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The Cannabis Conundrum: Constitutional & Policy Concerns in Taxation of the Marijuana Industry

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THE CANNABIS CONUNDRUM: CONSTITUTIONAL & POLICY CONCERNS IN TAXATION OF THE MARIJUANA INDUSTRY

BECKETT CANTLEY¹
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Abstract

The cannabis industry has greatly expanded over the last few years, with a majority of states legalizing cannabis in some form.³ However, despite the growing popularity of the cannabis industry and more companies entering the market, the Internal Revenue Service (“IRS”) has remained steadfast in denying business deductions for cannabis companies. Under Internal Revenue Code (“IRC”) § 280E, the IRS can disallow all ordinary and necessary business expenses by companies trafficking in illegal drugs.⁴ The disallowance of ordinary and necessary business expenses greatly hinders cannabis companies, especially for companies legally operating under state law. Several cannabis companies have also attacked the harsh effects of IRC § 280E on constitutional and public policy grounds.⁵ Despite a general shift in medical, legal, and public opinion supporting the full legalization of marijuana, legislation still lags far behind. There is currently pending legislation to address the deductions allowed for marijuana companies and reflects a shift in public policy.

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³ Jeremy Berke & Shayanne Gal, *All the States Where Marijuana is Legal—and 5 More that Just Voted to Legalize It*, BUS. INSIDER (Nov. 6, 2020), <https://www.businessinsider.com/legal-marijuana-states-2018-1>.

⁴ 26 U.S.C. § 280E (2018).

⁵ See, e.g., *N. Cal. Small Bus. Assistants, Inc. v. Comm’r of Internal Revenue*, 153 T.C. 65 (2019); *Alpenglow Botanicals, L.L.C. v. Comm’r of Internal Revenue*, 894 F.3d 1187 (10th Cir. 2018); *Patients Mut. Assistance Collective Corp. v. Comm’r of Internal Revenue*, 151 T.C. 176 (2018); *Olive v. Comm’r of Internal Revenue*, 792 F.3d 1146 (9th Cir. 2015); *Californians Helping to Alleviate Med. Problems, Inc. v. Comm’r of Internal Revenue*, 128 T.C. 173, 181 (2007); *Beck v. Comm’r of Internal Revenue*, 110, T.C.M. 2015-149141 (2015); *Richmond Patient’s Grp. v. Comm’r of Internal Revenue*, 119, T.C.M. Memo 2020-521342 (2020); *Alternative Health Care Advocates v. Comm’r of Internal Revenue*, 151 T.C. 225 (2018).

One recent attack on IRC § 280E is that the provision violates the Sixteenth Amendment.⁶ Under this theory, cannabis companies argue the definition of income under the Sixteenth Amendment requires gain, and thus the disallowance of ordinary and necessary business expenses imposes a tax on more than a company's income.⁷ For example, the Sixteenth Amendment permits a taxpayer to reduce gross receipts by cost of goods sold before a tax may be imposed. The correct method in calculating cost of goods sold also provides another point of contention between the IRS and cannabis companies. Courts continue to classify cannabis companies as "resellers" instead of "producers," which reduces the amount that cannabis companies can deduct as cost of goods sold.⁸

Despite the growing popularity of cannabis companies and a growing number of states legalizing marijuana, courts are unlikely to invalidate IRC § 280E as unconstitutional until a sufficient groundswell of support for the policy benefits such a change would permit arises. This article will discuss: (I) a brief evolution of the public support, policies, and rationales behind marijuana legalization and the conflicts arising under the Sixteenth Amendment; (II) competing state and federal laws concerning cannabis regulation; (III) and the constitutionality of IRC § 280E under both the Sixteenth Amendment and the Eighth Amendment; and conclude with (IV) a public policy argument for legislation removing marijuana from the purview of IRC § 280E.

⁶ See *N. Cal. Small Bus. Assistants*, 153 T.C. at 69–72; *Alpenglow Botanicals*, 894 F.3d at 1195; *Patients Mut. Assistance Collective Corp.*, 151 T.C. at 208–09.

⁷ See *N. Cal. Small Bus. Assistants*, 153 T.C. at 69, 81; *Alpenglow Botanicals*, 894 F.3d at 1199–1200; *Patients Mut. Assistance Collective Corp.*, 151 T.C. at 204–06.

⁸ *Richmond Patients Grp.*, 119 T.C.M. 1342 at 14–15; *Alternative Health Care Advocates*, 151 T.C. at 242–44; *Patients Mut. Assistance Collective Corp.*, 151 T.C. at 206–07.

TABLE OF CONTENTS

I. Overview	41
II. Evolution of Cannabis Public Policy and the Sixteenth Amendment	42
a. <i>Public Policy Evolution</i>	42
b. <i>16th Amendment Enactment History & Policy</i>	43
III. The Cannabis Tax Dilemma	44
a. <i>Legality of Cannabis—Federal vs. State</i>	44
i. <i>Federal Schedule I Drug</i>	44
ii. <i>States Legalizing & Taxing Cannabis</i>	45
iii. <i>Proposed Federal Legalization Legislation</i>	46
b. <i>IRC § 280E: Federal Taxation of Income from Illegal Activities</i>	48
c. <i>Cost of Goods Sold Dilemma: Reseller or Producer?</i>	50
i. <i>Overview of Section 471 and Section 263A and relevant regulations</i>	50
ii. <i>Relevant Case Law</i>	51
IV. Constitutional Challenges to Deduction Denials	57
a. <i>Attacks on Sixteenth Amendment Definitions of Income</i>	57
b. <i>Eighth Amendment Argument of Excessive Fines</i>	60
V. Public Policy Arguments in Favor of Congressional Action	61
a. <i>Public Policy Rationales</i>	61
b. <i>Case Law Attacks on Non-Constitutional Grounds</i>	62
VI. Conclusion	63

I. Overview

Internal Revenue Code (“IRC”) § 280E disallows all ordinary and necessary business expenses for taxpayers involved in the trafficking of illegal drugs.⁹ As a result, marijuana companies often carry a high tax burden because these companies cannot deduct ordinary and necessary business expenses, but these taxpayers may still exclude cost of goods sold.¹⁰ Because of increased tax liabilities, many marijuana companies have challenged IRC § 280E on several different grounds, including as a violation of the Sixteenth Amendment to the U.S. Constitution (“Sixteenth Amendment”).¹¹ However, despite many taxpayer arguments against IRC § 280E, the courts have continually upheld IRC § 280E as constitutional and applicable to marijuana companies operating legally under state law.¹²

⁹ 26 U.S.C. § 280E (2018).

¹⁰ *Alternative Health Care Advocates*, 151 T.C. at 242.

¹¹ *See Patients Mut. Assistance Collective Corp.*, 151 T.C. 176, at 208–09 186–88 (2018).

¹² *See N. Cal. Small Bus. Assistants*, 153 T.C. at 74; *Alpenglow Botanicals*, 894 F.3d at 1201–02; *Patients Mut. Assistance Collective Corp.*, 151 T.C. at 184–187.

To explore these concepts in more detail, Part II provides a brief history and evolution of public support, policies, and rationales behind marijuana legalization and the conflicts arising under the Sixteenth Amendment¹³ and policy concerns raised when Congress enacted the amendment. Next, Part III introduces the cannabis tax dilemma, with issues ranging from the conflicts between federal and state law, to analyzing a few pieces of legislation pending in Congress pertaining to marijuana. Each piece of legislation addresses the conflict between federal and state law differently, but all work towards ending application of IRC § 280E to cannabis-related businesses and allowing legally operating businesses under state law to deduct ordinary and necessary business expenses. Part III also introduces IRC § 280E, and provides a brief history on its enactment, and explains how courts uphold IRC § 280E against marijuana companies legally operating under state law.¹⁴ Further, Part III also addresses the dilemma of whether marijuana companies are “resellers” or “producers” by reviewing how the court determines if a taxpayer is a reseller or producer.¹⁵ Part IV examines whether IRC § 280E violates the Sixteenth Amendment and the arguments set forth by taxpayers and the government.¹⁶ Looking at recent case law, courts have held on multiple occasions that IRC § 280E does not violate the Sixteenth Amendment, despite taxpayers arguing that the definition of income means gain under the Sixteenth Amendment, and without deducting necessary and ordinary business expenses, a company’s gross income does not accurately reflect income.¹⁷ This section will also analyze arguments for and against IRC § 280E violating the Eighth Amendment.¹⁸ Lastly, Part V provides a public policy argument for legislation removing marijuana from the purview of IRC § 280E followed by an overview of the conclusions and arguments reached in this article.

II. Evolution of Cannabis Public Policy and the Sixteenth Amendment

a. Public Policy Evolution

The War on Drugs began in June 1971 when President Richard Nixon declared drug abuse to be “public enemy number one” and increased federal funding for drug-control agencies and

¹³ U.S. Const. amend. XVI.

