendly approach. In 1981, Congress enacted Section 280E into the Internal Revenue Code, which forbids businesses who traffic Schedule I or II substances, as defined by the Controlled Substances Act, from deducting ordinary business expenses when filing their federal taxes.[5] Section 280E re-focused deductibility to hinge on the legality of the income source itself.

Section 280E reaches further than the drafters intended, does not satisfy any War on Drugs policy goals, and cripples the legal cannabis industry, one

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1 German Lopez, *The Federal Government Is Taxing Marijuana Businesses to Death*, VOX (May 11, 2015, 3:35 PM), https://www.vox.com/2014/11/17/7210705/marijuana-legalization-280E (quoting Steve DeAngelo).

2 Jack Healy, *Legal Marijuana Faces Another Federal Hurdle: Taxes*, N.Y. TIMES (May 9, 2015), https://www.nytimes.com/2015/05/10/us/politics/legal-marijuana-faces-another-federal-hurdle-taxes.html.

3 *See* Comm'r v. Tellier, 383 U.S. 687, 691 (1966); Welch v. Helvering, 290 U.S. 111, 113 (1933).

4 *See* H.R. REP. NO. 64-16763, at 757 (1916).

5 I.R.C. § 280E (1982).

of the fastest growing industries in the United States.[6] With thirty-three states and the District of Columbia now allowing the sale of medical or adult-use cannabis—defying the plant's Schedule I status—state-legal cannabis business owners must pay taxes on gross receipts, instead of net income, because cannabis is a Schedule I substance under federal law.

Selling cannabis as a medicine or for adult-use has been legal in the United States since 1996, when California enacted the first state-legal medical cannabis program.[7] Cannabis positively impacts states that implement a medical or adult-use program, but cannabis business owners—those who touch the plant—are unfairly treated when paying their federal taxes, compared to mainstream business owners.[8] Due to Section 280E, cannabis businesses owners pay taxes on a gross receipts basis, rather than a net basis, which results in effective tax rates from 40 to 70%, compared to the typical corporate tax rate of around 21%.[9] For example, in 2014, John Davis earned $53,369 in profits from his state-legal medical cannabis dispensary, the Northwest Patient Resource Center, but due to Section 280E, Davis ended up owing $46,340 in taxes—an effective tax rate of 86%.[10] John Davis is just one example of the gravely disproportionate tax bills state-legal cannabis businesses owners pay every tax season. The tax landscape was not always this lopsided. With the evolution of cannabis as a legal commodity, Section 280E is now an outdated drug policy that prevents legal businesses from growing.

This Comment proposes that bringing Section 280E into harmony with the original understanding of income taxation and the current legal landscape of the cannabis industry will result in a fairer treatment of legal cannabis business owners. Despite cannabis business owners' effort to resolve this

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6 *See* BRUCE BARCOTT & BEAU WHITNEY, SPECIAL REPORT: CANNABIS JOBS COUNT, LEAFLY 1 (2019).

7 *See* CAL. HEALTH & SAFETY CODE § 11362.5 (West 1996).

8 Renu Zaretsky, *High Hopes and Altered States: Choices, Marijuana, and Tax Revenue*, TAX POL'Y CTR. (Aug. 1, 2018), https://www.taxpolicycenter.org/taxvox/high-hopes-and-altered-states-choices-marijuana-and-tax-revenue-0 (stating that Washington and Colorado have both raised over $300 million in tax revenue since implementing their state cannabis laws, and Nevada collected over $30 million in taxes within six months of cannabis sales).

9 Tom Huddleston, Jr., *The Marijuana Industry's Battle Against the IRS*, FORTUNE (Apr. 15, 2015, 5:00 PM), http://fortune.com/2015/04/15/marijuana-industry-tax-problem/; *see also* TAX FOUND., PRELIMINARY DETAILS AND ANALYSIS OF THE TAX CUTS AND JOBS ACT (2017).

10 *See* Joseph Henchman, *Marijuana Legalization and Taxes: The Impact of Section 280E*, TAX FOUNDATION SPECIAL REPORT (2016), https://files.taxfoundation.org/legacy/docs/TaxFoundation_SR231.pdf (quoting Jack Healy, *Legal Marijuana Faces Another Federal Hurdle: Taxes*, N.Y. TIMES (May 9, 2015), https://www.nytimes.com/2015/05/10/us/politics/legal-marijuana-faces-another-federal-hurdle-taxes.html).

problem in court, the most feasible solution is legislative action. This Comment proposes the most effective solution is the STATES Act. Part II explains the United States' long-standing pro taxpayer approach to federal income taxation. Part III explains how the War on Drugs and the federal government's enforcement of 'no tolerance' drug policies, like Section 280E, changed this approach. Part IV explains how Section 280E reaches further than the drafters intended, does not satisfy any War on Drugs policy goals, and cripples the legal cannabis industry. Part V shows strategies cannabis business owners are using to alleviate themselves from the burdens of Section 280E. Part VI suggests the STATES Act is the most politically feasible solution to this problem because it better aligns with the intent of Section 280E and gives United States cannabis business owners a fair chance at competing in the global marketplace.

II. THE EVOLUTION OF THE PRO TAXPAYER INTERNAL REVENUE CODE

The Internal Revenue Code is the domestic portion of federal statutory tax law that governs all federal tax laws, including income tax.[11] In reviewing the history of the Code, a preliminary question into the taxability of illegal income is necessary. In 1913, this issue would never have arisen because the Revenue Act of 1913 taxed income only from "lawful business[es]."[12] Lawmakers criticized the approach—to tax only legal businesses—because it limited the potential tax revenue the United States could collect.[13] Namely, Senator Jon Sharp Williams, the senator sponsoring the Revenue Act of 1913, rejected amendments that would have limited deductions for expenses only to those incurred in a "legitimate" or "lawful" "trade or business."[14] In the senate debate, he stated that "the object of the bill is to tax a man's income . . . not to reform men's moral characters[;] . . . the law does not care where he got [his income] from, so far as the tax is concerned . . . ."[15] Despite Senator Williams' effort, the drafters of 1913 Tax Code codified the limitation and taxed only "lawful business[es]."[16]

In 1916, due to President Woodrow Wilson's call for revenue to support the United States' preparation for World War I, the drafters of the Internal Revenue Code adopted Senator Williams' approach—to tax income from any

11 I.R.C. § 26 (2018).

12 H.R. REP. NO. 63-3321, at 167 (1913).

13 *See* 50 CONG. REC. 3849 (1913).

14 *Id.*

15 *Id.*

16 H.R. REP. NO. 63-3321, at 167 (1913).

source. Congress removed the word "lawful" from the Code and began to tax income derived from "any source whatever."[17] Driven to raise revenue, the drafters were not concerned whether the person's tax came from a legal source, just that the taxpayer paid taxes.[18] This revision indicates Congress's intent to treat individuals engaged in legal and illegal businesses equally in order to best reflect the taxpayers' ability to pay.[19] In theory, under the 1916 Code, the Internal Revenue Service ("IRS") would collect income tax from bank robbers or drug traffickers, even though these were illegal enterprises.

Federal income tax applies only to net income, which is based on a fairly simple formula: start with gross income,[20] subtract business expenses to calculate net income,[21] then pay taxes on that amount.[22] Deductibility of business expenses is key to calculating net income and still serves a major role in today's income tax return forms.[23] From 1916 to the late 1940s, U.S. courts regularly allowed individuals engaged in illegal business to deduct business expenses, such as rent and salaries, so long as the expenses themselves were "ordinary and necessary" under Section 162, the section that allows deductions for business expenses.[24] In answering what the basic requirements of "ordinary and necessary" were under Section 162, the Supreme Court imposed only the minimal requirement that the expense be "appropriate and helpful" for "the development of the [taxpayer's] business."[25] So long as the expenses themselves were "appropriate and helpful" for "the development of the [taxpayer's] business," the legality of

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17 H.R. REP. NO. 64-16763, at 757 (1916).

18 Comm'r v. Tellier, 383 U.S. 687, 691 (1966); W. Elliot Brownlee, *Wilson and Financing the Modern State: The Revenue Act of 1916*, 129 PROC. AM. PHIL. SOC'Y 173, 176 (1985).

19 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, 254 (2016).

20 I.R.C. § 61 (1984) (stating that gross income is "all income from whatever source derived").

21 I.R.C. § 162(a) (2016) (stating that taxpayers engaged in business, legal or not, deduct business expenses under Section 162 of the 1954 Tax Code, which "allow[s] [a] deduction of all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . .").

22 U.S. DEP'T OF TREASURY, INTERNAL REVENUE SERV., FORM 1040 (2019), https://www.irs.gov/pub/irs-pdf/f1040.pdf.

23 *See* U.S. DEP'T OF TREASURY, INTERNAL REVENUE SERV., FORM 1040 (1916); U.S. DEP'T OF TREASURY, INTERNAL REVENUE SERV., FORM 1040 (2019); I.R.C. § 162(a) (2016).

24 I.R.C. § 162(a) (2016); *see* Rutkin v. United States, 343 U.S. 130, 137 (1952) (holding that income from extortion is taxable); Comm'r v. Heininger, 320 U.S. 467, 475 (1943) (holding that attorneys' fees (a legal expense) were a deductible business expense even though it came from an illegal enterprise); United States v. Wampler, 5 F. Supp. 796, 797 (D. Md. 1934) (holding income derived from fraud is taxable); United States v. Sullivan, 274 U.S. 259, 263–64 (1927) (noting the deletion of the word "lawful" and held income earned in violation of the National Prohibition Act was taxable).

25 *See* Welch v. Helvering, 290 U.S. 111, 113 (1933); *see also* H.R. REP. NO. 64-16763, at 757 (1916).

the business itself played no role in deciding to allow the deduction.[26] Were this not the case, individuals who derived income from illegal business could avoid taxation merely by choosing to earn their living outside the bounds of the law.

The 1916 Tax Code was effective for two reasons. First, the notion that income from illegal businesses should be subject to taxation upheld the drafter's intent to tax income from any source.[27] The United States successfully raised revenue under the 1916 Code. The Code increased receipts in the federal budget from $683 million in 1915 to over $3.6 billion in 1918.[28] Second, the 1916 Code served as a useful tool to deter illegal activity, such as tax evasion. But fear of other illegal activity—opium and heroin abuse—grew from World War I and into the 1950s.[29] Uneasiness in allowing illegal enterprises to benefit from tax deductions started to worry the public. As a result, when determining deductibility, courts started to consider the public's uneasiness alongside the drafters' goal to raise revenue.[30] In 1947, the United States Tax Court adopted the public's concern when it disallowed expenses from bribes because bribes themselves were illegal and contrary to public policy.[31]

High ranking U.S. officials also shared their disapproval of allowing illegal enterprises to deduct business expenses. At the 1953 American Bar Association's annual meeting, Attorney General Herbert Brownell Jr. stated, "I see nothing ordinary or necessary in expenses incurred in . . . delivering dope, rent for houses used for gambling or other vice."[32] It soon became clear that allowing illegal enterprises to deduct business expenses was unpalatable to the courts and the American public. But the question, "are business

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26 *Welch*, 290 U.S. at 113.

