



7-1-2021

## Puff, Puff, Tax: Internal Revenue Code Section 280E Penalizes State-Sanctioned Marijuana Companies and Undermines the Ability-To-Pay Principle

Joseph E. Thomas

Follow this and additional works at: <https://digitalcommons.law.villanova.edu/vlr>



Part of the [Taxation-Federal Commons](#), and the [Tax Law Commons](#)

---

### Recommended Citation

Joseph E. Thomas, *Puff, Puff, Tax: Internal Revenue Code Section 280E Penalizes State-Sanctioned Marijuana Companies and Undermines the Ability-To-Pay Principle*, 66 Vill. L. Rev. 451 (2021).

Available at: <https://digitalcommons.law.villanova.edu/vlr/vol66/iss2/5>

This Comment is brought to you for free and open access by Villanova University Charles Widger School of Law Digital Repository. It has been accepted for inclusion in Villanova Law Review by an authorized editor of Villanova University Charles Widger School of Law Digital Repository.

2021]

PUFF, PUFF, TAX: INTERNAL REVENUE CODE SECTION 280E  
PENALIZES STATE-SANCTIONED MARIJUANA  
COMPANIES AND UNDERMINES THE ABILITY-  
TO-PAY PRINCIPLE

JOSEPH E. THOMAS\*

I. HASHING IT OUT: AN INTRODUCTION

Picture this: you go into business selling floral arrangements. You rent a small storefront, hire employees, and advertise the store. You purchase flowers in bulk, and your employees prepare the flowers for the retail floor. The employees inspect the flowers and remove any they cannot sell. They trim the leaves, stems, and thorns, arrange bouquets, and package them for sale. Your business is a hit, and in one year your store brings in \$1 million in sales! When you file your federal taxes, you exclude the cost of the flowers and deduct rent, employee salaries, and advertising costs from the \$1 million in sales and pay taxes on the remaining balance.<sup>1</sup>

Now picture this: the following year, instead of floral arrangements, you sell marijuana flower (legally, under state law, of course).<sup>2</sup> Similarly, you purchase the marijuana in bulk, and your employees inspect the marijuana and reject any unsuitable buds. They trim the marijuana, package it, and label it before it reaches the retail floor. Your marijuana business is

---

\* J.D. Candidate, 2022, Villanova University Charles Widger School of Law; B.F.A. in Acting, 2013, California Institute of the Arts. I dedicate this Comment to the memory of my mother, Joanne Thomas. Thanks to Professor Jane Voegele, Professor Leslie Book, and Professor Orli Oren-Kolbinger for their thoughtful critiques. Lastly, I would like to recognize my entire family for their unwavering love. And above all, thanks to God, without whom my existence would be fruitless.

1. In 2017, the Tax Cuts and Jobs Act (TCJA) reduced the corporate income tax rate from 35% to 21%. *See* H.R. REP. NO. 115-466, at 343 (2017). To avoid double taxation of profits (i.e., once at the corporate level, and again when the profit is distributed to shareholders), many businesses are structured as pass-through entities, such as a limited liability company (LLC) or an S-Corp. *See Forming a Corporation*, IRS, <https://www.irs.gov/businesses/small-businesses-self-employed/forming-a-corporation> [<https://perma.cc/9WY6-799T>] (last updated Mar. 12, 2021). Pass-through entities avoid double taxation because income “passes through” to the owner who reports it on their personal tax return. *See generally Topic No. 407 Business Income*, IRS, <https://www.irs.gov/taxtopics/tc407> [<https://perma.cc/3BJ9-2A2M>] (last updated Mar. 5, 2021) (explaining various ways businesses may be taxed). Addressing equitable concerns surrounding the tax rate reduction for corporations, the TCJA also enacted a temporary 20% business deduction for qualifying pass-through entities. *See generally* H.R. REP. NO. 115-466, at 205–24.

2. Marijuana flower, also commonly referred to as “buds,” are the part of the marijuana plant people can smoke. *See* Patients Mut. Assistance Collective Corp. v. Comm’r, 151 T.C. 176, 179 (2018).

also a hit and brings in \$1 million in sales. When you file your taxes this year, however, you may exclude *only* the cost of the marijuana from your sales. The ordinary and necessary business deductions you took last year for rent, employee salaries, and advertising are disallowed by section 280E of the Internal Revenue Code (IRC) because you “trafficked” marijuana.<sup>3</sup> As a result, your tax bill is significantly higher than in the previous year.