¹⁴ See *N. Cal. Small Bus. Assistants*, 153 T.C. at 67–68; *Alpenglow Botanicals*, 894 F.3d at 1196; *Patients Mut. Assistance Collective Corp.*, 151 T.C. at 184–87; *Olive*, 792 F.3d at 1148; *Californians Helping to Alleviate Med. Problems*, 128 T.C. at 181; *Beck*, 110 T.C.M. at 14–15; *Richmond Patients Grp.*, 119 T.C.M. at 13; *Alternative Health Care Advocates*, 151 T.C. at 237.

¹⁵ *Richmond Patients Grp.*, 119 T.C.M. at 15–17; *Alternative Health Care Advocates*, 151 T.C. at 242–44; *Patients Mut. Assistance Collective Corp.*, 151 T.C. at 206–08.

¹⁶ *N. Cal. Small Bus. Assistants*, 153 T.C. at 69–72; *Alpenglow Botanicals*, 894 F.3d at 1198–202; *Patients Mut. Assistance Collective Corp.*, 151 T.C. at 208–09.

¹⁷ See *N. Cal. Small Bus. Assistants*, 153 T.C. at 79–81; *Alpenglow Botanicals*, 894 F.3d at 1200, 1202; *Patients Mut. Assistance Collective Corp.*, 151 T.C. at 208–09.

¹⁸ U.S. Const. amend. VIII.

drug-treatment efforts.¹⁹ President Nixon focused both on limiting access to narcotics while at the same time increasing treatment opportunities for all addicted persons. During Nixon’s presidency, Congress passed the Controlled Substances Act²⁰ which combined existing federal drug laws, expanded their scope, and changed the nature of federal drug law policies, and expanded Federal law enforcement pertaining to controlled substances.

The War on Drugs accelerated substantially under President Ronald Reagan with massive increases in incarcerations for nonviolent drug offenses and the “Just Say No” campaign.²¹ The focus of this section on public policy does not seek to diminish the racial inequalities highlighted by the disparity in criminal convictions during the height of the War on Drugs; rather, this article expresses gratitude for amendments to the Controlled Substances Act and continued reform and change driven by political parties and concerned citizens who have worked tirelessly to moderate harsh prison sentences.

From the beginning of the War on Drugs until the early 2000s, support for cannabis and marijuana hovered around twenty-five percent of Americans.²² However, scientific advances in uses for cannabinoids and softening toward marijuana use have led to increased support. By the end of 2018, a Gallup poll reported that nearly two-thirds of Americans support legalizing marijuana.²³ Proponents of marijuana legalization have cited increased tax revenue from taxing marijuana sales, medicinal reasons, reduced law enforcement focus on minor pot sales, and a decreasing belief in the harm caused by using the drug. This article does not attempt to promote any of these positions as *panacea rationales* for the full legalization but raises them to note the change in public opinion and increased public policy support.

b. 16th Amendment Enactment History & Policy

The Founding Fathers generally opposed a personal income tax at the federal level, having spent their lives and treasures opposing direct taxes by a faraway government. Yet, during the Civil War, an income tax was briefly levied and upheld by the Supreme Court.²⁴ Oddly, the imposition of an income tax via the Sixteenth Amendment seems to have begun as a series of political trickery between parties. A Senator proposed an income tax bill intending to embarrass the opposing party by forcing them to oppose the bill. Unfortunately, it appeared likely to succeed.

¹⁹ Chris Barber, *Public Enemy Number One: A Pragmatic Approach to America’s Drug Problem*, RICHARD NIXON FOUNDATION (Nov. 10, 2020, 5:09 PM), <https://www.nixonfoundation.org/2016/06/26404/>.

²⁰ 21 U.S.C. § 801 (2018).

²¹ See *Just Say No*, HISTORY (Aug. 21, 2018), <https://www.history.com/topics/1980s/just-say-no> (describing surge in nonviolent drug offense incarcerations from 50,000 in 1980 to 400,000 by 1997).

²² Justin McCarthy, *Two in Three Americans Now Support Legalizing Marijuana*, GALLUP (Oct. 22, 2018), https://news.gallup.com/poll/243908/two-three-americans-support-legalizing-marijuana.aspx?g_source=link_news9&g_campaign=item_258149&g_medium=copy.

²³ *Id.*

²⁴ *Springer v. United States*, 102 U.S. 586, 589, 592, 602 (1880).

President Taft, unwilling to have such a bill pass and unable to garner enough support within his own party, proposed a Constitutional amendment rather than legislation. Convinced that the States would not ratify an amendment to impose a federal income tax, the amendment was presented, and—to the astonishment of its promoters—unanimously approved in the Senate and overwhelmingly by the House.²⁵

The Sixteenth Amendment, ratified in 1913, says, “The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the Several States, and without regard to any census or enumeration.”²⁶ The Sixteenth Amendment came in response to *Pollock v. Farmers’ Loan and Trust Co.*, which “held that income derived from real estate could not constitutionally be subject to direct taxation without apportionment.”²⁷ During this time period, “the Amendment was a political necessity in the early twentieth century if Congress was going to reenact an un-apportioned income tax.”²⁸ The Sixteenth Amendment was therefore necessary in order to protect new income tax legislation so that the courts could not overturn it in the future.²⁹

The purpose of this article is not to enter the debate of the constitutionality of an income tax or on the perceived abuses of power by the IRS in the collection and enforcement of such tax. We, as the authors, simply note that since the Sixteenth Amendment’s ratification and the subsequent enactment of the Revenue Act of 1913,³⁰ the tax code has expanded to its current levels of regulatory bloat, repetitive text, and poorly defined provisions. This article observes that tax reform is an easily repeated refrain, but difficult goal to obtain. Further, pre-amendment sources of federal income included tariffs, international treaties, and excise taxes. Tariffs were deemed to unfairly “tax” the poor, and the income tax was designed to shift the burden onto wealthier individuals. Since its inception, the IRS and legislative changes have sought to capture or restrict the creativity of the American taxpayer—often lagging behind public policy and the creativity it seeks to restrict.

III. The Cannabis Tax Dilemma

a. *Legality of Cannabis—Federal vs. State*

i. *Federal Schedule I Drug*

²⁵ 44 Cong. Rec. 4389, 4389–90, 4440 (1909).

²⁶ U.S. Const. amend. XVI.

²⁷ *United States v. Sitka*, 845 F.2d 43, 45–46 (2d Cir. 1988).

²⁸ Erik M. Jensen, *Did the Sixteenth Amendment Ever Matter? Does it Matter Today?*, 108 NW. U. L. REV. 799, 814 (2014).

²⁹ *Id.* at 799, 817.

³⁰ Pub. L. No. 63–16, 38 Stat. 166 114 (October 3, 1913).

Since the inception of the Controlled Substances Act, marijuana has been a Schedule I drug, along with ecstasy, LSD, and heroin.³¹ Under the Controlled Substances Act, Schedule I drugs have been “deemed to have a high potential for abuse and no accepted medical use.”³² However, with a growing number of states legalizing marijuana in some form, and a growing number of patients using marijuana instead of other drugs such as opioids, the reclassification of marijuana or possibly declassification seems more likely moving forward.³³ In terms of federal enforcement policy, the Tax Court in *Patients Mutual Assistance Collective Corp.* noted,

One might think the Supremacy Clause would have stifled the spread of state attempts at legalizing what remained illegal under federal law,” but “Congress complicated the situation by enacting a series of appropriations riders that prevent the Department of Justice (DOJ) from using any funds ‘to prevent . . . [States that permit medical marijuana use] from implementing their own laws that authorize the use, distribution, possession, or cultivation of medical marijuana.’³⁴

Thus, even though marijuana is illegal under federal law, the federal law is unenforceable in states that legalized marijuana.³⁵ However, the IRS is a part of the Treasury Department, not the DOJ. Therefore, the enforcement of the IRC sections relating to illegal drugs, such as IRC § 280E, remain in full effect.³⁶ In fact, the Tenth Circuit said, “the IRS has shown no similar inclination to overlook federal marijuana crimes.”³⁷

ii. States Legalizing & Taxing Cannabis

As of 2020, thirty-six states have legalized medical marijuana, with fifteen of those thirty-six states, and the District of Columbia, legalizing marijuana for recreational use for those over the age of twenty-one.³⁸ Legalizing marijuana has many benefits for states, the main one being

³¹ John Vigorito, Comment, *Creating Constitutional Cannabis: An Individual State’s Tenth Amendment Right to Legalize Marijuana*, 46 U. TOL. L. REV. 221, 223–24 (2014).

³² Rebecca L. Haffajee, Robert J. MacCoun & Michelle M. Mello, *Behind Schedule—Reconciling Federal and State Marijuana Policy*, 379 NEW ENG. J. MED. 501, 501 (2018).

³³ *See id.* at 502.

³⁴ *Patients Mut. Assistance Collective Corp. v. Comm’r of Internal Revenue*, 151 T.C. 176, 185–86 (2018).

³⁵ *Id.* at 186.