27 H.R. REP. NO. 64-16763, at 757 (1916).

28 OFFICE OF MGMT. & BUDGET, TABLE 1.1—SUMMARY OF RECEIPTS, OUTLAYS, AND SURPLUSES OR DEFICITS (-): 1789–2021, https://obamawhitehouse.archives.gov/omb/budget/Historicals.

29 See David F. Musto, *Drug Abuse Research in Historical Perspective*, *in* PATHWAYS OF ADDICTION: OPPORTUNITIES IN DRUG ABUSE RESEARCH 284, 284–86 (1996).

30 *See* Nat'l Outdoor Advert. Bureau, Inc. v. Helvering, 89 F.2d 878, 881 (1937) (considering public policy when allowing the deduction of a business expense from a fraudulent advertising business); David F. Musto, *supra* note 29, at 286; *see also* United States v. Sullivan, 274 U.S. 259, 264 (1927) (Holmes, J., stating, "[I]t will be time enough to consider [whether there is a legality a requirement to deduct business expenses under Section 162] when a taxpayer has the temerity to raise it."); *see generally* Stralla v. Comm'r, 9 T.C. 801 (1947) (In 1947, the question whether there was a legality requirement to deduct business expenses under Section 162 reached the United States Tax Court.).

31 *Stralla*, 9 T.C. at 822.

32 *Deductibility of Illegal Expenses Under Section 162 of the Internal Revenue Code: A Justification for Vagueness*, 66 YALE L.J. 602, 604 n.14 (1957) (citing Address to American Bar Association Annual Meeting, Aug. 27, 1953, 78 A.B.A. REP. 334, 338 (1953)).

expenses that are not illegal *per se*, but are still contrary to public policy, deductible?" remained unanswered.

In 1952, the Supreme Court first attempted to answer this question.[33] In answering it in the affirmative, the Supreme Court developed what has come to be known as the "public policy doctrine."[34] Placing greater emphasis on the legality of the business expense itself, the Court would disallow a business expense deduction if the expense frustrated "policies evidenced by some governmental declaration of them."[35] Six years later, in 1958, the Supreme Court reformed its application of the public policy doctrine.[36]

The Supreme Court appeared skeptical of the public policy doctrine because it tried to satisfy the public's uneasiness but continued to uphold the drafter's intent to tax income derived from "any source whatever."[37] In expanding the doctrine, the Court disallowed a business expense deduction if the deduction itself was used to lessen the economic effect of a penalty imposed by statute.[38] This holding expanded the list of ways the Court could disallow business expense deductions under the doctrine. In limiting the doctrine, the Court disallowed a business expense deduction only if the deduction contravened a federal policy expressed in a statute or regulation, rather than "policies evidenced by some governmental declaration of them" as the Court laid out six years earlier.[39] For example, the Court allowed the deductions of rent and wages to conduct an illegal gambling business because paying rent and payroll did not violate an expressed federal policy through statute or regulation.[40] The Court forewarned that disallowing tax deductions to illegal businesses would result in discrimination not provided for in the Code.[41]

In 1966, the Supreme Court again narrowed the application of the public policy doctrine when it held where there are no violations of an expressed federal policy, only in extremely limited circumstances may the Court

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33 *See* Lilly v. Comm'r, 343 U.S. 90, 91 (1952).

34 *See id.* at 94.

35 *Id.* at 97.

36 *See* Comm'r v. Sullivan, 356 U.S. 27, 28–29 (1958).

37 H.R. REP. NO. 64-16763, at 757 (1916).

38 *See Sullivan*, 356 U.S. at 28–29.

39 *See id.* (allowing the deductions for rent and wages to conduct an illegal gambling business); Lilly v. Comm'r, 343 U.S. 90, 97 (1952); Charles A. Borek, Comment, *The Public Policy Doctrine and Tax Logic: The Need for Consistency in Denying Deductions Arising from Illegal Activities*, 22 U. BALT. L. REV. 45, 53 (1992); Carrie F. Keller, Comment, *The Implications of I.R.C. § 280E in Denying Ordinary and Necessary Business Deductions to Drug Traffickers*, 47 ST. LOUIS L.J. 157, 160–61 (2003).

40 *See Sullivan*, 356 U.S. at 28–29.

41 *See id.* at 27, 29.

disallow deductions for business expenses.[42] In defining extremely limited circumstances, the deduction must frustrate sharply defined national or state policies and the allowance of such deduction must be severe and immediate.[43] The case was of a taxpayer who deducted attorneys' fees as a business expense for his securities fraud business.[44] The Commissioner of the IRS argued that allowing the taxpayer to deduct these expenses, even though the expenses themselves were legal, violated public policy because the IRS would be benefitting an illegal enterprise.[45]

Justice Stewart, writing for the Court, held the taxpayer's legal expenses were deductible because the expenses satisfied the meaning of "ordinary" and "necessary" under Section 162, and no exceptional circumstance existed to enforce the public policy doctrine.[46] This holding suggests per se illegal business expenses are not automatically disallowed because an expense could frustrate sharply defined policies yet not be severe and immediate. The public policy doctrine resulted in inconsistent treatment of business owners because an illegal business owner could be taxed on a gross receipts basis, while another illegal business owner could be taxed on a net income basis.

The Supreme Court's solution to ease the public's uneasiness and uphold the drafters' intent to raise revenue—the public policy doctrine—gave too much discretion to the Court and resulted in an unclear rule.[47] So, Congress codified the narrow treatment of the public policy doctrine into the 1969 Tax Code.[48] The 1969 Code still allowed deductions for legal expenses made in relation to an illegal business, but Section 162 now disallowed deductions, on the basis of public policy, for illegal business expenses such as bribes and kickbacks or other illegal payment under any law.[49] The codification satisfied Congress's intent to limit the public policy doctrine, as the Supreme Court encouraged since 1958.[50] The codification set a clear rule,

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42 Comm'r v. Tellier, 383 U.S. 687, 693–94 (1966).

43 *See id.* at 694 (quoting Tank Truck Rentals v. Comm'r, 356 U.S. 30, 35 (1958)).

44 *Id.* at 688.

45 *Id.* at 690.

46 *Id.* at 694 (construing the term "necessary" as imposing only the minimal requirement that the expense be "appropriate and helpful" for "the development of the [taxpayer's] business"). *But see* Tank Truck Rentals v. Comm'r, 356 U.S. 30, 35–36 (1958) (disallowing the deduction of payment of fines imposed for violations of state maximum weight laws because allowing this deduction would immediately frustrate the policy of imposing the penalties in the first place).

47 S. REP. NO. 91-552, at 273 (1969) (indicating that the legislation "represents a codification of the general court position").

48 *See* Tax Reform Act of 1969, Pub. L. No. 91-172, § 902, 83 Stat. 487, 710 (codified as amended at I.R.C. §§ 162(c), (f), (g) (2016)).

49 *See id.*

50 *See* Comm'r v. Sullivan, 356 U.S. 27, 29 (1958).

promoted public safety, and upheld the drafter's intent to raise revenue, which is the main responsibility of the IRS.[51]

The codification of Section 162 hinged deductibility on the legality of business expense, not the legality of the business itself. This more nuanced approach did not survive Congress's codification of the 1982 Tax Code. With public concern about illicit drug use rising and President Nixon's declaration of the War on Drugs in the 1970s, the 1982 Tax Code turned the reading of Section 162 on its head. The 1982 Code re-focused Section 162 to turn on the legality of the business, rather than the legality of the business expense.

III. HOW PRESIDENT NIXON'S "WAR ON DRUGS" RESHAPED THE INTERNAL REVENUE CODE

America and cannabis have a well-documented industrial and medicinal relationship. Around 1611, colonist farmers cultivated America's first cannabis crop and used the plant as fiber for rope and clothing.[52] By the 1850s, cannabis was a patent medicine available in U.S. pharmacies, where it remained a staple for sixty years.[53] In 1906, Congress passed the Federal Food and Drug Act, one of the nation's first efforts to regulate commercial drugs, food, and dietary supplements.[54] This Act allowed the U.S. Department of Agriculture to ensure the safe use of cannabis through its Bureau of Chemistry.[55] However, by the early 1920s, cities and states in the South began prohibiting the use of cannabis.[56] In many of these states, the rationale was racially motivated.[57] Lurid newspaper headlines promoting the alleged dangers of cannabis swept the nation and led to the establishment of the Federal Bureau of Narcotics ("FBN")—an agency used to warn Americans about the alleged perils of "pot."[58]

Public concern about illegal drug use rose in the 1930s due to the FBN's media campaign that warned Americans of the alleged perils of cannabis.[59]

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51 *See* Thor Power Tool Co. v. Comm'r, 439 U.S. 522, 542 (1979) (stating that the main purpose of the IRS is the equitable collection of revenue).

52 STEVE FOX, PAUL ARMENTANO & MASON TVERT, MARIJUANA IS SAFER SO WHY ARE WE DRIVING PEOPLE TO DRINK? 46 (2013).

53 *Id.*

54 *Part I: The 1906 Food and Drug Act and Its Enforcement*, U.S. FOOD & DRUG ADMIN. (2019), https://www.fda.gov/AboutFDA/History/FOrgsHistory/EvolvingPowers/ucm054819.htm.

55 *Id.*

56 FOX, *supra* note 52, at 47.

57 *Id.*

58 *Id.* at 48.

59 *Id.*

In 1930, Congress renamed the FBN the Food and Drug Administration ("FDA")—an agency that became the new regulatory body for drugs in the United States. In 1937, Representative Robert L. Doughton of North Carolina responded to the public's concern when he introduced House Bill 6385.[60] The bill sought to stamp out the adult-use of cannabis by imposing a prohibitive tax on the plant.[61]

House Bill 6385 was challenged. First, Fiorello La Guardia, then mayor of New York City, formed a committee to study the effects of cannabis.[62] In 1944, the committee published the La Guardia Report, which concluded that cannabis was not addictive, was not motivating in major crimes, and was not common among children.[63] Second, in a legislative hearing, the American Medical Association ("AMA") opposed the bill when it argued that the proposed legislation would severely hamper physicians' ability to utilize cannabis's therapeutic potential.[64] Despite the La Guardia Report and the AMA's protest, President Franklin Roosevelt signed the Marihuana Tax Act into law, ushering in the federal government's venture into the criminal enforcement of cannabis laws.[65]

The 1960s, almost thirty years after the passage of federal cannabis prohibition, brought dramatic social change to the United States, and in many ways, cannabis was at the center of it.[66] The counterculture movement centered on freedom, civil rights, and peace. Drugs, specifically cannabis, seemed to crystallize all the negatives of the counterculture due to its presence in music and widespread use among young adults.[67] Cannabis struck uneasiness in parents, local law enforcement, and likely triggered President Nixon's focus on substance abuse during his presidency.[68]

In 1971, with the goal to stop drug use in the United States, President Nixon declared a War on Drugs.[69] As part of his War on Drugs, President Nixon enacted the Comprehensive Drug Abuse Prevention and Control Act of 1970, which has had lasting effects on today's United States cannabis

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60 *Id.* at 50.

