

**Baker  
McKenzie.**

## Section 280E: A Growing Problem?

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# Introduction

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- The Cannabis Revolution
- Legalization in Canada
- US Changes
  - State laws
  - 2018 Farm Bill
  - Enforcement Policy
- What are the tax traps?
- Who should be concerned?



# Agenda

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- Part I: Section 280E Overview and Application
- Part II: What are the Key Section 280E Elements?
- Part III: Where does Section 280E apply?
- Part IV: How could Section 280E change?





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## Section 280E Overview and Application

## Legal Landscape Before Section 280E

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- United States v. Constantine, 296 U.S. 287 (1935).
  - A tax may not impose a higher burden on illegal income and must “be imposed alike on the just and the unjust.”
- Public Policy Doctrine and Section 162(c).
- Edmondson v. Commissioner, T.C. Memo. 1981-623.
  - Taxpayer allowed to deduct expenses associated with selling amphetamines, cocaine, and marijuana.
- Congress enacted Section 280E in 1982 in reaction to the Edmondson ruling.



## Section 280E

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*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 Schedule 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.*



## 280E Application

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- Section 280E does not prevent taxpayers from reducing their gross revenues by cost of goods sold.
- Legislative history excepts cost of goods sold.
  - To preclude possible challenges on constitutional grounds.
- Inventory Rules
- Filing?



## Section 280E Application - Example

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	Cannabis Business	Non-Cannabis Business
▪ Gross Revenue	\$1,000,000	\$1,000,000
▪ Cost of Goods Sold	\$650,000	\$650,000
▪ Gross Income	\$350,000	\$350,000
▪ Deductible Business Expenses	\$0	\$200,000
▪ Taxable Income	\$350,000	\$150,000
▪ Tax Due (30% Rate)	\$105,000	\$45,000
▪ Effective Tax Rate	70%	30%
▪ Cash Flow	\$45,000	\$105,000







## Key Elements of Section 280E

## Section 280E Elements

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There are three parts to Section 280E:

1. Taxpayer must carry on a trade or business;
2. Taxpayer's trade or business must consist of trafficking in controlled substances; and
3. Trafficking must be prohibited by federal law or state law in which the trade or business is conducted.



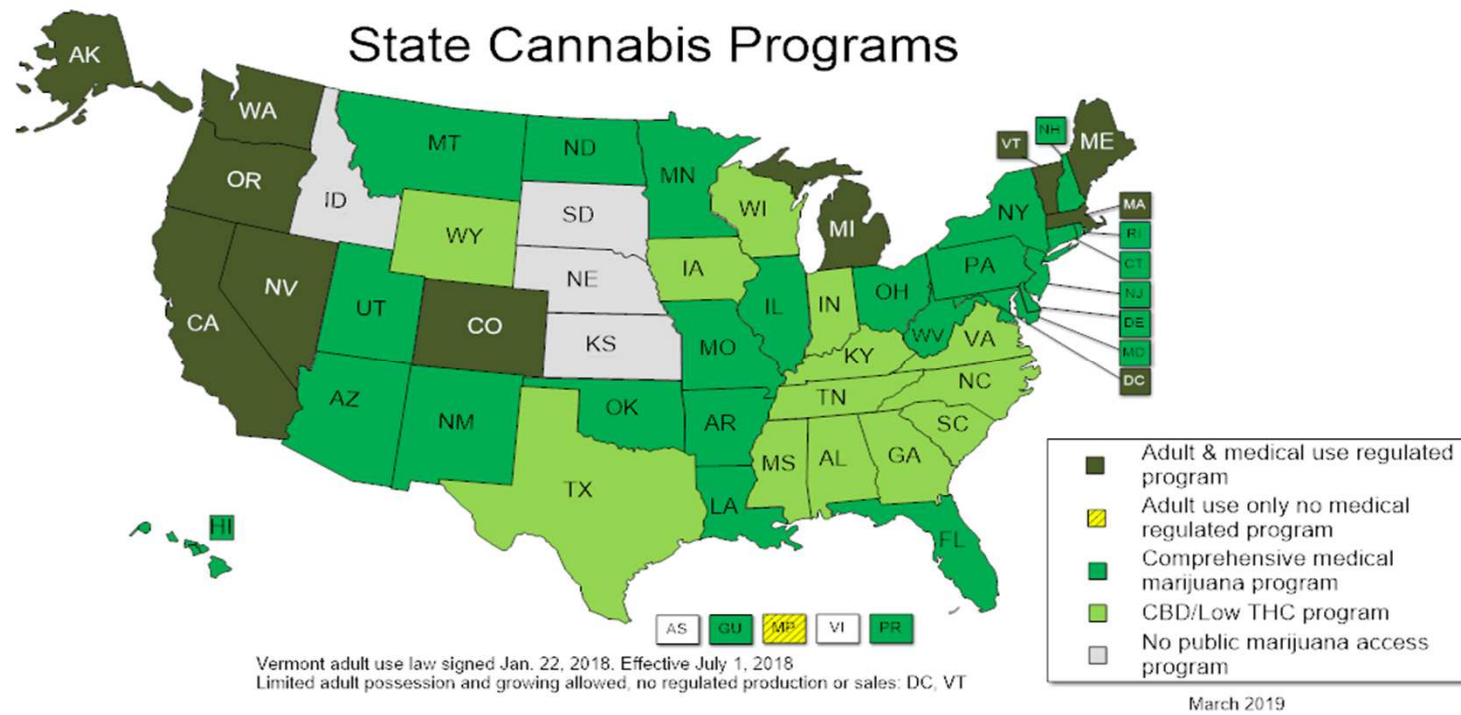
# What is a Controlled Substance?