³⁶ *Id.*; 26 U.S.C. § 280E (2018)..

³⁷ *Alpenglow Botanicals, L.L.C. v. United States*, 894 F.3d 1187, 1193 (10th Cir. 2018) (quoting *Feinberg v. Comm’r of Internal Revenue*, 808 F.3d 813, 814 (10th Cir. 2015)).

³⁸ Berke & Gal, *supra* note 3.

the increased tax revenues from marijuana sales.³⁹ Additionally, the legalization of marijuana creates jobs and reduces the amount of money needed to enforce marijuana laws.⁴⁰ For example, in Washington State, the total revenue from marijuana-related sales tax and licensing fees totaled \$395.5 million in Fiscal Year 2019.⁴¹ Additionally, marijuana revenues surpassed liquor sales revenues by \$172 million, and grew from the previous fiscal year by about \$28 million.⁴² However, despite the widespread legalization of marijuana, IRC § 280E still applies to marijuana companies legally operating within a state, greatly increasing tax liabilities every year and possibly preventing new companies from entering the industry.⁴³

To present balanced counterpoints to the public policy arguments of state revenue, no legislative change can have only positive outcomes. As this article is designed to inform scholars and decision-makers of public policy and legislation, full spectrum information is critical to enacting legislation. For example, advocates opposing legalization cite the costs of commercial marijuana mitigation as one of the biggest factors negating the value of legalization. In Colorado, a 2018 study cited a 4.5:1 increase in costs related to healthcare, high school dropouts, accidental poisonings, traffic fatalities, court costs for impaired drivers, juvenile use, and employer-related costs.⁴⁴ To counter the aforementioned increased costs, tax revenues collected from marijuana-related businesses could be applied toward increased traffic safety measures, educating young users—similar to the advertisements required by cigarette companies—or mitigating healthcare costs.

iii. Proposed Federal Legalization Legislation

The Marijuana Opportunity, Reinvestment, and Expungement (“MORE”) Act, proposed by Rep. Jerry Nadler (D-NY), will likely move to a vote in the coming months.⁴⁵ Introduced in the House of Representatives over one year ago, the MORE Act cleared its early and important hurdles in the House Judiciary Committee. The MORE Act would move to “federally de-schedule cannabis, expunge the records of those with prior marijuana convictions, and impose a federal five percent sales tax with that revenue being reinvested in communities most impacted by the drug

³⁹ Mrinalina Krishna, *The Economic Benefits of Legalizing Weed*, INVESTOPEDIA (updated Nov. 12, 2020), <https://www.investopedia.com/articles/insights/110916/economic-benefits-legalizing-weed.asp>.

⁴⁰ *Id.*

⁴¹ *Washington Marijuana Revenues, And Health*, WASH. ST. TREASURER, <https://tre.wa.gov/portfolio-item/washington-state-marijuana-revenues-and-health/> (last visited Nov. 18, 2020).

⁴² *Id.*

⁴³ Liam McKillop, Note, *Pass the Revenue: How Section 280E is Harming the Medical Marijuana Industry*, 2 INT’L COMP. POL’Y & ETHICS L. REV. 849, 850 (2019).

⁴⁴ *Economic and Social Costs of Legalized Marijuana*, CENTENNIAL INST. 3 (Nov. 18, 2018), <http://cdn-centennial.pressidium.com/centennial/wp-content/uploads/2019/03/Economic-and-Social-Costs-of-Legalized-Marijuana-v1.3.pdf>.

⁴⁵ Kyle Jaeger, *Congress Planning Vote on Federal Marijuana Legalization Bill in September, Sources Say*, MARIJUANA MOMENT (July 24, 2020), <https://www.marijuanamoment.net/congress-planning-vote-on-federal-marijuana-legalization-bill-in-september-sources-say/>.

war.”⁴⁶ However, like the several other marijuana bills—noted below—pending a vote in the 2020 congressional year, this bill seems unlikely to pass due to a lack of sufficient bi-partisan support amidst the other crises currently before Congress.⁴⁷

Among the introduced legislation, the one most hoped for by the marijuana industry may be the Strengthening the Tenth Amendment Through Entrusting States (“STATES”) Act, proposed by Senators Cory Gardner (D-CO) and Elizabeth Warren (D-MA). The STATES Act would strengthen the Tenth Amendment by allowing businesses operating legally under state law to be exempt from the Controlled Substances Act.⁴⁸ While this bill would not reschedule marijuana under the Controlled Substances Act—marijuana thus retaining its status as a Schedule I drug under federal law⁴⁹—the STATES Act does remove the obstacle of IRC § 280E compliance. Marijuana companies following the laws of their state would no longer be prohibited from recognizing normal business expenses in states which legalized marijuana.⁵⁰ Further, Attorney General William Barr seems open to the idea of allowing the states to choose whether to legalize marijuana, reducing the conflict between current federal and state laws pertaining to marijuana.⁵¹ A bill of this nature would strengthen states’ ability to legislate marijuana policy specific to their state and allow marijuana companies legally operating in the state to be treated the same as every other legally operating business.⁵² As a huge positive step forward for marijuana companies, this bill unfortunately seems to lack sufficient support to leave the House.

In what was billed as the “most pro-cannabis Congress” in history,⁵³ there has been only one bill passed on one issue. As the state of the Union has focused on the various hot-button issues of the day, pro-cannabis members of Congress have seen initial successes fail to build momentum and continuing support. In what is now viewed as the only possibility for bill passage in 2020, pro-cannabis legislators have their eye on the Secure and Fair Enforcement (“SAFE”) Banking

⁴⁶ *Id.*

⁴⁷ Whitt Steineker, *3 Cannabis Legislation Predictions Ahead of the 2020 Election*, CANNABIS BUS. TIMES (July 6, 2020), <https://www.cannabisbusinesstimes.com/article/3-cannabis-legalization-predictions-2020/>.

⁴⁸ Melissa Kuipers Blake, *Marijuana and the 10th Amendment: Strange Bedfellows or Natural Allies*, L. WEEK COLO. (Apr. 15, 2019), <https://www.bhfs.com/Templates/media/files/Marijuana%20and%20the%2010th%20Amendment.pdf>.

⁴⁹ *Id.*

⁵⁰ McKillop, *supra* note 43, at 872.

⁵¹ Jeffrey A. Singer, *AG Barr Signals Support for Tenth Amendment-Style Approach to Marijuana Legalization*, FOUND. FOR ECON. EDUC. (Apr. 12, 2019), <https://fee.org/articles/ag-barr-signals-support-for-tenth-amendment-style-approach-to-marijuana-legalization/>.

⁵² *See id.*

⁵³ Kellan Howell, *This Congressman Says the New Congress Could Legalize Weed*, NEWSY (Jan. 7, 2019), <https://www.newsy.com/stories/earl-blumenauer-legal-weed-could-pass-in-new-congress/>.

Act.⁵⁴ The SAFE Banking Act would permit financial institutions to conduct business with marijuana companies operating in states where marijuana is legal. The hope for the SAFE Banking Act lies in tacking the provisions onto a must-pass coronavirus aid or other appropriations bill.⁵⁵ Attachment to a coronavirus aid bill would be a boon to the marijuana companies because it would permit a normally all-cash business to transition to contactless payments and allow customers to order marijuana products online.⁵⁶ If—and that appears to be a very big “if”—marijuana companies are allowed to transition to online sales and contactless payment, that may convince otherwise reluctant financial institutions to reconsider. However, as commentator Jeffrey Singer pointed out, even if financial institutions are permitted to work with marijuana companies, the nature of the business may still lead to low or slow adoption of pro-marijuana bank policies.⁵⁷ Likely, those institutions that would choose to interact with marijuana companies would be those desperate for a boost to their year-end projections.

b. IRC § 280E: Federal Taxation of Income from Illegal Activities

IRC § 280E provides, “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.”⁵⁸ Despite being legalized in a majority of states, “medical marijuana recommended by a physician as appropriate to benefit the health of the user” still falls under the purview of 26 U.S.C. § 280E.⁵⁹

IRC § 280E was enacted as a direct response to *Edmondson v. Comm’r*, a case which permitted a taxpayer to deduct ordinary and necessary business expenses, despite the fact the taxpayer was involved in trafficking drugs.⁶⁰ The Tax Court further noted in *Californians Helping to Alleviate Med. Problems, Inc.*, “Section 280E and its legislative history express a congressional intent to disallow deductions attributable to a trade or business of trafficking in controlled substances.”⁶¹ However, even though a taxpayer may participate in trafficking an illegal substance, the Tax Court held “that section 280E does not preclude petitioner from deducting

⁵⁴ See Natalie Fertig, *Coronavirus spells doom for federal cannabis legislation*, POLITICO (May 12, 2020), <https://www.politico.com/news/2020/05/12/coronavirus-cannabis-legislation-252313>.

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ See *Cannabis Banking*, AM. BANKERS ASS’N, <https://www.aba.com/advocacy/our-issues/cannabis> (last visited Nov. 18, 2020).