61 *Id.*

62 JOHN HUDAK, MARIJUANA: A SHORT HISTORY 38 (2016).

63 *Id.*

64 FOX, *supra* note 52, at 51.

65 *Id.* at 45.

66 HUDAK, *supra* note 62, at 41.

67 Albert Rosenfeld, *Marijuana: Millions of Turned-on Users*, LIFE, July 7, 1967, at 17.

68 HUDAK, *supra* note 62, at 42; *A Brief History of the Drug War*, DRUG POL'Y ALLIANCE, http://www.drugpolicy.org/issues/brief-history-drug-war (last visited Feb. 16, 2019).

69 ELAINE B. SHARP, THE DILEMMA OF DRUG POLICY IN THE UNITED STATES 1 (1994).

market.[70] Title II of this Act, also known as the Controlled Substances Act ("CSA"), serves as the legal foundation for the government's War on Drugs.[71] The Act created the Drug Enforcement Administration ("DEA") to enforce the CSA and determine how certain drugs and substances will be regulated.[72] The CSA also categorizes drugs and substances.[73] Rather than leaving the classifications of drugs to the FDA or scientific community, Congress categorized the substances into five "schedules" based on the drug or substance's medicinal value and potential for abuse.[74]

Schedule I drugs are considered the most dangerous because they have high potential for abuse and have no currently accepted medical use in the United States.[75] Congress classified cannabis, LSD, and heroin as Schedule I drugs.[76] Schedule II drugs also have high potential for abuse but have an accepted medical use in the United States.[77] Cocaine is a Schedule II drug.[78] Schedule III drugs have a lower potential for abuse and have a currently accepted medical use.[79] Schedule IV drugs have an even lower potential for abuse and a currently accepted medical use.[80] Schedule V drugs are considered to be the least dangerous because they have the lowest potential for abuse and have a currently accepted medical use.[81] Schedule V substances are typically over-the-counter medicines, such as cough medications with small amounts of codeine.

The classification of cannabis as a Schedule I drug was intended to be temporary because the CSA also called for the creation of a federal commission to study cannabis.[82] After two years of research, Congress's cannabis commission, the National Commission on Marijuana and Drug Abuse, rebutted negative claims about cannabis.[83] Speaking before Congress, the commission's chairperson, Republican governor Raymond P. Shafer of

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70 HUDAK, *supra* note 62, at 53.

71 Edward J. Roche, Jr., *Federal Income Taxation of Medical Marijuana Businesses*, 66 TAX LAW. 429, 438 (2013); 21 U.S.C. § 812 (2016).

72 21 U.S.C. § 812 (2016).

73 *Id.*

74 *Id.*; HUDAK, *supra* note 62, at 54.

75 21 U.S.C. § 812 (2016).

76 *Id.*

77 *Id.*

78 *Id.*

79 *Id.*

80 *Id.*

81 *Id.*

82 FOX, *supra* note 52, at 54–55.

83 *Id.* at 55 (finding no causal connection between the consumption of cannabis and the commission of violent or aggressive acts).

Pennsylvania, recommended Congress decriminalize cannabis "because of little proven danger of physical or psychological harm" and that cannabis should no longer be classified as a Schedule I drug.[84] President Nixon did not adopt the commission's recommendation, thus keeping cannabis under the Schedule I classification.[85]

The CSA expanded government power over the regulation of drugs on all levels.[86] State legislatures expanded on the federal initiative and utilized the CSA's scheduling system to update their criminal statutes in accordance with the CSA.[87] With the DEA empowered, and the most comprehensive prohibition of substances in American history enacted into law, future presidents would rely heavily on the DEA and CSA to boost their "tough on crime, tough on drugs" initiatives.[88]

President Nixon resigned in August 1974, but the War on Drugs raged on. Throughout the 1980s, public concern about drug use built, largely due to media portrayals of people addicted to the smokable form of cocaine dubbed "crack."[89] This concern set up President Ronald Reagan's expansion of Nixon's War on Drugs policies soon after he took office in 1981.[90] President Reagan took numerous approaches to deter drug use—mostly through "no tolerance" criminal statutes like mandatory prison sentencing for simple possession—but President Reagan also combatted drug trafficking through federal taxation.[91]

As previously discussed, up until 1982, the Internal Revenue Code and U.S. courts used the legality of the business expense, not the legality of the business itself, as the touchstone to determine tax deductibility. The United States Tax Court permitted individuals engaged in illegal drug trafficking to deduct their ordinary and necessary business expenses, as long as the expenses satisfied the interpretation of "ordinary" and "necessary" under

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84 *Id.* at 56.

85 *Id.*; *see* Dan Baum, *Legalize it All: How to Win the War on Drugs*, HARPER'S MAG. (Apr. 2016), https://harpers.org/archive/2016/04/legalize-it-all/ (It is documented that the CSA's scheduling framework was racially motivated. In 2016, John Ehrlichman, an aide to President Nixon, told Harper's Magazine the goal of the War on Drugs was to disrupt black communities, stating, "[We got] the public to associate the hippies with marijuana and blacks with heroin, and then [criminalized] both heavily. Did we know we were lying about the drugs? Of course we did.").

86 HUDAK, *supra* note 62, at 54.

87 *See* NAT'L CRIMINAL JUSTICE ASS'N, A GUIDE TO STATE CONTROLLED SUBSTANCES ACTS 13–122 (1999) (describing how each state modeled their laws after the CSA).

88 HUDAK, *supra* note 62, at 54.

89 *A Brief History of the Drug War*, DRUG POL'Y ALLIANCE, http://www.drugpolicy.org/issues/brief-history-drug-war (last visited Feb. 16, 2019).

90 HUDAK, *supra* note 62, at 71.

91 *Id.*

Section 162 as the Supreme Court set out in 1966.[92] In direct response to *Edmondson v. Commissioner*, a case that had been decided before the United States Tax Court in 1981, the drafters of the 1982 Tax Code parted ways with the 1969 Tax Code and turned the focus of deductibility to the legality of the business itself.[93]

In *Edmondson*, the petitioner, a self-employed drug dealer, sold cannabis, cocaine, and amphetamines out of his apartment.[94] He asserted his right under Section 162 to deduct business expenses, even though his enterprise was illegal.[95] In the taxable year in question, the petitioner's business expenses included $105,300 in cost of goods sold, $787 in rent, $216 in telephone calls, and $50 for a small scale.[96] The Tax Court held Edmonson was allowed to deduct those expenses because the expenses "constitute[d] . . . ordinary and necessary expense[s] of petitioner's business."[97] Thus, the Tax Court continued the regular application of "ordinary and necessary" under Section 162 to only mean "appropriate and helpful" in the "development of the [taxpayer's] business."[98]

After this opinion was published, Congress sought to prevent other drug traffickers from following suit.[99] Congress's Senate Finance Committee thought allowing drug dealers to benefit from business expense deductions, while "stealing billions of dollars per year from U.S. citizens," was against the public's best interest.[100] The Committee urged that "such deductions must be disallowed on public policy grounds."[101] As a result, Congress used the CSA's categorization system and enacted Section 280E as part of the Tax Equity and Fiscal Responsibility Tax Act of 1982.[102] Section 280E is a tax

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92 S*ee* Edmondson v. Comm'r, 42 T.C.M. (CCH) 1533 (1981) (allowing a drug dealer to deduct his business expenses in relation to his drug trafficking business and construing the term "necessary" as imposing only the minimal requirement that the expense be "appropriate and helpful" for "the development of the [taxpayer's] business"); *see also* Comm'r v. Tellier, 383 U.S. 687, 694 (1966) (construing the term "necessary" as imposing only the minimal requirement that the expense be "appropriate and helpful" for "the development of the [taxpayer's] business").

93 26 U.S.C. § 280E (1982); *Edmonson*, 42 T.C.M. (CCH) 1533.

94 *Edmondson*, 42 T.C.M. (CCH) at 1533.

95 *Id.*

96 *Id.*

97 *Id.*

98 *See* Comm'r v. Tellier, 383 U.S. 687, 694 (1966) (construing the term "necessary" as imposing only the minimal requirement that the expense be "appropriate and helpful" for "the development of the [taxpayer's] business").

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

100 *Id.*

101 *Id.*

102 *See* Tax Equity and Fiscal Responsibility Tax Act of 1982, Pub. L. No. 97-248, § 351, 96 Stat. 324 (codified as 26 U.S.C. § 280E (1982)).

law that denies the deduction of virtually all business expenses to businesses selling Schedule I or Schedule II controlled substances under the Controlled Substances Act:

> No deduction or credit shall be allowed for any amount 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.[103]

With the enactment of Section 280E, if a taxpayer trafficked a Schedule I or II substance, they lost the ability to deduct virtually all business expenses under Section 162, except for cost of goods sold. On its face, Section 280E contradicts the originally stated purpose of the Code—to tax all income regardless of the legality of the enterprise.[104] Section 280E stands in direct conflict with the drafters' intent to derive tax revenue from "any source whatever."[105] The Supreme Court and Tax Court used the drafters' intent as a foundation for determining deductibility from 1916 to 1981. The decision to enact Section 280E hinged on Congress's primary goal to deter drug use, which contradicts the drafters' intent not to change a man's moral character.[106]

The desired result of Section 280E was to burden drug traffickers when they filed federal income tax for their business by disallowing virtually all business expense deductions of their illegal enterprise. In theory, the drug trafficker would be overburdened by the lack of available deductions under Section 162 and eventually dissolve their illegal drug trafficking business. Congress did not change Section 162 in any way. Congress merely took the ability to deduct business expenses under Section 162 away from drug dealers, except for cost of goods sold, which is discussed later in this Comment.[107]

The 1982 House Report does not shed light on Congress's intent behind Section 280E, but the 1982 Senate Report shows that Congress relied on public policy as the primary reason to add Section 280E into the Tax Code.[108] The Report noted Congress's dislike for drug dealing when it stated that drug

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103 26 U.S.C. § 280E (1982).

104 50 CONG. REC. 3849 (1913).

105 H.R. REP. NO. 64-16763, at 757 (1916).

106 50 CONG. REC. 3849 (1913).

107 S. REP. NO. 97-494, at 309 (1982) (allowing deductions for COGS because Congress feared possible constitutional challenges to the law).

108 *Id.*

dealers "should not be afforded the benefit of business expense deductions."[109] Congress believed "there is sharply defined public policy against drug dealing."[110] The Senate Report shows no indication that Congress tried to satisfy the public policy doctrine test set out by the Supreme Court, but the codification aligned with the doctrine.[111] Reading the legislative history, it is reasonable to infer that Congress thought an exceptional circumstance existed, as the Court defined in 1966.[112] Allowing drug dealers to deduct business expenses frustrated sharply defined national policy and the CSA, and allowing these deductions was severe and immediate because the United States was fighting a "War on Drugs."