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- Section 280E cross references the Controlled Substances Act (the “CSA”).
- CSA has 5 Schedules.
- Marijuana (all parts of the cannabis plant) - Schedule I.
  - High potential for abuse.
  - No accredited medical use.
- 2018 Farm Bill - Removed hemp, defined as having less than .3% THC concentration, from the definition of marijuana under the CSA.
  - States may not prohibit the transportation of hemp and hemp products throughout the state.



# What is the state law?



# What is the Federal Enforcement Policy?

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- Cole Memorandum (August 29, 2013)
  - Joint state-federal approach.
  - Where states have implemented robust regulatory regimes, federal priorities are less at risk.
  - Federal resources concentrated on marijuana cases involving:
    - organized crime
    - cover for other illegal drugs
    - violence, firearms
    - distribution to minors
    - diversion from states where it is legal to states where it is illegal
    - drugged driving
    - public lands/federal property
- 2019 – Attorney General William Barr stated, “I do not intend to go after parties who have complied with state law in reliance on the Cole Memorandum.”



## What is “Trafficking”? – Introduction

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- Section 280E does not define “trafficking”.
- Only one other Internal Revenue Code provision defines trafficking.
  - Section 7208: “Knowingly or willfully buy[ing], sell[ing], offer[ing] for sale, or giv[ing] away . . . washed or restored stamp[s] to any person for use.”
- CSA § 801(2) describes trafficking as “[t]he illegal importation distribution, and possession and improper use of controlled substances.”



## What is “Trafficking”? – Case Law

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- The C.H.A.M.P., 128 T.C. 173 (2007), standard: Tax Court held that Section 280E trafficking is “engaging in a commercial activity” by “buying and selling regularly”.
  - Facts:
    - Taxpayer operated business that dispensed medical marijuana and provided caregiving services.
    - IRS argued that Section 280E barred C.H.A.M.P. from deducting any expenses (excluding COGS).
  - Question: Whether taxpayer’s involvement in trafficking of a controlled substance prevented it from deducting expenses relating to its other lines of business.
  - Holding: Supplying medical cannabis was trafficking under Section 280E.
- Oakland Cannabis Buyers’ Coop., 532 U.S. 483 (2001): Supreme Court found CSA broadly prohibits the manufacturing, distribution, dispensing, or possession with the intent to manufacture, dispense, or distribute, of controlled substances, including medical cannabis.

# What is “Trafficking” when a state legalizes or decriminalizes cannabis?

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- A state’s decriminalization or legalization of cannabis does not preclude “trafficking” under federal law. Olive v. Commissioner, 72 F.3d 1146 (9th Cir. 2015).
- Olive Facts:
  - In addition to sale of medical marijuana, taxpayer operated “Vapor Room”, which offered patrons suffering from AIDS, HIV, cancer, and other terminal diseases a place to socialize and consume marijuana.
  - Olive argued that Section 280E did not apply to legal businesses under state law.
- Olive Holding: Dispensing marijuana pursuant to state law still constitutes trafficking for purposes of Section 280E.





# What is “Trafficking” when a business has multiple segments?

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- Olive v. Commissioner, 792 F.3d 1146 (9th Cir. 2015)
  - Facts: Olive argued that the Vapor Room had two lines of business: a marijuana dispensary and another related to the provision of other services, such as yoga and food.
  - Olive Test: The Court applied the following factors from Rupp v. Commissioner.
    - Whether the undertakings are conducted at the same place;
    - Whether the undertakings were part of a taxpayer’s efforts to find sources of revenue from his or her land;
    - Whether the undertakings were formed as separate activities;
    - Whether one undertaking benefited from the other;
    - Whether the taxpayer used one undertaking to advertise the other;
    - The degree to which the undertakings shared management;
    - The degree to which one caretaker oversaw the assets of both undertakings;
    - Whether the taxpayers used the same accountant for the undertakings; and
    - The degree to which the undertakings shared books and records.
- Olive Holding: Taxpayer “provided the additional services and activities incident to, and as part of, the Vapor Room’s dispensing of medical marijuana.”



## What is “Trafficking”– C.H.A.M.P. vs. Olive

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- Both cases allowed cost of goods sold to reduce gross revenue from sales.
  - Is the second line of business still a viable option?
  - What would happen if Rupp’s factors were applied to C.H.A.M.P. facts?



## Are there ways to circumvent “trafficking”?

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- Management Company Structure and Alternative Health Care Advocates, 151 T.C. No. 13 (Dec. 20, 2018).
  - Facts:
    - Used management companies to operate nonregulated portions of the business.
    - IRS audits management company, which was deemed to run the dispensary.
    - Appeals Officer imposed Section 280E on both entities.
  - Result: Went to trial in December 2016 and decision issued in December 2018 disallowing deductions.





Where does Section 280E apply?

## Question

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- Recap: Section 280E disallows trafficking in controlled substances prohibited by federal or state law.
- Does Section 280E apply outside the US?
- What happens if the taxpayer is dealing with controlled substances in a country where the use, manufacture, and/or sale of controlled substances is legal?





# IV

How could Section 280E change?

# Recent Proposed Legislation

Bill	Description & Status
SAFE Banking ACT (H.R. 1595)	<ul style="list-style-type: none"><li>▪ Would expand financial services to legitimate cannabis-related businesses and service providers</li><li>▪ Currently pending in House</li></ul>
Regulate Marijuana Like Alcohol Act (H.R. 420)	<ul style="list-style-type: none"><li>▪ Remove cannabis from purview of CSA; regulate cannabis in same manner as alcohol</li><li>▪ Pending in House Subcommittee</li></ul>