⁵⁸ 26 U.S.C. § 280E (2018).

⁵⁹ *Californians Helping to Alleviate Med. Problems, Inc. v. Comm’r of Internal Revenue*, 128 T.C. 173, 181 (2007).

⁶⁰ See *Edmondson v. Comm’r of Internal Revenue*, T.C.M. 1981-623 (1981).

⁶¹ *Californians Helping to Alleviate Med. Problems*, 128 T.C. at 182.

expenses attributable to a trade or business other than that of illegal trafficking in controlled substances simply because petitioner also is involved in the trafficking in a controlled substance.”⁶² As is often the case in making laws applicable generally to a diverse nation, Congress is unable to legislatively predict the societal, environmental, medical, and social changes to sufficiently keep pace with such changes. Surely, no member of Congress in 1981, when the U.S. Tax Court decided *Edmondson* thought that within forty years, a majority of the states would allow marijuana use in some form.

In *Olive v. Comm’r of Internal Revenue*, the Ninth Circuit made clear that even though medical marijuana companies were legal under state law, this fact did not exempt these companies from IRC § 280E.⁶³ The Ninth Circuit said, “Congress might not have imagined that some states would do in the future years has no bearing on our analysis,” and “application of the statute does not depend on the illegality of marijuana sales under state law; the only question Congress allows us to ask is whether marijuana is a controlled substance ‘prohibited by Federal law.’”⁶⁴ The court continued, stating, “If Congress now thinks that the policy embodied in § 280E is unwise as applied to medical marijuana sold in conformance with state law, it can change the statute. [The Ninth Circuit] may not.”⁶⁵ Even though this case dealt with a medical marijuana company, the reasoning employed by the court in regards to IRC § 280E also applies to recreational marijuana companies legally operating under state law.⁶⁶ As discussed in the Proposed Federal Legislation, Section II.a.iii *supra*, current attempts to legislate such changes requires significant bi-partisan support in both House and Senate—a challenging feat. The bills that have been proposed are currently languishing, hoping for a tie-in to an emergency appropriations bill.

In upholding the constitutionality of IRC § 280E, the Tenth Circuit examined *Comm’r v. Sullivan*, a case in which the “Supreme Court refused the IRS’s attempt to deny the cost of rent and wages as ordinary and necessary business expense deductions for a gambling business operating in violation of state law.”⁶⁷ The Tenth Circuit noted the holding in *Sullivan*, “to deny the business ‘the normal deductions of the rent and wages necessary to operate it’ would ‘come close to making this type of business taxable on the basis of its gross receipts, while all other businesses would be taxable on the basis of net income,’” and further elaborated, “‘*If that choice is to be made, Congress should do it.*’”⁶⁸ The court then noted that Congress later acted in

⁶² *Id.*; 26 U.S.C. § 280E.

⁶³ *Olive v. Comm’r of Internal Revenue*, 792 F.3d 1146, 1150 (9th Cir. 2015).

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *See id.* at 1147, 1150 (holding that Congress intended for marijuana sales, regardless of the purpose of the sale, to come within the orbit of IRC § 280E).

⁶⁷ *Alpenglow Botanicals, LLC. v. United States*, 894 F.3d 1187, 1201 (10th Cir. 2018) (citing *Comm’r v. Sullivan*, 356 U.S. 27, 28 (1958)).

⁶⁸ *Id.* (emphasis in original).

disallowing all deductions for drug traffickers under 26 U.S.C. § 280E.⁶⁹ The court continued, “Where the Supreme Court proposed that Congress make the choice whether to deny such deductions, we find it difficult to conclude Congress acted unconstitutionally in doing so”, and further explained, “It would be strange indeed for the Supreme Court to invite Congress to pass legislation violating the Constitution.”⁷⁰ Thus, IRC § 280E has continually been found to be constitutional and enforceable, even against legally operating marijuana businesses.⁷¹ Further, the Tenth Circuit clearly explains how the Supreme Court mentioned Congress could act in limiting and disallowing these types of deductions.

c. Cost of Goods Sold Dilemma: Reseller or Producer?

i. Overview of Section 471 and Section 263A and relevant regulations

In several recent marijuana company IRC § 280E cases, the courts have classified the taxpayer as a reseller instead of as a producer, limiting the amount of costs the taxpayers can include in costs of goods sold.⁷² One of the main arguments in these cases is whether the taxpayer is subject to 26 C.F.R. § 1.471-3(b) or (c).⁷³ Under 26 C.F.R. § 1.471-3(b), “Cost means: (b) In the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods.”⁷⁴ However, under 26 C.F.R. § 1.471-3(c), “Cost means: (c) In the case of merchandise produced by the taxpayer since the beginning of the taxable year, (1) the cost of raw materials and supplies entering into or consumed in connection with the product, (2) expenditures for direct labor, and (3) indirect production costs incident to and necessary for the production of the particular article, including in such indirect production costs as appropriate portion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit.”⁷⁵ Under 26 C.F.R. § 1.471-3(c), the taxpayer can include more costs

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ *See id.*

⁷² *Alternative Health Care Advocates v. Comm’r*, 151 T.C. 225, 242–44 (2018); *Patients Mut. Assistance Collective Corp. v. Comm’r*, 151 T.C. 176, 210 (2018); *Richmond Patient’s Grp. v. Comm’r*, 119 T.C.M. (CCH) 1342 *15–17 (2020).

⁷³ *See id.*; 26 C.F.R. § 1.471-3(b)-(c) (2010).

⁷⁴ 26 C.F.R. § 1.471-3(b) (2010).

⁷⁵ 26 C.F.R. § 1.471-3(c) (2010).

in the cost of goods sold calculation, and so taxpayers prefer that this section apply to their business.⁷⁶

The proper tax treatment of costs incurred in a production depends on whether the amount expended represents a deductible expense or a capital expenditure. Expenditures are classified as capital expenditures under IRC § 263, which applies generally, and IRC § 263A, which applies to costs of property produced and property acquired for resale. Section 263A contains uniform rules—viewed in addition to those rules promulgated under IRC § 471—under which direct and indirect costs of property produced by a taxpayer or acquired for resale must be capitalized. The rules generally require the capitalization of direct and allocable indirect costs of property covered by the rules.⁷⁷ Capitalized costs are recovered through depreciation, amortization, cost of goods sold, as an adjustment to basis, or otherwise, when the taxpayer uses, sells, or otherwise disposes of the property.⁷⁸ The rules under § 263A concerning specific taxpayer situations apply equally whether a cannabis company is determined to be a reseller or a producer.

ii. *Relevant Case Law*

In *Alternative Health Care Advocates v. Comm’r*, the Tax Court noted that a taxpayer in the manufacturing or merchandising business “can subtract [cost of goods sold or ‘COGS’] from gross receipts to arrive at gross income,” and is not a deduction, but rather “an offset to gross receipts for the purpose of calculating gross income.”⁷⁹ IRC § 471 usually governs in the determination of cost of goods sold, along with the 26 C.F.R. § 1.471-3 and 1.471-11.⁸⁰ In computing COGS, “Producers must include in COGS both the direct and indirect costs of creating inventory.”⁸¹ The taxpayer argued that under IRC § 263A, to which IRC § 471 points for additional rules, allowed the company to “include both direct and indirect cost of its inventory in computing COGS.”⁸² However, the court noted, “Section 263A puts into COGS only expenses otherwise deductible,” and thus “by operation of section 280E these indirect expenses are not deductible, they cannot be added to COGS.”⁸³ Additionally, under IRC § 263A, “[t]he term ‘produce’ includes construct, build, install, manufacture, develop, improve’, ‘create, raise, or grow.’”⁸⁴ The court also found that the taxpayer was not a producer as described under IRC § 471

⁷⁶ *See id.*

⁷⁷ §263(a)(2); Treas. Reg. §1.263A-1(a)(3)(i).

⁷⁸ Treas. Reg. §1.263A-1(e)(3)(ii)(I).

⁷⁹ *Alternative Health Care Advocates v. Comm’r*, 151 T.C. 225, 242 (2018).

⁸⁰ *Id.*; 26 U.S.C. § 471.

⁸¹ *Id.*

⁸² *Id.*; 26 U.S.C. § 263A (2019); 26 U.S.C. § 471 (2019).

⁸³ *Id.* at 243.