Section 280E reaches further than Section 162 because Section 280E even disallows deductions for expenses that are not illegal per se (e.g., salaries, rent, telephone) to businesses who traffic Schedule I or II substances. In comparison, Section 162 only disallows deductions for illegal expenses.[113] Section 280E reintroduced the inconsistency the 1969 Congress eliminated when they codified the public policy doctrine into Section 162. Under the 1969 Code, state-legal cannabis businesses owners would be able to deduct all business expenses afforded to mainstream industries because business expenses in today's legal cannabis industry meet "ordinary and necessary" under the Supreme Court's interpretation of Section 162.[114] Business expenses like rent, payroll, and advertising are "appropriate and helpful" for "the development of the [taxpayer's] business."[115]

By denying virtually all business deductions to businesses who traffic Schedule I or II substances, those businesses must pay taxes on gross receipts compared to another legal, or even illegal, business that pays taxes on net income. This Comment focuses on the application of Section 280E to the United States legal cannabis industry because cannabis is the only Schedule I drug that has a legitimate marketplace. When applied, Section 280E contradicts the intent of Section 280E itself—to punish illegal drug dealers—

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109 *Id.*

110 *Id.*

111 *See* Charles A. Borek, Note, *The Public Policy Doctrine and Tax Logic: The Need for Consistency in Denying Deductions Arising from Illegal Activities*, 22 U. BALT. L. REV. 45, 56 (1992).

112 *See* Comm'r v. Tellier, 383 U.S. 687, 694 (quoting Tank Truck Rentals v. Comm'r, 356 U.S. 30, 35 (1958)).

113 I.R.C. § 162(c), (f), (g) (2016) (disallowing tax deductions for specified illegal payments).

114 *See Tellier*, 383 U.S. at 694 (construing the term "necessary" as imposing only the minimal requirement that the expense be "appropriate and helpful" for "the development of the [taxpayer's] business"); *see also* H.R. REP. NO. 64-16763, at 757 (1916).

115 Edmondson v. Comm'r, 42 T.C.M. (CCH) 1533 (1981) (holding that cost of goods sold, rent, telephone calls, and a small scale "constitute[d] . . . ordinary and necessary expense[s] of petitioner's trade or business").

because Section 280E punishes legal businesses. Section 280E is outdated because trafficking cannabis is legal in thirty-three states and D.C. Section 280E does not satisfy the expectations for any of its goals: combatting the flow of drugs into the United States, significantly reducing drug use, or having an educational impact.[116]

IV. SECTION 280E CRIPPLES THE DEVELOPMENT OF THE UNITED STATES LEGAL CANNABIS INDUSTRY AND DOES NOT REDUCE ILLEGAL DRUG USE

The Nixon and Reagan administrations set the stage for such low support for cannabis reform going into Bill Clinton's presidency in 1992. Vilifying and marketing cannabis to the American public as a threat successfully maintained the status quo "no tolerance" drug policies, but support for legalization began to increase. Americans who experimented with cannabis saw that they did not become murderers or college drop outs.[117] Their experience with cannabis was far less evil than the government warned for decades.[118] The traditional War on Drugs advertisements started to evoke humor, rather than fear, and the generation that led the counterculture movement started to have children.[119] From 1996 to 2000, seven states, including California, passed medical cannabis laws, which positively affected public opinion of the plant.[120]

A. A Short History of United States Cannabis Markets

The cannabis industry is similar to any other traditional agricultural industry. Farmers grow the crop in greenhouses or outdoors, regularly tend to the crop, and develop irrigation systems to achieve the best yield. Farmers also research how best to prevent pests and disease, which pesticides are safe and effective, and how genes and environment affect the production of key plant chemicals, like tetrahydrocannabinol ("THC") and cannabidiol ("CBD").

As Americans were exposed to functioning and legal cannabis markets, more states soon followed. By 2000, support for cannabis legalization polled

116 HUDAK, *supra* note 62, at 81.

117 *Id.* at 93.

118 *Id.*

119 *Id.* at 91.

120 *Id.*; *see* Henchman, *supra* note 10, at 2.

at 31% among Americans.[121] In 2013, 85% of Americans supported legalizing cannabis.[122] In 2019, with over 66% of Americans supporting the legalization of cannabis, thirty-three states and D.C. have state-regulated medical or adult-use cannabis markets.[123] Legal Cannabis markets stimulate state economies and fight the opioid crisis that claims tens of thousands of lives each year.[124] For example, Florida, with a comparatively limited medical cannabis program, had over 200,000 registered medical cannabis patients within three years of implementing their program.[125] In 2018, Florida was projected to generate between $200 million and $300 million in sales revenue—a high projection for such a young and limited program that does not sell edible products, the second most common delivery method among consumers.[126] With Governor Ron DeSantis' recent signing of SB-182, a bill that allows dispensaries to sell the whole flower, that projection could be higher in 2019.[127]

States vary widely in how they regulate their respective cannabis programs. Some states, like Florida, implement a vertically integrated market where Medical Marijuana Treatment Centers ("MMTC"), sometimes referred to as dispensaries, sell cannabis only to registered patients. In a vertically integrated system, a cannabis business must grow, cultivate, process, deliver, and sell the cannabis. This all-in-house process is coined "seed-to-sale." Other states implement horizontally integrated markets, where licenses are awarded per sector. For instance, if a business owner wanted to only cultivate, she would apply for a license for solely cultivation. If a business owner wanted to only operate retail stores, she would apply for a license just for retail operations.

As states started to implement their cannabis programs, the federal government prosecuted violators of the CSA regardless of if the violators

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121 HUDAK, *supra* note 62, at 92.

122 *Id*. at 90.

123 *See* National Cannabis Industry Association, *NCIA's 2019 Policy Re-Cap*, YOUTUBE (Dec. 21, 2018), https://www.youtube.com/watch?time_continue=2&v=ivSz3RxpsL8.

124 National Cannabis Industry Association, *The Benefits of Legalization—An Animated Educational Video*, YOUTUBE (Dec. 4, 2018), https://www.youtube.com/watch?v=AzHHa8rKe0Y.

125 *OMMU Weekly update – Jan. 4, 2019*, FLA. DEP'T. OF HEALTH OFFICE OF MED. MARIJUANA USE (2019), http://www.floridahealth.gov/newsroom/2019/01/010419-ommu-update.html.

126 Jeff Smith, *How Florida's $250M Medical Cannabis Market Could Open Up to New Businesses in 2019*, MARIJUANA BUS. DAILY (Dec. 18, 2018), https://mjbizdaily.com/florida-medical-cannabis-2019/.

127 Samantha J. Gross, *On Medical Marijuana, Florida Gov. Ron DeSantis Wants to Heed the Will of Voters*, TAMPA BAY TIMES (Jan. 17, 2019), https://www.tampabay.com/florida-politics/buzz/2019/01/17/on-medical-marijuana-florida-gov-ron-desantis-wants-to-heed-the-will-of-voters/.

complied with their state's law.[128] But, as public opinion about the plan continued to shift, and more states legalized the plant, the Department of Justice ("DOJ") lowered their prosecution priority for state-legal cannabis businesses. In 2009, Deputy United States Attorney David W. Ogden issued the "Ogden Memorandum," which announced the DOJ would not focus their prosecutorial resources to pursue cannabis companies who are in "clear and unambiguous compliance" with their state's cannabis laws.[129] In 2011, Deputy United States Attorney James M. Cole reaffirmed the DOJ's position from the Ogden Memo but reminded cannabis business owners they are still in violation of the Controlled Substances Act, even though they might comply with state law.[130]

In 2013, the DOJ, speaking directly to states who wanted to legalize cannabis, announced in the "2013 Cole Memo" that state legislation would be tolerated only if the state provided tight control of the market.[131] After the DOJ issued the 2013 Cole Memo, states built their cannabis licensing and taxation regulations to comply with the DOJ's guidelines. States and cannabis businesses owners are willing to operate under the DOJ guidelines because the memoranda eased relationships between cannabis businesses and ancillary businesses like landlords, municipal governments, and security companies.

In 2018, Attorney General Jeff Sessions reintroduced tension and uncertainty amongst cannabis business owners when he rescinded the 2013 Cole Memo.[132] In issuing the "Sessions Memo," Sessions rescinded all guidance on cannabis enforcement, which gave U.S. Attorneys full discretion

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128 *See, e.g.*, United States v. Oakland Cannabis Buyer's Co-op., 532 U.S. 483, 486 (2001); United States v. Cannabis Cultivators Club, 5 F. Supp. 2d 1086, 1092–93 (N.D. Cal. 1998).

129 *See* U.S. DEP'T OF JUSTICE, MEMORANDUM FOR SELECTED UNITED STATE ATTORNEYS ON INVESTIGATIONS AND PROSECUTIONS IN STATES AUTHORIZING THE MEDICAL USE OF MARIJUANA (Oct. 19, 2009).

130 *See* U.S. DEP'T OF JUSTICE, MEMORANDUM FOR SELECTED UNITED STATE ATTORNEYS: GUIDANCE REGARDING THE OGDEN MEMO IN JURISDICTIONS SEEKING TO AUTHORIZE MARIJUANA FOR MEDICAL USE (June 29, 2011).

131 *See* U.S. DEP'T OF JUSTICE, MEMORANDUM FOR ALL UNITED STATE ATTORNEYS: GUIDANCE REGARDING MARIJUANA ENFORCEMENT (Aug. 29, 2013) (listing eight compliance requirements with which the DOJ will tolerate their legislation including preventing distribution to minors, and preventing cannabis revenues from going to criminal enterprises, gangs, and cartels).

132 *See* U.S. DEP'T OF JUSTICE, MEMORANDUM FOR ALL UNITED STATE ATTORNEYS: MARIJUANA ENFORCEMENT (Jan. 4, 2018) [hereinafter ENFORCEMENT MEMO] (revoking Cole Memo); Brad Auerbach, *How Cannabis Entrepreneurs Feel About Sessions' Reversal of the Cole Memo*, FORBES (Mar. 3, 2018, 7:32 PM), https://www.forbes.com/sites/bradauerbach/2018/03/03/how-cannabis-entrepreneurs-feel-about-sessions-reversal-of-the-cole-memo/#3fce5474c4ae ("Sessions' rescission of the Cole and Ogden Memos will likely have at least a temporary chilling effect, particularly on new investment and banking.").

to determine to what extent they should enforce federal law.[133] Ironically, Attorney General Sessions pushed the cannabis conversation forward at the federal level because, just two months later, Congress added a rider to the DOJ's 2018 budget. This rider countered Sessions' recession of the 2013 Cole Memo because the rider forbade the DOJ from spending any of the budget prosecuting medical cannabis dispensaries or patients, thus reviving the ideals of the 2013 Cole Memo.[134] Confidence amongst stakeholders in the cannabis industry continued to grow when President Trump's attorney general nominee, William Barr, stated at his confirmation hearing on January 15, 2019, "My approach [is] not to upset settled expectations and the reliant interests that have arisen as a result of the [2013] Cole memorandum."[135] Even though the DOJ's attitude towards cannabis shifted to a more accepting view of the industry, the application of Section 280E has not.