⁸⁴ *Id.*

or IRC § 263A because “we are unable to conclude that the dispensary grew, created, or improved its marijuana products to the extent required by section 263A or 471 when the only evidence before us is that the dispensary inspected, packaged, trimmed, dried, and maintained the stock.”⁸⁵ Further, after analyzing *Suzy’s Zoo v. Comm’r*⁸⁶, the court did not agree with the taxpayer’s argument that “it was a ‘producer’ as it was the owner of the marijuana produced by its patient-members.”⁸⁷ The court disagreed that the taxpayer had “the type of contract-manufacturing arrangement the Court of Appeals recognized in *Suzy’s Zoo v. Commissioner*.”⁸⁸

In *Richmond Patients Grp. v. Comm’r*, another IRC § 280E medical marijuana case, the court clarified the analysis between reseller and producer.⁸⁹ The court begins by providing a general overview of COGS, and then provides more insight into IRC § 263A.⁹⁰ Under IRC § 263A the taxpayer is told, “both producers and resellers to include ‘indirect’ inventory costs in COGS.”⁹¹ Further, “Indirect costs are defined broadly as all costs other than direct material costs and direct labor costs (for producers) and acquisition costs (for resellers).”⁹² However, because “Section 263A includes in COGS only expenses that are otherwise deductible,” “section 263A does not allow Richmond to capitalize indirect costs into COGS that it would not otherwise be able to deduct.”⁹³ Further, the court noted, “For purposes of section 471 ‘produce’ means the same thing as in section 263A(g)(1) and section 1.263A-2(a)(1)(i).”⁹⁴ In analyzing *Patient’s Mutual Assistance Collective Corp.*, the court noted that the taxpayer was a reseller when it “did not own the marijuana plants during cultivation, did not own or control the grower-provider, and was under no obligation to purchase what the grower produced.”⁹⁵ In looking at the activities of the taxpayer, the court found the taxpayer exhibited fewer characteristics of a producer than the taxpayer in *Patients Mutual Assistance Collective Corp.* because the taxpayer “did not provide live plants, clones, or seeds to its members.”⁹⁶ Further, the taxpayer acted as a seller because it did not make improvements “to the marijuana from the time it was purchased to the time it was sold,” and only “inspected, sent out for testing, trimmed, dried and maintained the stock, and packaged and labeled

⁸⁵ *Id.*

⁸⁶ *Id.* at 244.

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ See *Richmond Patient’s Grp. v. Comm’r*, T.C. Memo 2020-52, at *16 (2020).

⁹⁰ *Id.* at *14–15.

⁹¹ *Id.* at *15.

⁹² *Id.*

⁹³ *Id.*

⁹⁴ *Id.* at *16.

⁹⁵ *Id.*

⁹⁶ *Id.*

marijuana.”⁹⁷ Thus, the court found the taxpayer to be a reseller and unable to incorporate indirect costs into COGS as a producer would.⁹⁸

In *Reading v. Comm’r*, petitioners argued that living expenses were equivalent to the “cost of goods concept,” but the court denied their argument.⁹⁹ Petitioners argued that disallowing personal, living, and family expenses exceeded Congress’s authority under the Sixteenth Amendment.¹⁰⁰ The court noted, “accepting the conclusions that some kind of ‘gain’ must be realized for there to be income, the flaw in petitioners’ analogy of what they call the ‘cost of doing labor’ to the ‘cost of goods sold’ concept—essentially its failure to acknowledge the difference between people and property—may be shown.”¹⁰¹ Further, the court said the “‘cost of goods sold’ concept embraces expenditures necessary to acquire, construct, or extract a physical product which is to be sold; the seller can have no gain until he recovers the economic investment that he has made directly in the actual item sold.”¹⁰²

In *Alpenglow Botanicals, LLC v. United States*, the Tenth Circuit analyzed the Sixteenth Amendment in regards to ordinary and necessary business expenses and COGS.¹⁰³ The Tenth Circuit said, “To ensure taxation of *income* rather than sales, the ‘cost of goods sold’ is a mandatory exclusion from the calculation of a taxpayer’s gross income.”¹⁰⁴ Further, the court noted, “Congress has unquestioned power to condition, limit, or deny deductions from gross income in arriving at the net which is to be taxed.”¹⁰⁵ The Tenth Circuit distinguished between ordinary and necessary business expenses and COGS by saying, “Although there can be similarity between expenses that qualify as cost of goods sold and ordinary and necessary business expenses (such as labor), the cost of goods sold relates to acquisition or creation of the taxpayer’s product, while ordinary and necessary business expenses are those incurred in the operation of day-to-day business activities.”¹⁰⁶ Further, “The cost of goods sold is a well-recognized exclusion from the calculation of gross income, while ordinary and necessary business expenses are deductions.”¹⁰⁷

⁹⁷ *Id.*

⁹⁸ *Id.* at *17.

⁹⁹ *Reading v. Comm’r*, 70 T.C. 730, 732 (1978).

¹⁰⁰ *Id.*

¹⁰¹ *Id.* at 733.

¹⁰² *Id.*

¹⁰³ *Alpenglow Botanicals, LLC v. United States*, 894 F.3d 1187, 1198 (10th Cir. 2018).

¹⁰⁴ *Id.* at 1199.

¹⁰⁵ *Id.* at 1200.

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

The court concluded, “Congress’s choice to limit or deny deductions for these expenses under § 280E does not violate the Sixteenth Amendment.”¹⁰⁸

In *Alterman v. Comm’r*, the court further explained the cost of goods sold dilemma in the context of marijuana companies, even though the court did not go into analysis between a producer and a seller.¹⁰⁹ In this case, the IRS conceded some production costs, but did not concede that this was the correct method in determining cost of goods sold.¹¹⁰ More importantly, the court said:

Properly computed, cost of goods sold equals

- the cost of merchandise on hand at the beginning of the taxable year (“beginning inventory”), sec. 1.471-3(a), Income Tax Regs.,
- plus the cost of merchandise purchased since the beginning of the taxable year (“purchase costs”), *id.* para. (b),
- plus the direct and indirect cost of producing merchandise (“production costs”), *id.* para. (c), sec. 1.471-11, Income Tax Regs.,
- minus the cost of inventory on hand at the end of the tax year (“ending inventory”), sec. 1.471-1, Income Tax Regs.¹¹¹

By this analysis, the court seems to suggest the taxpayer should account for indirect costs incurred, which runs counter to classifying marijuana companies as resellers instead of producers.¹¹²

In *Suzy’s Zoo v. Comm’r*, the taxpayer was held to be a producer under section IRC § 263A.¹¹³ In this case, the Tax Court found, “The facts of this case lead us to conclude that petitioner is and has been the only ‘owner’ of its paper products up until the time that they are sold to its customers, and, thus, that petitioner is the only producer of those products or purposes of section 263A.”¹¹⁴ Further, the taxpayer had ownership interest throughout the entire production, from the creation of cartoon characters for cards until the cards are printed by a third-party printer.¹¹⁵ The taxpayer argued the printer should be considered the producer because it physically creates the product, but the court found, “The printer’s reproduction of petitioner’s characters onto

¹⁰⁸ *Id.* at 1202.

¹⁰⁹ *Alterman v. Comm’r*, T.C. Memo 2018-83, at *30–37 (2018).

¹¹⁰ *Id.* at *39 n. 29.

¹¹¹ *Id.* at *31.

¹¹² *See id.*

¹¹³ *Suzy’s Zoo v. Comm’r*, 114 T.C. 1 (2000).

¹¹⁴ *Id.* at 8.

¹¹⁵ *Id.*

ordinary paper is merely one small step in petitioner’s process of exploiting its characters as sellable images, and the reproduction process is mechanical in nature in that it involves little independence on the printers’ part and is subject to petitioner’s control, close scrutiny, and approval.”¹¹⁶

On appeal, the Ninth Circuit affirmed the Tax Court, however the Ninth Circuit’s reasoning seems to be beneficial to taxpayers arguing to be classified as a producer.¹¹⁷ For instance, the Ninth Circuit said that under 26 C.F.R. § 1.263A-(2)(a)(3), “production includes ‘purchasing, storage, and handling’ costs of property held for ‘future production,’ along with ‘post-production’ costs, thereby expanding the horizon of ‘produce’ from the present to the future.” Based on reviewing IRC § 263A’s legislative history and accompanying regulations, the Ninth Circuit held, “the term ‘produce’; is to be broadly construed under § 263A.”¹¹⁸ Further, the court said “the only requirement for being a ‘producer’ under § 263A is that the taxpayer be ‘considered an owner of the property produced under Federal income tax principles.’”¹¹⁹ Additionally, “The determination of ownership is ‘based on all of the facts and circumstances, including the various benefits and burdens of ownership vested with the taxpayer,’” and “A taxpayer may be considered an owner of property produced, even though the taxpayer does not have legal title to the property.”¹²⁰ Thus, based on the Ninth Circuit’s reasoning that produce should be broadly construed, the companies arguing to be classified a producer should not have to meet all the same facts as set forth in *Suzy’s Zoo*.¹²¹ In *Suzy’s Zoo*, which analyzed IRC § 263A, the taxpayer argued to be categorized as reseller instead of a producer.¹²² In finding the taxpayer to be a producer, both the Tax Court and the Ninth Circuit point to the amount control and ownership of the product by the taxpayer.¹²³ However, all the facts in the case pointed to the taxpayer being a producer, not setting forth the exact requirements for taxpayers to be classified as a producer in future cases.¹²⁴ Thus, although some of the marijuana companies did not exert the same amount of control and ownership over the product as the taxpayer in *Suzy’s Zoo*, this should not disqualify them from being classified as a producer instead of a reseller.¹²⁵

¹¹⁶ *Id.*

¹¹⁷ *Suzy’s Zoo v. Comm’r*, 273 F.3d 875 (9th Cir. 2001).