B. Section 280E Is Outdated Because the Sale of Cannabis Is a Legal Business

Cannabis businesses in any medical or adult-use market must adhere to Section 280E and may only deduct their cost of goods sold ("COGS") as a business expense. COGS includes seeds, soil, water, nutrients, and expenses related to the cultivation and harvesting of the plant. Section 280E does not significantly affect cultivators because the overwhelming majority of their business expenses fall under COGS. However, costs associated with distribution, sale, administration, management, promotion, advertisement, overhead, and support are not allowable deductions. These costs include rent, shipping, employee salaries, contractor expenses, legal, management, accounting, utilities such as electricity, internet, telephone services, health insurance, rent and overhead, and compliance. [136] For most companies, a large percentage of the overall costs of the business do not fall into COGS.

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133 *See* ENFORCEMENT MEMO, *supra* note 132.

134 Consolidated Appropriations Act, 2018, Pub. L. No. 115-41, § 538, 132 Stat. 348, 444–45 (2018) ("None of the funds made available under this Act to the Department of Justice may be used, with respect to any of the [47] States [listed] . . . to prevent any of them from implementing their own laws that authorize the use, distribution, possession, or cultivation of medical marijuana.").

135 *Attorney General Confirmation Hearing, Day 1* (C-SPAN television broadcast Jan. 15, 2019).

136 NAT'L CANNABIS INDUS. ASS'N, INTERNAL REVENUE CODE SECTION 280E: CREATING AN IMPOSSIBLE SITUATIONS FOR LEGITIMATE BUSINESSES (2015), https://thecannabisindustry.org/uploads/2015-280E-White-Paper.pdf; *see* Derek Davis, *Taxes and Cannabis: How 280E Affects the Industry*, COLO. POT GUIDE BLOG (July 28, 2016), https://www.coloradopotguide.com/colorado-marijuana-blog/article/taxes-and-cannabis-how-280e-affects-the-industry/.

Paying taxes on gross receipts creates a significant tax burden that in many cases can make a company unprofitable. Without these deductions available, legal cannabis business owners must pay taxes on all their revenue without deducting business expenses to reduce their taxable income.[137] State-legal cannabis businesses owners are being unfairly treated compared to any other business, legal or illegal, because cannabis businesses owners cannot deduct business expenses, and thus pay taxes on gross receipts rather than net income. By disallowing cannabis business owners the opportunity to deduct business expenses, the Internal Revenue Code converts an income tax into a gross receipts tax. This tax rate is effectively a rate of 70% or higher, compared to the average corporate tax rate of 21%.[138] In turn, Congress punishes cannabis business owners who try to comply with the law, while creating a competitive advantage for illicit market dealers that Section 280E was enacted to punish.

Section 280E punishes legitimate businesses. This is not the intent of Section 280E. The legislative record suggests Section 280E was enacted to punish illegal drug dealers, not legal businesses.[139] Today, the distinction between legal cannabis businesses and illegal drug trafficking is material. The former distributes lab tested medicine to patients, while the latter sells unregulated substances to consumers who could be underage. Since the enactment of Section 280E, the federal government's opinion on cannabis businesses evolved to a more accepting perspective, and the opinion of cannabis changed globally. Countries such as Germany, Italy, Mexico, Switzerland, Australia, Argentina, and the United Kingdom have all legalized cannabis as a medicine. In 2018, Canada became the first G5 country to legalize adult-use cannabis federally. In January 2019, the World Health Organization proposed rescheduling cannabis within international law because the current classification of cannabis is not consistent with the research showing the medicinal benefits of the plant.[140]

Despite the slow and gradual implementation of legal cannabis programs, cannabis companies are quickly becoming global players. For example, one Canadian cannabis company, Aurora Cannabis Inc., operates

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137 *See* Henchman, *supra* note 10, at 2.

138 *See* NAT'L CANNABIS INDUS. ASS'N, *supra* note 136; Tax Foundation Staff, *Preliminary Details and Analysis of the Tax Cuts and Jobs Act*, TAX FOUNDATION (Dec. 2017), https://files.taxfoundation.org/20171220113959/TaxFoundation-SR241-TCJA-3.pdf.

139 S. REP. NO. 97-494, at 309 (1982) (enacting Section 280E because the U.S. Tax Court recently allowed a taxpayer to deduct expenses resulting from the "illegal drug trade").

140 Letter from Director General Tedros Adhanom to United States Secretary General Antonia Guterres (Jan. 24, 2019) (on file https://www.marijuanamoment.net/read-the-world-health-organizations-marijuana-rescheduling-recommendations/).

in twenty-four countries.[141] U.S. consumer spending on legal cannabis reached $10.4 billion dollars in 2018.[142] Even if no other states reform their laws, cannabis spending is expected to top $26.3 billion by 2025.[143] In late 2018, a Gallup poll showed two-thirds of Americans support the legalization of cannabis in some form.[144] This momentum underscores the immediate need to reform Section 280E to fully realize the potential for cannabis in the United States economy.[145] The legal cannabis industry is scaling, and Section 280E does not fit within what the U.S. and global markets have become.

When Congress passed Section 280E into law, no state had enacted legislation legalizing any form of cannabis. To Congress's credit, in 1981, Congress did not suspect legal drug trafficking would one day be a viable businesses model. In 2019, with thirty-three states and the District of Columbia now hosting medicinal or adult-use cannabis markets, Section 280E is applied to state-legal cannabis businesses more often than it is to the types of illegal drug dealers the drafters intended to penalize.[146] Although Schedule I and II substances might make up the greater majority of the illegal drug trade, Section 280E does not apply to drug traffickers who sell Schedule III, IV, or V substances.[147]

As applied, Section 280E contradicts the intent of Section 280E itself—to punish illegal drug dealers—not legal businesses. While the legislative record points to illegal drug traffickers as the targets of Section 280E, the IRS applies Section 280E to cannabis businesses in states that have legalized cannabis in some form because cannabis is still a Schedule I substance under federal law.[148] While some states legalized cannabis for medicinal or adult-

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141 *Overview*, AURORA CANNABIS INC., https://investor.auroramj.com/about#overview_section (last visited December 11, 2019).

142 *New Industry Group, The National Cannabis Roundtable, Launches with Former House Speaker John Boehner as Honorary Chairman*, GREENSPOONMARDER (Feb. 8, 2019), https://www.gmlaw.com/news/new-industry-group-the-national-cannabis-roundtable-launches-with-former-house-speaker-john-boehner-as-honorary-chairman/?fbclid=IwAR24S6CvzEdn8DjOhPR-wxor2POn4Yt6039vJ4KVhU_K5wvqeh1UQHCvYQ8.

143 *Id.*

144 *Id.*

145 *Id.*

146 *See* Gonzales v. Raich, 545 U.S. 1, 29 (2005) (holding that 280E applies even in States that have purported to legalize the sale of marijuana in some circumstances); NAT'L CANNABIS INDUS. ASS'N, *supra* note 136.

147 Carrie F. Keller, *The Implications of I.R.C. § 280E in Denying Ordinary and Necessary Business Expense Deductions to Drug Traffickers*, 47 ST. LOUIS L.J. 157, 168 (2003).

148 *See* 21 U.S.C. § 812 (2016); Olive v. Comm'r, 792 F.3d 1146, 1150 (9th Cir. 2015); Californians Helping to Alleviate Med. Problems, Inc. v. Comm'r (CHAMP), 128 T.C. 173, 182 (2007); S. REP. NO. 97-494, at 309 (1982) (enacting Section 280E because the U.S. Tax Court recently allowed a taxpayer to deduct expenses resulting from the "illegal drug trade").

use, federal law still considers the plant illegal, which means the IRS can continue, and does continue, to impose Section 280E on legal businesses that "traffic" the plant when they file their federal income tax.[149]

In turn, state-legal cannabis businesses struggle to survive because they have virtually no ability to deduct business expenses, compared to other businesses, legal or illegal, who are able to deduct rent on business property, salaries and wages, advertising, licensing fees, repair, and legal fees. With state markets online and operating, and Congress allowing the markets to grow without worry of federal prosecution by the DOJ, Section 280E remains an obstacle for state cannabis businesses because it denies state-legal cannabis business owners any deduction for any business expense, except for COGS. Despite the change in law at the state level, federal law has not changed, and this Comment proposes the need to.

C. Section 280E Does Not Satisfy Any IRS or War on Drugs Policy Goals

The goals of the War on Drugs were to combat the flow of illegal drugs into the United States, significantly reduce illegal drug abuse, and educate the public about illegal drugs and substances.[150] Section 280E does not reduce the flow of illegal drugs into the United States, it indirectly subsidizes it. Every state is contending with an illicit market that comprised more than 85% of cannabis sales in North America in 2016.[151] In 2018—two years after Massachusetts legalized cannabis—90% of cannabis sales were from the illicit market.[152] In 2019, cannabis sales in California totaled roughly $12 billion—$8.7 billion of that was generated in the illicit market.[153]

The illicit market is unregulated; thus, their products are not likely to be lab tested. Products from the illicit market pose a danger to human health. Recently, an outbreak of lung injury associated with the use of vaping

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149 26 U.S.C. § 280E (1982).

150 HUDAK, *supra* note 62, at 81.

151 Sean Williams, *The U.S. Has a Marijuana Legalization Catch-22 on Its Hands*, MOTLEY FOOL (Sept. 9, 2018, 11:41 AM), https://www.fool.com/investing/2018/09/09/the-us-has-a-marijuana-legalization-catch-22-on-it.aspx.

152 Naomi Martin, *Why Most Massachusetts Marijuana Sales Are on the Black Market, Two Years After Legalization*, BOS. GLOBE (Feb. 2, 2019, 4:35 PM), https://www.bostonglobe.com/news/marijuana/2019/02/02/illicit-pot-market-remains-stubbornly-robust/Fqq5baxLvgkrTB1ABJRbEL/story.html.

153 *California: Lessons from the World's Largest Cannabis Market Executive Summary*, BDS ANALYTICS (2019), https://bdsanalytics.com/wp-content/uploads/2019/08/2019_BDS_California_CIB_Exec_Summ_Final_With_A.pdf.

products spread across the United States—hospitalizing over 2,600 people.[154] The Center for Disease Control and the Federal Food and Drug Administration recommend people not use vaping products from informal sources like the illicit market.[155] Of 50% of patients who reported where they purchased their device, 78% of them reported informal sources.[156] A 2018 study published by Eaze Solutions reported that 18% of respondents purchased cannabis from the illicit market, "due to the illicit market having cheaper products and no tax."[157]

Not only do illicit market operators undercut legal obstacles from the start, like licensing and permit requirements, but Section 280E cripples the legal market's potential to scale, provide cheaper medicine, donate to charity, and give raises to their employees.[158] These burdens make it less appealing to a potential employee, consumer, or patient. Because of the business owner's inability to expand, patients have to drive upwards of sixty miles to get their medicine.[159] State-imposed lab testing for pesticides can cost upwards of $30,000 per year out of pocket.[160] While these tests are absolutely necessary to make the legal market safe for consumers, cannabis businesses cannot deduct these tests as a business expense. Even though these business expenses are legal, thus deductible under Section 162, cannabis businesses are forced to inflate prices in order to make up for their inability to deduct business expenses. Consequently, Section 280E pulls consumers and patients

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154 *Outbreak of Lung Injury Associated with the Use of E-Cigarette, or Vaping, Products*, CDC https://www.cdc.gov/tobacco/basic_information/e-cigarettes/severe-lung-disease.html (last updated Feb. 11, 2020).