¹¹⁸ *Id.* at 879.

¹¹⁹ *Id.* at 880 (quoting Treas. Reg. § 1.263A-2(a)(1)(ii)(A)).

¹²⁰ *Id.*

¹²¹ *Suzy’s Zoo v. Comm’r*, 114 T.C. 1 (2000), aff’d, 273 F.3d 875 (9th Cir. 2001).

¹²² *Id.* at 876–80; *Suzy’s Zoo*, 114 T.C. 1 (2000), aff’d, 273 F.3d 875 (9th Cir. 2001).

¹²³ *Id.* at 879–80; *Suzy’s Zoo*, 114 T.C. 1 (2000), aff’d, 273 F.3d 875 (9th Cir. 2001).

¹²⁴ *Suzy’s Zoo*, 114 T.C. 1 (2000), aff’d, 273 F.3d 875 (9th Cir. 2001).

¹²⁵ See *Richmond Patient’s Grp. v. Comm’r*, T.C. Memo 2020-52, at *12–17 (2020); *Alternative Health Care Advocates v. Comm’r*, 151 T.C. 225, 242–44 (2018); *Patients Mut. Assistance Collective Corp. v. Comm’r*, 151 T.C. 176, 210–13 (2018); *Suzy’s Zoo*, 114 T.C. 1 (2000), aff’d, 273 F.3d 875 (9th Cir. 2001).

The taxpayers' in *Richmond Patients Grp.*, *Alternative Health Care Advocates*, and *Patient's Mut. Assistance Collective Corp.* all argued through the reasoning set forth in *Suzy's Zoo*, the marijuana companies should be classified as producers under IRC § 471.¹²⁶ In *Patient's Mut. Assistance Collective Corp.*, the court reasoned the definition of producer should be the same under 26 U.S.C. § 471 and 26 U.S.C. § 263A, even though the court already established 26 U.S.C. § 263A does not apply in cases where 26 U.S.C. § 280A applies.¹²⁷ The taxpayer argued to be classified as a producer because it "exercised a high degree of control over the growers it purchased marijuana from," by purchasing "marijuana only from its members, and even then only if the members used Harborside's clones (which they either bought or received for free), took Harborside's growing class, followed Harborside's best practices, and met Harborside's quality-control standards."¹²⁸ However, the Tax Court found Harborside "didn't create the clones, maintain tight control over them, order specific quantities, prevent sales to third parties, or take possession of everything produced."¹²⁹ Since Harborside did not own the products all the way through production, the court held that Harborside was a reseller of the products instead of a producer as described in *Suzy's Zoo*.¹³⁰

Once marijuana companies have cleared the initial hurdle of legitimacy, then the nearly insurmountable hurdle of removing themselves from application of IRC § 280E, there remains an effectual struggle to be deemed a producer to maximize the benefits of IRC §§ 471 and 263A. Although a few courts have held marijuana companies to be resellers instead of producers, there is still the possibility that certain marijuana companies could be classified as a producer in the future.¹³¹ For instance, a marijuana company that maintains control of the product all the way through planting, cultivating, packaging, and selling would fit the description of a producer under the terms of *Suzy's Zoo*.¹³² Thus, even though some companies have not been classified as a producer, marijuana companies now have some guidance as to how to operate in order to maximize tax savings under IRC § 280E.¹³³ Ultimately, because IRC § 263A includes in COGS only expenses that are otherwise deductible and Congress retains the authority to under the Sixteenth Amendment to establish deny deductions for costs of goods sold or other deductions¹³⁴, the battle for cannabis companies remains with a reluctant legislature.

¹²⁶ *Id.*

¹²⁷ *Patients Mut. Assistance Collective Corp.*, 151 T.C. at 207–11.

¹²⁸ *Id.* at 212.

¹²⁹ *Id.* at 212–13.

¹³⁰ *Id.* at 213; *Suzy's Zoo v. Comm'r*, 114 T.C. 1 (2000), aff'd, 273 F.3d 875 (9th Cir. 2001).

¹³¹ See *Richmond Patient's Grp. v. Comm'r*, T.C. Memo 2020-52, at *12–17 (2020); *Alternative Health Care Advocates v. Comm'r*, 151 T.C. 225, 242–44 (2018); *Patients Mut. Assistance Collective Corp.*, 151 T.C. 176, 210–13 (2018).

¹³² See *Id.*; *Suzy's Zoo v. Comm'r*, 114 T.C. 1 (2000), aff'd, 273 F.3d 875 (9th Cir. 2001).

¹³³ See *id.*

¹³⁴ See e.g., IRC § 280E.

IV. Constitutional Challenges to Deduction Denials

a. Attacks on Sixteenth Amendment Definitions of Income

As another avenue of attack, marijuana companies' main argument against the applicability and constitutionality of IRC § 280E is the meaning of "income" under the Sixteenth Amendment. There have been many cases discussing the meaning of income for tax purposes, yet the definition of income under the Sixteenth Amendment remains open for interpretation.¹³⁵ Marijuana companies argue for a more narrow definition of income; one that takes into account both cost of goods sold and the ordinary and necessary business expenses incurred by the company before the income can be taxed.¹³⁶ However, the IRS has taken the position, and the Tax Court has agreed, "Deductions from gross income do not turn on equitable considerations; rather they are pure acts of legislative grace, the prudence of which is left to Congress."¹³⁷ Thus, "section 280E is enacted under Congress' unquestionable authority to tax gross income pursuant to the Sixteenth Amendment and is directed at persons who operate a business in violation of State or Federal law."¹³⁸

In several recent cases, the taxpayer has challenged the constitutionality of IRC § 280E, but in each case the court upheld its validity.¹³⁹ In arguing the meaning of income is gain, taking into account ordinary and necessary expenses incurred by a marijuana business, taxpayers point to the meaning of income described in *Eisner v. Macomber*.¹⁴⁰ In *Eisner*, the Supreme Court said, "Here we have the essential matter: not a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested or employed, and coming in, being 'derived,' that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal; --that is income derived from property."¹⁴¹ Additionally, "The meaning of the word 'income' in the Sixteenth Amendment is the same as the word has when 'used in common speech' and is the

¹³⁵ See *Helvering v. Edison Bros. Stores, Inc.*, 133 F.2d 575, 579 (8th Cir. 1943); *Eisner v. Macomber*, 252 U.S. 189 (1920); *Davis v. United States*, 87 F.2d 323, 324 (2nd Cir. 1937); *N. Cal. Small Bus. Assistants, Inc. v. Comm'r*, 153 T.C. 65 (2019); *Reading v. Comm'r*, 70 T.C. 730 (1978); *Pittsburgh Milk Co. v. Comm'r*, 26 T.C. 707 (1956); *Anderson Oldsmobile, Inc. v. Hofferbert*, 102 F.Supp. 902 (D. Md. 1952).

¹³⁶ See *N. Cal. Small Bus. Assistants, Inc.*, 153 T.C. at 77–84 (Gustafson, J., concurring in part and dissenting in part); *Alpenglow Botanicals, LLC v. United States*, 894 F.3d 1187, 1198–02 (10th Cir. 2018); Opening Brief for the Appellant, *Patient Mut. Assistance Collective Corp. v. Comm'r*, 2020 WL 2948092, at *48–67 (9th Cir. 2020).

¹³⁷ *N. Cal. Small Bus. Assistants, Inc.*, 153 T.C. at 70.

¹³⁸ *Id.*

¹³⁹ *N. Cal. Small Bus. Assistants, Inc.*, 153 T.C. 65 (2019); *Alpenglow Botanicals, LLC*, 894 F.3d 1187, 1198–02 (10th Cir. 2018); *Patients Mut. Assistance Collective Corp. v. Comm'r*, 151 T.C. 176 (2018).

¹⁴⁰ *Eisner v. Macomber*, 252 U.S. 189 (1920); Brief for the Appellant, *supra* note 115, at *36–46; *N. Cal. Small Bus. Assistants, Inc.*, 153 T.C. at 77–84 (Gustafson, J., concurring in part and dissenting in part).

¹⁴¹ *Eisner*, 252 U.S. at 207.

gain derived from, or through a sale or conversion of, capital assets, from labor, or from both combined.”¹⁴²

Taxpayers also point to *Davis v. United States* to further clarify the definition of income as set forth in *Eisner*.¹⁴³ The Second Circuit said, “It will be well to note at the start that our scheme of income taxation provides for a method of computation whereby all receipts during the taxable period which are defined as gross income are gathered together and from the total are taken certain necessary items like cost of property sold; ordinary and necessary expenses incurred in getting the so-called gross income; depreciation, depletion, and the like in order to reduce the amount computed as gross income to what is in fact income under the rule of *Eisner v. Macomber*.”¹⁴⁴

Further, Judge Gustafson’s concurring in part and dissenting in part opinion from *N. Cal. Small Bus. Assistants, Inc.* provides taxpayers a small glimmer of hope to continue arguing against the constitutionality of IRC § 280E.¹⁴⁵ Judge Gustafson reasoned that IRC § 280E imposes a tax on gross receipts that does not accurately reflect the taxpayer’s actual income, and thus goes beyond the bounds of taxing income under the Sixteenth Amendment and imposes a penalty under the Eighth Amendment.¹⁴⁶ In looking at the meaning of income, Judge Gustafson acknowledged that courts widely recognize that “under the Sixteenth Amendment it is ‘mandatory’ to allow a reduction for COGS, since we do not know whether a taxpayer-seller had any ‘income’ at all until we know whether the price obtained for the item he sold exceeded the cost he had incurred to produce that item.”¹⁴⁷ Additionally, the exclusion of COGS is not expressly included in the Sixteenth Amendment, yet even taxpayer’s under 280E can account for COGS.¹⁴⁸ Just like COGS, Judge Gustafson argues when Congress “taxes gross receipts without accounting for the ordinary and necessary expenses that are incurred in the course of business and must be paid before one can be said to have gain.”¹⁴⁹ In analyzing *Eisner*, “even after *Glenshaw Glass*, one can still say: ‘Implicit in this construction [in *Eisner v. Macomber* of ‘income’ as it is used in the Sixteenth Amendment] is the concept that gain is an indispensable ingredient of ‘income,’ and it is this concept which provides the standard by which we must determine whether the tax . . . is a tax on ‘income’ within the meaning of the 16th amendment.”¹⁵⁰ Additionally, IRC § 280E bars all

¹⁴² *Sprouse v. Comm’r*, 122 F.2d 973, 975 (9th Cir. 1941).

¹⁴³ *Davis v. United States*, 87 F.2d 323, 324 (2d Cir. 1937).

¹⁴⁴ *Id.*

¹⁴⁵ *N. Cal. Small Bus. Assistants, Inc.*, 153 T.C. at 77–90 (Gustafson, J., concurring in part and dissenting in part).

¹⁴⁶ *Id.*

¹⁴⁷ *Id.* at 80.

¹⁴⁸ *See Id.* at 81.

¹⁴⁹ *Id.*

¹⁵⁰ *Id.* at 82 (quoting *Penn. Mut. Indem. Co. v. Comm’r*, 32 T.C. 653, 680 (1959) (Train, J., dissenting, emphasis in original), *aff’d*, 277 F.2d 16 (3d Cir. 1960).

deductions when applied, instead of limiting deductions such as IRC § 162(f).¹⁵¹ Since IRC § 280E bars all ordinary and necessary deductions, Judge Gustafson would have held that this disallowance “transforms the ostensible income tax into something that is not an income tax at all, but rather a tax on an amount greater than a taxpayer’s ‘income; within the meaning of the Sixteenth Amendment.”¹⁵²

On the other hand, the Tenth Circuit disagreed with Judge Gustafson in a footnote, but did not expand on its reasoning behind the disagreement.¹⁵³ The Tenth Circuit said, “We are unpersuaded by this dissent,” and “We agree with the majority, which ruled that §280E falls within Congress’s authority under the Sixteenth Amendment to establish deductions.”¹⁵⁴ The Tenth Circuit further noted that the court continually ruled “that the IRS is properly enforcing § 280E.”¹⁵⁵ Thus, it appears taxpayers face an uphill battle when challenging the application and constitutionality of IRC § 280E.¹⁵⁶

In another case, the Tenth Circuit provided clear reasoning for why the complete disallowance of ordinary and necessary business expenses does not violate the Sixteenth Amendment.¹⁵⁷ The court started by stating that the definition of income provided in IRC § 61(a) is the Sixteenth Amendment’s definition of income.¹⁵⁸ Further, the court noted “Congress has the unquestioned constitutional and statutory authority to tax gross income.”¹⁵⁹ To ensure that Congress does not tax sales instead of income, “the ‘cost of goods sold’ is a mandatory exclusion from the calculation of a taxpayer’s gross income.”¹⁶⁰ However, taxable income is gross income minus deductions, where deductions are “matters of ‘legislative grace’ specifically authorized by

¹⁵¹ See *N. Cal. Small Bus. Assistants, Inc.*, 153 T.C. at 83 (describing the impact of 26 U.S.C. § 280E); See also 26 U.S.C. § 162(f) (describing deductions for trade or business expenses); See also 26 U.S.C. § 280E (prohibiting deductions for expenditures in connection with the illegal sale of drugs).

¹⁵² *Id.* at 84.

¹⁵³ See *Standing Akimbo, LLC v. United States*, 955 F.3d 1146, 1158 n.7 (10th Cir. 2020).

¹⁵⁴ *Id.*

¹⁵⁵ *Id.*; see also *High Desert Relief, Inc. v. United States*, 917 F.3d 1170 (10th Cir. 2019); *Green Sol. Retail, Inc. v. United States*, 855 F.3d 1111 (10th Cir. 2017); *Alpenglow Botanicals, LLC v. United States*, 894 F.3d 1187 (10th Cir. 2018).

¹⁵⁶ See *Standing Akimbo, LLC v. United States*, 955 F.3d 1146, 1158 n.7 (10th Cir. 2020) (describing the difficulty of challenging the constitutionality of IRC § 280E).

¹⁵⁷ See *Alpenglow Botanicals, LLC*, 894 F.3d at 1198–1203 (examining the relationship between disallowing ordinary and necessary business expenses and the Sixteenth Amendment).

¹⁵⁸ See *Alpenglow Botanicals, LLC*, 894 F.3d at 1199 (citing *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934)).

¹⁵⁹ *Id.* (citing *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934)).

¹⁶⁰ *Id.* at 1199–1200 (citing *Max Sobel Wholesale Liquors v. Comm’r*, 630 F.2d 670, 671 (9th Cir. 1980); *Sullenger v. Comm’r*, 11 T.C. 1076, 1077 (1948); 26 C.F.R. § 1.61-3(a)).

statute.”¹⁶¹ Additionally, “Congress has unquestioned power to condition, limit, or deny deductions from gross income in arriving at the net which is to be taxed.”¹⁶² Under 26 U.S.C. § 162(a), Congress authorized a deduction allowing “a business to deduct from its gross income ‘all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on the trade or business.’”¹⁶³ However, IRC § 162 disallows certain categories of deductions, such as expenses for illegal bribes or fines and penalties for taxpayers not subject to IRC § 280E.¹⁶⁴ Thus, Congress did not violate the Sixteenth Amendment in enacting 26 U.S.C. § 280E because Congress has wide discretion in allowing or disallowing deductions to gross income, which occurs after the taxpayer has accounted for cost of goods sold in calculating gross income.¹⁶⁵ Additionally, one commentator noted while examining psychic income, “While the drafters of the Sixteenth Amendment are unlikely to have been thinking, at least very consciously, about psychic income, it is generally agreed that the amendment does not significantly constrain how taxable income can be defined by Congress and the courts.”¹⁶⁶

b. Eighth Amendment Argument of Excessive Fines

Taxpayers have also argued IRC § 280E is unconstitutional under the Eighth Amendment’s Excessive Fines Clause.¹⁶⁷ The Tax Court noted, “The Eighth Amendment’s ‘protection against excessive fines guards against abuses of government’s punitive or criminal-law enforcement authority’, and applies to civil and criminal penalties alike.”¹⁶⁸ However, after analyzing the Sixteenth Amendment, the court found the disallowance of deductions does not constitute a penalty, and thus 26 U.S.C. § 280E does not violate the Eighth Amendment.¹⁶⁹ While the current status of case law protects section 280E from constitutional challenge, there may be an exploitable chink in the armor a court may be willing to see.

The concurrences and dissents in *Alpenglow Botanicals* are particularly illuminating of the limited space in which these constitutional challenges may proceed. In Judge Gustafson’s

¹⁶¹ *Id.* at 1200 (citing *Commodore Mining Co. v. Comm’r*, 111 F.2d 131, 134 (10th Cir. 1940)).

¹⁶² *Id.*

¹⁶³ *Id.*; *See also* 26 U.S.C. § 162(a) (describing deductions for trade and business expenses).

¹⁶⁴ *See generally* 26 U.S.C. § 162(c) & (f) (prohibiting deductions for illegal activities such as bribery).

¹⁶⁵ *See Alpenglow Botanicals, LLC*, 894 F.3d at 1198–03.

¹⁶⁶ Daniel N. Shaviro, *Psychic Income Revisited: Response to Professors Johnson and Dodge*, 45 TAX L. REV. 707, 711 N. 17 (1990).

¹⁶⁷ *See N. Cal. Small Bus. Assistants, Inc. v. Comm’r*, 153 T.C. 65, 68 (2019); *See generally* 26 U.S.C. § 280E (prohibiting deductions for expenditures relating to the illegal sale of drugs); *See* U.S. CONST. amend. VIII. (outlawing excessive fines as punishment for violating the law).