155 *Id.*

156 *Id.*

157 *See The High Cost of Illegal Cannabis*, EAZE INSIGHTS (2018), https://cms-assets.eaze.com/content/2018/08/07204402/Eaze-Insights_08_01_2018_V4.pdf.

158 *The Small Business Tax Equity Act: Supporting a Just Cause at NCIA Lobby Days*, NAT'L CANNABIS INDUS. ASS'N, https://thecannabisindustry.org/tag/mindrite-pdx/ (last visited Feb. 16, 2020) ("MindRite can't write off their tens of thousands of dollars in charitable donations because 280E hinders it."); *see* National Cannabis Industry Association, *NCIA's 2019 Policy Re-Cap*, YOUTUBE (Dec. 21, 2018), https://www.youtube.com/watch?time_continue=2&v=ivSz3RxpsL8; National Cannabis Industry Association, *What Is Section 280E of the IRS Tax Code, and How Does It Affect Cannabis Businesses?*, YOUTUBE (Apr. 16, 2018), https://www.youtube.com/watch?v=ecSfsIGqEdo.

159 Brad Branan & Nathaniel Levine, *Weed Is Legal. But this Map Shows Just How Much of California Is a 'Pot Desert,'* SACRAMENTO BEE (Mar. 25, 2018, 9:03 AM), https://www.sacbee.com/news/state/california/california-weed/article205524479.html.

160 Bart Schaneman, *Mandatory Testing Costly for Colorado Marijuana Growers*, DENVER POST (Aug. 26, 2018, 6:00 AM), https://www.denverpost.com/2018/08/26/colorado-marijuana-mandatory-pesticide-testing/.

into the illicit market because the prices are cheaper.[161] Until Section 280E is modernized to allow cannabis companies to deduct similar expenses taken by more mainstream industries, patients and adult-consumers will continue to use cheaper, unregulated illicit-market cannabis products.

If the federal government wants to deter illegal drug use and abuse, they should tax cannabis businesses on a net income basis, rather than a gross receipts basis.[162] Taxing cannabis businesses on a net income basis would make it less profitable for illicit market sellers to make illegal sales, thus diverting more business through legal regulatory channels. States and municipalities are taking notice of how tax laws like Section 280E strengthen the competitive position of illegal markets, thus hurting legal businesses.[163] In 2017, Colorado reduced its state cannabis tax in order to remain competitive with the illicit market.[164] More recently, a California state bill was introduced specifically to "protect legitimate taxpaying businesses and stop the illegal illicit market."[165]

Over time, Section 280E will not help the IRS raise revenue, which is its main responsibility.[166] In molding the public policy doctrine, the Supreme Court tried to balance the public's uneasiness towards illegal activities with the Code's intent to raise revenue by taxing income derived from whatever source. Congress's codification of Section 280E did not evenly balance the two. Section 280E tips the public's uneasiness to far outweigh the Code's intent to raise revenue by taxing income derived from whatever source. Yes, the IRS is using Section 280E to generate tax revenue, but these revenues will only last so long. If Congress does not reform Section 280E, is it reasonable to think the IRS will eventually tax the cannabis industry out of business and as a result lose out on future revenue. In fact, California officials blamed the growth of the illicit market for their underachieving tax

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161 *The High Cost of Illegal Cannabis*, *supra* note 157, at 2 (84% of respondents are highly likely to purchase through the illicit market in the future due to the illicit market having cheaper products and no tax).

162 A reading of the legislative history of Section 280E suggests that this was, in fact, their goal.

163 *Fitch: CA Cannabis Tax Cut Reflects Challenge of Illegal Sales*, FITCH RATINGS (Feb. 22, 2018), https://www.fitchratings.com/site/pr/10021117.

164 *High Times with 280E*, ALVAREZ & MARSAL HOLDINGS, LLC, 1, 3 (2016), https://www.alvarezandmarsal.com/printpdf/19641.

165 *See* A.B. 286, 2019–2020 Leg., Reg. Sess. (Cal. 2018); Jeff Daniels, *California Proposes Slashing Pot Taxes to Help Regulated Industry Compete with Black Market*, CNBC (Jan. 28, 2019, 7:18 PM), https://www.cnbc.com/2019/01/28/calif-bill-introduced-to-slash-pot-taxes-as-legal-industry-struggles.html?__source=twitter%7Cmain.

166 *See* Thor Power Tool Co. v. Comm'r, 439 U.S. 522, 542 (1979) (stating that the main purpose of the IRS is the equitable collection of revenue).

revenues.[167] Taxing cannabis businesses on a net income basis would allow the businesses to reach sustainability, and, in turn, would let the United States reap tax revenues for years to come.

V. THE CURRENT LEGAL LANDSCAPE ALLOWS CANNABIS BUSINESSES TO CO-EXIST ALONGSIDE SECTION 280E

Section 280E is crippling the United States cannabis market from developing. Without tax deductions available to mainstream businesses, cannabis businesses cannot mature, thus leaving patients and adult consumers having to resort to the illicit market. Congress should amend Section 280E for three reasons. First, Section 280E negatively impacts business owners, patients, and consumers. Business owners struggle to stay afloat, patients in rural areas lack access to medicine, and adult consumers are forced to purchase unregulated cannabis from the illicit market. Second, the social context in which Section 280E was enacted changed. The sale of medical or adult-use cannabis in the United States is a legitimate industry that employs over 211,000 people full-time.[168] By comparison, 112,000 people work in textile manufacturing and 52,000 people work in coal mining in the United States.[169] Third, the IRS uses Section 280E to punish legitimate businesses, which is not the intent of Section 280E.[170]

States recognize the cannabis industry as a legitimate business, but lawmakers are thwarting the United States' ability to compete in the global market because they have not provided a level playing field for U.S. cannabis companies to develop. The most effective way to help business owners stay afloat and give patients and consumers access to safe cannabis is through legislative action. Lawmakers have taken inconsequential steps to address this problem. In 2017, Congress signed the most significant overhaul of the Tax Code since 1986—the 2017 Tax Cuts and Jobs Act.[171] The Act did not repeal or even amend Section 280E. Despite these hurdles, the current legal landscape provides creative avenues for cannabis businesses to alleviate their

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167 Brooke Staggs, *California Made $345 Million, Not Predicted $1 Billion, on Legal Cannabis in 2018*, WHITTIER DAILY NEWS (Feb. 19, 2019), https://www.whittierdailynews.com/2019/02/19/california-made-345-million-not-predicted-1-billion-on-legal-cannabis in2018/?fbclid=IwAR1_A6W8s0ufYEwsQdOF2PLyXdIAHur2jhQzdcCV6Lx07RzfB4oIkg8OYC0.

168 *See* BARCOTT & WHITNEY, supra note 6, at 1.

169 *Id.* at 2.

170 S. REP. NO. 97-494, at 309 (1982) (enacting Section 280E because the U.S. Tax Court recently allowed a taxpayer to deduct expenses resulting from the "illegal drug trade").

171 William G. Gale, *A Fixable Mistake: The Tax Cuts and Jobs Act*, BROOKINGS (Sept. 25, 2019), https://www.brookings.edu/blog/up-front/2019/09/25/a-fixable-mistake-the-tax-cuts-and-jobs-act/.

tax burden. The two most successful methods cannabis business owners use to maneuver around Section 280E are the second-line-of-business argument and accounting as many costs as possible into the COGS section of the business's tax return.

A. Second-Line-of-Business Argument

Under the second-line-of-business argument, a cannabis business owner argues that it is engaged in two trades or businesses; thus, Section 280E should only apply to the line of business where cannabis is trafficked. In 2007, Californians Helping to Alleviate Medical Problems, Inc. ("CHAMP") raised this argument.[172] CHAMP, a nonprofit medical cannabis community center whose members had debilitating diseases, operated with a dual purpose.[173] Its primary purpose was to provide caregiving services to its members, and its secondary purpose was to provide medical cannabis in compliance with California law.[174] In providing caregiving services, CHAMP offered field trips, social events, educational classes, and distributed food and hygiene supplies.[175] CHAMP argued that its business expenses for its caregiving services should not be subject to Section 280E because the expenses were separate and apart from petitioner's supplying of medical cannabis.[176]

The U.S. Tax Court agreed, holding that CHAMP could not deduct business expenses for supplying cannabis but could deduct expenses associated with its caregiving services.[177] The court found, after considering the "degree of economic interrelationship between the two undertakings," that CHAMP was involved in more than one business.[178] The Court did not apply Section 280E to the part of the business where CHAMP provided caregiving services because the caregiving services were substantially different from CHAMP's distribution of medical cannabis.[179] CHAMP could deduct the business expenses related to the caregiving services because these expenses related to the separate "caregiving" services, which are justified

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172 Californians Helping to Alleviate Med. Problems, Inc. v. Comm'r (CHAMP), 128 T.C. 173, 180 (2007).

173 *Id*. at 174–75.

174 *Id.* at 174.

175 *Id.* at 183.

176 *Id.* at 180.

177 *Id.* at 183.

178 *Id.*

179 *Id.*

under Section 162. Despite a victory in this case, the U.S. Tax Court rarely accepts the second-line-of-business argument.

In contrast, in 2012, Martin Olive, an owner of a medical cannabis dispensary in California, unsuccessfully argued that his company operated two separate businesses.[180] Similar to CHAMP, Olive argued that he should be allowed to deduct expenses associated with his business's caregiving services.[181] The Tax Court disagreed and held Olive could not deduct expenses from his caregiving services.[182] Using the "degree of organizational and economic interrelationship of the businesses" analysis to determine the parameters of the business, the Court distinguished Olive's business from the business in *CHAMP*.[183] The primary purpose of Olive's medical cannabis dispensary was the retail sale of cannabis under California's medical cannabis law.[184] The business provided minimal activities and services.[185]

The differences between both companies were stark. Olive's business did not separate its dispensing of medical cannabis from its caregiving services, whereas 72% of CHAMP employees worked in the caregiving business and provided its caregiving services regularly, extensively, and substantially independent of providing medical cannabis.[186] CHAMP rented space at a church for peer group meetings and yoga classes, and the church did not allow cannabis on the church's premises.[187] All of Olive's employees worked in the cannabis business and regularly sold and helped patients consume cannabis on site.[188] Olive's business also had a single bookkeeper and accountant for all of its business, thus proving that the business was a single entity.[189] Both *Olive* and *CHAMP* established that the Tax Court will hold a cannabis business to a strict standard in establishing that it offers multiple lines of business.