¹⁶⁸ *N. Cal. Small Bus. Assistants, Inc.*, 153 T.C. at 68 (quoting *Timbs v. Indiana*, 139 S. Ct. 682, 686 (2019)).

¹⁶⁹ *Id.* at 72; *See Alpenglow Botanicals, LLC v. United States*, 894 F.3d 1187, 1202 (10th Cir. 2018); *Murillo v. Comm’r*, T.C. Memo 1998-13, at *3 (1998); *King v. United States*, 949 F. Supp. 787, 791 (E.D. Wash. 1996).

concurrency in part and dissent in part, Judge Gustafson put forward that IRC § 280E imposes a fine under the Eighth Amendment, but did not discuss whether the Eighth Amendment should extend to a corporation.¹⁷⁰ Judge Gustafson noted the purpose of IRC § 280E was to punish unlawful behavior, and just because a fine is labeled an income tax does not automatically mean the Eighth Amendment argument should be dismissed.¹⁷¹ Further, in Judge Copeland’s dissent, Judge Copeland stated his opinion that “Section 280E is punitive and requires further analysis under the Eighth Amendment on two separate grounds.”¹⁷² On the first ground, Judge Copeland argued IRC § 280E operates as a penalty provision and “attacks an entire industry (in this case, cannabis businesses) and sweeps so broadly as to deny every deduction the Code would otherwise allow, rather than specify a narrow range of expenses.”¹⁷³ Secondly, the purpose behind IRC § 280E was to deter the illegal trafficking of drugs which clearly shows IRC § 280E is a penalty.¹⁷⁴ Thus, Judge Copeland held IRC § 280E is a penalty for Eighth Amendment purposes, but did not analyze whether the Eighth Amendment is applicable to corporations and said further analysis would be needed to examine the excessiveness of the penalty under the Eighth Amendment.¹⁷⁵

V. Public Policy Arguments in Favor of Congressional Action

a. Public Policy Rationales

Current legislation places marijuana and cannabis on Schedule I of the federal drug register. Since 2018 there has been an increasingly softer stance on the variegated nature of the cannabis plant. While simply split between hemp and marijuana, the cannabis plant (in either variety) contains over 100 cannabinoids which include both cannabidiol (“CBD”) and tetrahydrocannabinol (“THC”). Marijuana naturally (and through genetic enhancement) has higher concentrations of THC, the drug that will produce the intoxicated effect. Hemp is richer in CBD, which is not intoxicating. As discussed previously, States have taken it upon themselves to either decriminalize or legalize the use of CBD products and, in a growing number of states, marijuana use.

A change in the taxation of marijuana and cannabis companies could be as simple as—yet another—exception to the rules within the IRC which would allow for certain businesses to reduce gross income by the cost of goods sold. At its most expansive, marijuana companies seek a complete legislative overhaul of the statutes governing taxation, de-listing from the drug schedules, or a constitutional overhaul of definitions within either (or both) of the Sixteenth and Eighth Amendments. As is often the case, there is likely middle ground between all the competing

¹⁷⁰ *Id.* at 90 (Gustafson, J., concurring in part and dissenting in part).

¹⁷¹ *Id.* at 88–89.

¹⁷² *Id.* at 93 (Copeland, J., dissenting).

¹⁷³ *Id.*

¹⁷⁴ *Id.*

¹⁷⁵ *Id.*

parties and voices in favor and opposition to decriminalization or completely legalization of marijuana. There are significant arguments bolstered by economics, medical studies, and anecdotal evidences that support or degrade the strength of both sides.

This article noted above that there are strong arguments for the legalization and decriminalization of marijuana, chief among them the increased revenue generated for states from the state level taxation of the newly-legal businesses' revenue. The arguments for legalization include its medicinal benefits, reduction of limited law enforcement resources spent policing what is deemed to be a minor offense, and a belief that by regulating marijuana the government could make its consumption more uniform and safer. Additional, more esoteric, arguments include the belief that marijuana specifically is not harmful to its users and that marijuana use is a personal choice and a freedom one should be permitted to enjoy.

As might be expected, the arguments against full legalization are at least as convincing. Looming largest among the arguments, the number of drug-impaired accidents and the damage to persons and property that would cause. Second to the health and liability concerns is that legalization would increase use of marijuana and lead to wider adoption of more addictive drugs. The last argument, also more esoteric, is that the legalization of marijuana will not benefit society, is actually bad for your health, and is immoral.

This article raises these concerns from both sides as a means of informing the legislative decision makers that this is a multi-faceted issue with strong feelings and rationale from students to law enforcement to business owners to municipal and state governments.

b. Case Law Attacks on Non-Constitutional Grounds

While not necessarily a public policy matter, the cases discussed here are, at their heart, arguments about the policy behind specific rulings rather than a constitutional attack on the Sixteenth or Eighth Amendments. As an example, companies have challenged the IRS' recharacterization of certain accounting calculations. Though *Osteopathic Medical, Oncology & Hematology, P.C., v. Comm'r*, examines different issues, the Tax Court held for the petitioners that the Commissioner may not "change a taxpayer's method of accounting with impunity."¹⁷⁶ In *Osteopathic Medical*, the IRS sought to recharacterize certain accounting methods which already compliantly stated income in such a way to increase the income reported, thus increasing the taxes owed by petitioner.¹⁷⁷ Despite the different issues under examination in this case, a policy argument may be made—albeit with sufficient support outside of court—that a recharacterization of cost of goods sold as a disallowed deduction from income may be an eventual avenue for attack by marijuana companies.¹⁷⁸

¹⁷⁶ *Osteopathic Med. Oncology & Hematology, P.C., v. Comm'r*, 113 T.C. 376, 381 (1999).

¹⁷⁷ *Id.*

¹⁷⁸ *See id.*; *Patients Mut. Assistance Collective Corp. v. Comm'r*, 151 T.C. 176, 204–14 (2018); Brief for the Appellant, *supra* note 115, at *56–64.

As a separate policy consideration, marijuana companies may be able to attack the scope with which deductions are constitutionally mandated under the Sixteenth Amendment.¹⁷⁹ For instance, Judge Gustafson’s opinion in *N. Cal. Small Bus. Assistants, Inc.* noted, “section 280E does not prompt a question as to the constitutionality of disallowing a deduction.”¹⁸⁰ Instead, IRC § 280E disallows all deductions, which Judge Gustafson argued results in “the determination of the supposed ‘income tax’ liability of a taxpayer trafficking in illegal drugs bypasses altogether any inquiry as to his gain.”¹⁸¹ Thus, disallowing all deductions runs afoul of the Sixteenth Amendment.¹⁸² This reasoning, however, seems to open the door as to which deductions must be allowed in order for a taxpayer’s income to be taxed under the Sixteenth Amendment.¹⁸³ For example, if this reasoning were to prevail in the future, would Congress be unable to change 26 U.S.C. § 162 because if deductions are changed, then Congress is no longer taxing a taxpayer’s “income?”¹⁸⁴ There would be the potential for many arguments as to which deductions should remain and which deductions Congress would be allowed to change. In other words, Judge Gustafson argued the disallowance of all deductions under IRC § 280E violates the Sixteenth Amendment, which means there are a certain amount of deductions Congress must allow in order to stay within the bounds of the Sixteenth Amendment.¹⁸⁵ On the other hand, this could just mean Congress is not permitted under the Sixteenth Amendment to deny all deductions, such as in IRC § 280E, but still have broad discretion in either permitting or disallowing deductions.¹⁸⁶

VI. Conclusion

Looking through several recent cases discussing the applicability and constitutionality of IRC § 280E, courts consistently find IRC § 280E to be constitutional under both the Sixteenth and Eighth Amendments and apply the section to marijuana companies operating legally under state law. However, under the umbrella of IRC § 280E arguments, marijuana companies may have success in the future arguing to be a producer for cost of goods sold purposes. Additionally, there are several pieces of legislation that, if ultimately successful, would deem IRC § 280E no longer applicable to marijuana corporations operating legally under the state. However, until legislation passes, courts seem likely to uphold IRC § 280E as constitutional, both on the basis that it is not a

¹⁷⁹ See generally *N. Cal. Small Bus. Assistants, Inc.*, 153 T.C. 65, 77–84 (2019) (Gustafson, J., concurring in part and dissenting in part).

¹⁸⁰ *Id.* at 83.

¹⁸¹ *Id.*

¹⁸² *Id.* at 84.

¹⁸³ See *id.*

¹⁸⁴ See 26 U.S.C. § 162.

¹⁸⁵ See *N. Cal. Small Bus. Assistants, Inc.*, 153 T.C. at 77 (2019) (Gustafson, J., concurring in part and dissenting in part).

¹⁸⁶ See *id.* at 90.

penalty, and because Congress has great discretion in determining which deductions taxpayers may utilize.