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180 Olive v. Comm'r, 139 T.C. 19, 39 (2012), *aff'd*, 792 F.3d 1146, 1147 (9th Cir. 2015).

181 *Id.* at 39.

182 *Id.*

183 *Id.* at 41; *see* 26 C.F.R. § 1.183–1 (2019) (explaining that determining the degree of organizational and economic interrelationship of various undertakings is the most significant factor in determining whether the taxpayer is engaged in several undertakings); *see also* Tobin v. Comm'r, 78 T.C.M. (CCH) 517 (1999) (listing certain factors to consider in deciding whether a taxpayer's characterization of two or more undertakings as a single activity including "whether the undertakings are conducted at the same place" and "the degree to which the undertakings shared management").

184 *Olive*, 139 T.C. at 42.

185 *Id.* at 19.

186 *Id.* at 40.

187 *Id.*

188 *Id.* at 41.

189 *Id*. at 42.

CHAMP and *Olive* are the current templates in determining whether a business expense is deductible under Section 280E. A cannabis business can deduct expenses related to a separate trade or business that does not involve trafficking of cannabis, but the Tax Court has reaffirmed its strict standard when analyzing the second-line-of-business argument in numerous cannabis cases since *Olive*.[190] Reading these holdings together, good works or community involvement are not sufficient, by themselves, to support a tax deduction outside the application of Section 280E. In order to be deductible, such activity must be considered a separate trade or business entered into with a motive to realize profit.

If a cannabis business owner is to have any hope of wielding the second-line-of-business argument, they must be prepared to show that the alternate business line is extensive enough to stand on its own. A court is more likely to accept a separate business activity if the business owner shows that business line would be a viable business even in the absence of the sale of cannabis. If the business owner asserts it has a second line of business, they should *treat it* like a second line of business, accounting separately for its income and expenses so that if the IRS or courts are kind enough to agree with the taxpayer, the amount of deductible expenses are readily available.[191]

B. Allocating Expenses as "Cost of Goods Sold"

While on its face, Section 280E disallows cannabis businesses the deduction of all business expenses, cannabis business owners have used cost of goods sold (COGS) to their advantage. COGS are the costs of acquiring inventory through purchase or production, including shipping costs, and

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190 *See* CHAMP, 128 T.C. 173, 174–75 (2007); Beck v. Comm'r, 110 T.C.M. (CCH) 141, T.C. Memo 2015-149, at *P15 (2015) (disallowing deductions under the second-line-of-business argument because petitioner did not sell any non-cannabis-related items or services); *see also* Patients Mut. Assistance Collective Corp. v. Comm'r, 151 T.C. 176, 198 (2018) (holding that, under the degree of economic interrelationship between the two activities, Harborside had a single trade or business—the sale of cannabis—because Harborside dedicated the lion's share of its resources to selling cannabis and cannabis products, which accounted for over 99.5% of its revenue); Alterman v. Comm'r, 115 T.C.M. (CCH) 1452, T.C. Memo 2018-83, at 26 (2018) (holding that, under the "degree of economic interrelationship between the two activities," a Colorado medical cannabis business, was a single entity because the "non cannabis" products, such as pipes and papers, merely complemented its efforts to sell cannabis); Canna Care, Inc. v. Comm'r, 110 T.C.M (CCH) 408, T.C. Memo 2015-206, at *5 (2015) (holding that Petitioner is a single medical cannabis dispensary because even though it received income from non-cannabis-related items like books and t-shirts, all income derived was incident to its cannabis business).

191 Tony Nitti, *Tax Court Again Denies Deductions of State-Legal Marijuana Facility*, FORBES (June 14, 2018), https://www.forbes.com/sites/anthonynitti/2018/06/14/tax-court-again-denies-deductions-of-state-legal-marijuana-facility/#c87cee5470fd.

directly related expenses.[192] Taxpayers, regardless of what business they are in, use this formula to calculate gross income—gross receipts minus COGS.[193] Congress did not disallow COGS deductions in Section 280E because it feared possible constitutional challenges to the law.[194] The IRS and the U.S. Tax Court permit cannabis retailers to deduct their COGS because of a historical view that COGS are a component of gross income and not a deduction by themselves.[195]

Some would argue this is a pro-cannabis business tax provision because it allows the business owner to recover some, though not all, business costs. While this argument is valid, at the macro level this is only a small triumph because the majority of business expenses are not deductible under COGS. Not only are COGS a minor part of a cannabis business's expenses, the IRS employs the COGS exception more narrowly to cannabis businesses, compared to businesses in mainstream industries.[196]

The IRS prohibits cannabis businesses from using revisions to the Code that were enacted after Section 280E went into effect.[197] In 2015, the IRS released an internal legal memorandum outlining a strict interpretation of Section 280E when applied to cannabis businesses.[198] Though this memorandum may not be used or cited by taxpayers as legal precedent, it does outline how some IRS officials analyze Section 280E and how to determine COGS. This prohibition forces cannabis businesses to use an outdated version of the Code, which is unfair because other businesses, including illegal ones, use updated, taxpayer friendly accounting laws.

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192 *See* Patients Mut. Assistance Collective Corp. v. Comm'r, 116 T.C.M. (CCH) 570. T.C. Memo 2018-208, 4 (2018); *see also* Reading v. Comm'r, 70 T.C. 730, 733 (1978), *aff'd*, 614 F.2d 159 (8th Cir. 1980) (COGS is the total amount "expenditures necessary to acquire, construct or extract a physical product which is to be sold.").

193 *See* 26 C.F.R. § 1.61–3 (2019).

194 *See* Eisner v. Macomber, 252 U.S. 189, 219 (1920) (denying deduction for COGS would cause the affected business to be taxed on an amount in excess of its "income," which goes beyond the Sixteenth Amendment); *see also* N. Cal. Small Bus. Assistants, Inc. v. Comm'r, No. 26889-16, 2019 U.S. Tax Ct. LEXIS 24, at *23 (T.C. Oct. 23, 2019) (Gustafson, J., concurring) (Section 280E was unconstitutional because the Sixteenth Amendment "requires" a deduction for COGS, and "[i]ncome may be defined as the *gain* derived from capital, from labor, or from both combined") (quoting *Eisner*, 252 U.S. at 206–07) (emphasis added); S. REP. NO. 97-494, at 309 (1982).

195 *See* McHan v. Comm'r, 91 T.C.M. (CCH) 1069, T.C. Memo. 2006-84, at *8 (2006) (recognizing that Section 280E does not disallow adjustments to gross receipts for COGS); Peyton v. Comm'r, 85 T.C.M (CCH) 1345, T.C. Memo. 2003-146, at *5 (2003); Franklin v. Comm'r, 65 T.C.M. (CCH) 2497, T.C. Memo 1993-184 at *8 (1993); *see also* I.R.S. Memorandum 201504011, 6 (Dec. 10, 2014) (applying the 1982 version, rather than the current version, of inventory rules to state marijuana retailers to prevent violating Section 280E).

196 I.R.S. Memorandum 201504011, 6 (Dec. 10, 2014).

197 *Id.*

198 *Id.*

When calculating COGS, cannabis businesses are forced to use Section 471 of the Code. Section 471, in place when Congress enacted Section 280E, instructs retailers to calculate their COGS as any direct cost they pay for inventory, the invoice price of the goods, plus any "transportation or other necessary charges incurred in acquiring possession of the goods."[199] Cultivators, under Section 471, must include both direct and indirect costs of creating their inventory in their COGS calculation.[200] Section 263A, enacted four years after Section 280E was enacted, expanded the application of Section 471. Section 263A broadened the definitions of indirect costs and gave retailers the ability to include "indirect" inventory expenses in their COGS.[201] Section 263A allows businesses to capitalize on indirect costs—such as administrative and inventory costs, as well as the amount paid in state excise taxes—and deduct them under COGS.[202] The goal of this expansion was to treat taxpayers more fairly, but the U.S. Tax Court is not willing to allow cannabis businesses to use Section 263A.[203]

Under the 2015 IRS memo, cannabis businesses are required to calculate COGS deductions using the regulations under Section 471 and not the new accounting methods other businesses have access to under Section 263A. The memorandum outlines a very narrow reading of the costs included in COGS because it suggests the IRS will not allow cannabis businesses to allocate purchasing, handling, and storage and administrative costs to COGS. Other than this memo, the IRS has not offered guidance regarding the application of Section 280E. With this gap in understanding, it is up to the courts to outline the—fairly narrow—parameters of Section 280E.

This issue was the focus of *Patients Mutual Assistance Collective Corp. v. Commissioner*.[204] Harborside, arguably the most famous medical cannabis dispensary in the United States, has been in a battle with the IRS since 2010 over a $36 million tax bill. From 2007 to 2012, Harborside calculated their COGS deductions using Section 263A of the Code.[205] The IRS argued that Harborside had to calculate COGS using Section 471 regulations for resellers.[206] The Tax Court held that Harborside cannot use Section 263A

199 26 C.F.R. § 1.471–3 (2019).

200 26 C.F.R. § 1.471–3(c) (2019).

201 26 U.S.C. § 263A(a)(2)(B) (2019).

202 *See* NAT'L CANNABIS INDUS. ASS'N, INTERNAL REVENUE CODE SECTION 280E: CREATING AN IMPOSSIBLE SITUATION FOR LEGITIMATE BUSINESSES 2 (2015), https://thecannabisindustry.org/uploads/2015-280E-White-Paper.pdf.

203 *See* S. REP. NO. 99-313, at 140 (1986); *see also* Patients Mut. Assistance Collective Corp. v. Comm'r of Internal Revenue, 151 T.C. 176, 204–05 (2018).

204 *Patients Mut. Assistance Collective Corp.*, 151 T.C. at 204–05.

205 *Id.*

206 *Id.*

because that section did not apply to drug traffickers under federal law.[207] Because federal law labels Harborside as a drug trafficker, Harborside must calculate COGS under Section 471.[208]

The Court concluded that Harborside was a reseller and not a producer.[209] This conclusion is important because the Section 471 rules that apply to resellers do not allow for extensive indirect costs to be included in inventory that the Section 263A rules do. This holding—the more expansive Section 263A inventory cost rules do not apply to businesses subject to Section 280E—is not favorable to cannabis businesses. However, the holding does provide cannabis business owners needed guidance regarding Section 263A's interaction with Section 280E when calculating their COGS. Thus, resellers face significant challenges by the IRS if they include indirect costs in inventory costs. Still, cultivators and producers must carefully consider how Section 471 applies to their business, depending on the activities of the business.

Harborside is left with two options: pay their tax bill or appeal to the United States Court of Appeals for the Ninth Circuit. Given the amount of money at stake, Harborside should appeal to the Ninth Circuit. There is a respectable chance Harborside could win an appeal because Harborside is not trying to reverse any finding of fact by the lower court, which is a high standard to meet. Rather, Harborside would appeal the legal application of Section 263A. The Tax Court hinted there might be some relief when it stated that the overlap between Section 280E and 263A created a "confusing legal environment."[210] The Ninth Circuit could be more sympathetic to Harborside, but Harborside has yet to appeal.

Although the Harborside case did not set legal precedent, the holding opened a new avenue for cannabis businesses to consider when calculating their COGS. Permitting cannabis businesses to use Section 471 forces cannabis businesses to use savvy accounting methods to try and fit more of their expenses into COGS in order to avoid the lack of deduction opportunities under Section 280E. This puts state-legal cannabis businesses in a peculiar position. Generally, a taxpayer would prefer to deduct an expense in real-time, rather than capitalizing it through COGS.[211] This is because a current deduction immediately reduces tax liability, whereas capitalizing the expense delays any deduction until the good is sold.[212] Thus,

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207 *Id.* at 209–10.

208 *Id.*

209 *Id.* at 210.

210 *Id.*

211 Roche, supra note 71, at 462.

212 *Id.* at 444.

the state-legal cannabis businesses are forced to throw everything they can in COGS. This approach is risky and can lead to severe consequences. Harborside's tax bill is just one example.

Will cannabis businesses be treated fairly one day? Maybe. There are arguments that have not been made, for example that the congressional intent behind Section 280E has not been met. It was not until 2015 when the courts first considered the congressional intent of Section 280E and whether applying Section 280E to state legal businesses aligned with that intent.[213] In an appeal of the 2012 *Olive* decision, Olive argued that the application of Section 280E to cannabis businesses did not align with the intent of Section 280E to deter illegal drug use.[214] The Ninth Circuit Court of Appeals was not persuaded and affirmed the Tax Court's decision.[215] Written law governs tax enforcement, yet the U.S. Tax Court and the United States Supreme Court always interpret the text of a statute to some degree of interpretation not included in the text.

The Supreme Court usually interprets the Code to carry out its legislative purpose; thus, reading beyond the plain meaning of the Code. When the language and suggested purpose of the Code conflict, the Supreme Court is willing to interpret the provision to align more closely to the provision's purpose, rather than a literal reading of the provision.[216] The legislative history of Section 280E suggests the drafters envisioned Section 280E to deter illegal drug trafficking, not cripple legal businesses. When reading the Code on its face, Section 280E seeks to deter illegal drug use, but when applied, Section 280E has little connection with the original intent of the rule. Revising Section 280E would advance Congress's intention to deter illegal drug dealing because it would help the legal market compete with the illicit market. Revising Section 280E would also restore fundamental fairness by assessing income tax on income for all businesses legal under state law.

The legal strategies previously discussed—operating a second line of business and COGS—have proven to work but created no lasting impact on the industry. It appears it will take legislative action to fix this problem. Congress should modernize Section 280E to better align with the drafters'

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213 *See* Olive v. Comm'r, 792 F.3d 1146, 1150 (9th Cir. 2015), *aff'd*, 139 T.C. 19, 40 (2012).

214 *See id.*

215 *See id.*

216 Deborah A. Geier, Commentary, *Interpreting Tax Legislation: The Role of Purpose*, 2 FLA. TAX REV. 492, 493 (1995) ("Tax law has a rich history of nonliteral interpretation in order to avoid results that one person or another has considered to be inconsistent with the purpose of the statute as a whole."); *see* Hillsboro Nat'l Bank v. Comm'r, 460 U.S. 370, 402 (1983) (focusing on the legislative history of the Code rather than its language in determining whether a tax benefit rule applied to the taxpayer).

intent to deter illegal drug use and to better align with today's legal cannabis industry.

VI. HOW CONGRESS CAN DETER DRUG USE AND RAISE REVENUE BY REFORMING SECTION 280E

Cannabis business owners want to pay state and federal taxes. Maintaining a strong working relationship with the IRS legitimizes these businesses, and, in turn, the entire cannabis industry. The current tax regime forces cannabis businesses to either ignore Section 280E on their tax filings or forego paying taxes altogether. The former forces these businesses to gamble on the IRS overlooking their filing, and the latter evaporates their revenues. Congress can solve this problem in one of two ways: amend the CSA or amend Section 280E.

A. Amend the CSA

The primary reason why state-legal cannabis businesses are required to comply with Section 280E is because their product is a Schedule I substance under federal law. If Congress amended the CSA to include an exception for state legal cannabis businesses, that would alleviate the tax burden cannabis business owners face. This reform is the heart of the Tenth Amendment Through Entrusting States (STATES) Act. Proposed by Senators Cory Gardner (R-CO) and Elizabeth Warren (D-MA), the STATES Act amends the CSA so that so long as the cannabis business complies with state law, the CSA provisions no longer apply to that business.[217] If enacted, the CSA would be rendered inapplicable to state-legal cannabis businesses, thus making Section 280E also inapplicable to these businesses.[218] Under the STATES Act, selling cannabis will not trigger Section 280E because businesses in compliance with state cannabis laws will not be in violation of the CSA, and therefore would not be "trafficking in controlled substances."[219]

Cannabis that state-legal cannabis businesses sell would not be considered a Schedule I substance.[220] The STATES Act does not make cannabis federally legal, or even re-schedule or decriminalize it, but the Act gives state-legal cannabis businesses a fair chance to compete, allows the full development of state markets, and gives these businesses the freedom to avail

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217 STATES Act, S. 3032, 115th Cong. § 5(a)(2) (2018).

218 *Id.*

219 26 U.S.C. § 280E (1982).

220 STATES Act, S. 3032, 115th Cong. § 5(a)(2) (2018).

themselves of tax benefits and modern accounting regulations currently denied to them. It allows states who want to move forward in this industry a chance to compete in the global market. With states like California having the sixth largest economy in the world, becoming a global player is a realistic goal.

The drafters of the STATES Act understand that ambiguity is an obstacle to cannabis businesses when filing taxes. This is why they included additional provisions to make it absolutely clear that statutes like Section 280E are not triggered.[221] The "Rule of Construction" provides that conduct in compliance with the Act: "(1) shall not be unlawful; [and] (2) shall not constitute trafficking in controlled substances under Section 401 of the Controlled Substances Act (21 U.S.C. 841) or any other provision of law; . . . ."[222] Opponents of this approach argue a more effective way to alleviate cannabis businesses from the burdens of Section 280E is to de-schedule cannabis entirely from the CSA. De-scheduling cannabis from the CSA would automatically remove cannabis businesses from the scope of Section 280E because cannabis would no longer be a Schedule I substance. Section 280E would not apply because the language specifically applies to businesses trafficking "schedule I substances."[223] In January 2019, Representative Earl Blumenauer filed House Resolution 420, which adopts this approach.[224] The bill removes cannabis from the CSA and establishes a nationally regulated industry overseen by the Bureau of Alcohol, Tobacco, Firearms, and Explosives.[225] This approach—regulating cannabis like alcohol—is a compelling idea, and some states are already doing it, but de-scheduling cannabis from the CSA is politically impractical.

While most lawmakers seem to tolerate a medical program in their state, it is inaccurate to suggest they are in favor of legalizing cannabis federally for adults twenty-one and over. Going from the harshest classification to complete freedom that quickly seems unlikely. Moreover, de-scheduling is too abrupt and would change too many things at once. It would end federal prohibition, thus leaving regulation of cannabis up to the states and allowing interstate commerce. It would introduce a new industry that many people are still skeptical of. Feasibly speaking, the STATES Act is a more realistic

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221 *See Killing Three Birds with One Bill: The STATES Act Simultaneously Harmonizes Federal Law with State Cannabis Laws and Addresses the Cannabis Industry's Banking and Tax Issues*, CANNABIS TRADE FED'N (2018), https://www.cannabistradefederation.com/states-act.

222 STATES Act, S. 3032, 115th Cong. § 5(a)(2) (2018) ("trafficking in controlled substances" mirrors the language of 26 U.S.C. § 280E (1982)).

223 26 U.S.C. § 280E (1982).

224 Regulate Marijuana Like Alcohol Act, H.R. 420, 116th Cong. § 201(a) (2019).

225 *Id.*

solution because it provides a solution set in the middle. The STATES Act would satisfy the opponents of federal legalization, while giving state-legal cannabis businesses a chance to operate on a level playing field. State's rights is the central idea of the STATES Act, and that would carry the day in Congress. De-scheduling is compelling and would immediately solve the problem, but it is just too abrupt.

B. Amend Section 280E

The other solution is to amend Section 280E itself. This approach is the heart of the Small Business Tax Equity Act of 2017. The legislation—S. 777 and H.R. 1810—exempts cannabis businesses acting in compliance with state law from Section 280E, thereby allowing them to take the ordinary business deductions afforded to all other legal businesses.[226] Under the Small Business Tax Act, Section 280E would read as normal, but include the language "unless such trade or business consists of cannabis sales conducted in compliance with State law," at the end of the rule.[227] This reform more narrowly addresses the unfair impact Section 280E has on states with regulated cannabis markets, without doing an entire overhaul of United States cannabis policy, but the future is not certain for the Small Business Tax Equity Act of 2017, which has not moved since its introduction into Congress in 2017.

Congress had the opportunity to address Section 280E just two years ago when they enacted the Tax Cuts and Jobs Act. This bill did not repeal Section 280E, or even amend it. But the Act helps owners of cannabis businesses that operate in pass-through form, like LLCs, partnerships, sole proprietorships, and S Corps, with Section 199A. Under 199A, these businesses can deduct up to 20% of their taxable income. Thus, for cannabis business owners affected by Section 280E, this deduction is significant. Eighty percent of the disallowed deductions are still there, but a 20% reduction helps alleviate a business' tax burden.

VII. CONCLUSION

Tax neutrality is based on the primary goal to raise revenue, not discriminating against certain groups of taxpayers. Section 280E is a non-neutral tax policy that punishes state legal businesses by denying them benefits that quite frankly are required for survival in the American economy.

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226 Small Business Tax Equity Act, H.R. 1810, 115th Cong. (2017).

227 *Id.*

Non-neutral tax policy is effective when it halts or hinders activities that are in opposition to public policy, but such policies can be problematic if they are not narrowly tailored and out of date with current markets.

Section 280E is written too broadly for today's legal cannabis markets. Section 280E hurts taxpayers that try to comply with the law, prevents the cannabis industry from giving patients the medicine they need, and benefits illicit market drug dealers. However, change is possible. The 115th Congress made changes at the federal level when it enacted the 2018 Farm Bill. The 116th Congress will continue to change the federal treatment of cannabis. State markets generate impressive revenues with Michigan announcing $42 million in cannabis sales within four months of implementing its adult-use cannabis market. Public support for Section 280E and federal enforcement against these businesses is unpopular, and cannabis businesses should not stand for it either. The United States is moving in the right direction as a society, but the biggest challenge is bringing the federal government's head out of the sand. There is a lot more revenue to be collected, a lot more investment to be had, and a lot more patients to help.