To add insult to injury, you might not even have enough profit to pay the taxes due. Assume your cost for the marijuana was \$300,000. If the cost to rent the storefront was \$200,000, employee salaries totaled \$300,000, and advertising cost \$100,000, you would have a \$100,000 profit.<sup>4</sup> But because section 280E disallows all of your deductions, you will be taxed as if you had a \$700,000 profit.<sup>5</sup> Applying a 21% corporate income tax rate, you would owe \$147,000 in federal income tax that year.<sup>6</sup> Having already paid your landlord, employees, and advertiser, your actual \$100,000 profit would fall \$47,000 short, not including state income taxes that your business would also owe. Had you instead continued to sell flower arrangements, you would be permitted to deduct your business expenses and would owe only \$21,000 in federal income tax.

Section 280E results in an oppressive tax burden that unfairly penalizes marijuana companies. The provision certainly cuts against the long-standing principle that income tax should coincide with a taxpayer’s ability to pay, regardless of whether section 280E is a prohibited penalty.<sup>7</sup> Such is the plight of marijuana companies which, on one hand, operate legally under state law, and on the other hand, traffic in illegal controlled substances under federal law.<sup>8</sup>

---

3. Section 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.

I.R.C. § 280E (2018).

4. \$1,000,000 (gross receipts) - \$300,000 (cost of goods sold) - \$200,000 (rent) - \$300,000 (salaries) - \$100,000 (advertising) = \$100,000 actual profit.

5. \$1,000,000 (gross receipts) - \$300,000 (cost of goods sold) = \$700,000 taxable income when section 280E applies.

6. \$700,000 (taxable income) x 21% (tax rate) = \$147,000. The 2017 TCJA established a 21% flat income tax rate for corporations beginning in 2018. See H.R. REP. NO. 115-466, at 343. Prior to the TCJA, corporations were taxed at progressive rates, depending on their amount of gross income. See *id.* at 342-43. The highest corporate income tax rate in 2017, for instance, was 35%. See *How Did the Tax Cuts and Jobs Act Change Business Taxes?*, TAX POL’Y CTR., <https://www.taxpolicycenter.org/briefing-book/how-did-tax-cuts-and-jobs-act-change-business-taxes> [https://perma.cc/57ZH-LQ9S] (last visited Mar. 31, 2021).

7. For a further discussion of the ability-to-pay principle, see *infra* notes 26-43 and accompanying text.

8. See *Drug Scheduling*, U.S. DRUG ENFORCEMENT ADMIN., [www.dea.gov/drug-scheduling](http://www.dea.gov/drug-scheduling) [https://perma.cc/ZF62-C5V4] (last visited Mar. 31, 2021). Marijuana

Marijuana companies provide societal benefits, such as jobs and tax revenue.<sup>9</sup> Additionally, patients with chronic conditions rely on medical marijuana to manage their symptoms.<sup>10</sup> Congress should amend section 280E to exclude marijuana companies that operate legally under state law. Otherwise, legitimate marijuana companies may be taxed out of business, which would strengthen the illegal drug trade. Part II of this Comment provides background on federal income taxation and tax policy, including the history of section 280E. Part III discusses case law arising from two marijuana dispensaries challenging section 280E. Part IV critiques the Tax Court's holdings in favor of section 280E and Congress's failure to amend the outdated code section. Lastly, Part V discusses how states and citizens would be negatively impacted by the continued enforcement of section 280E.

## II. THAT'S GROW BIZ: A CANNABIS-INFUSED LESSON ON FEDERAL INCOME TAXATION

Article I, Section 8 of the United States Constitution empowers Congress to “lay and collect taxes.”<sup>11</sup> Additionally, the Sixteenth Amendment grants Congress the power to “lay and collect taxes on *incomes*, from whatever source derived.”<sup>12</sup> To calculate taxes due, a business owner begins by computing the business's gross receipts, which generally equals the total amount the business received from sales.<sup>13</sup> The business owner then excludes the cost of goods sold from gross receipts to determine the business's gross income.<sup>14</sup> Typically, business owners can subsequently deduct ordinary and necessary business expenses from gross income to arrive at their taxable income.<sup>15</sup> Lastly, the taxpayer multiplies taxable income by

---

appears as a Schedule I drug under the Controlled Substances Act. *See id.* According to the Drug Enforcement Administration, Schedule I drugs have a high potential for abuse and have no currently accepted medical use. *See id.* Other Schedule I drugs include heroin, LSD, ecstasy, and peyote. *See id.*

9. For a further discussion of the benefits marijuana companies provide in communities where marijuana has been legalized, see *infra* notes 188–99 and accompanying text.

10. For a list of medical conditions that qualify for medical marijuana treatment, see *infra* note 198 and accompanying text.

11. U.S. CONST. art. I, § 8, cl. 1.

12. U.S. CONST. amend. XVI (emphasis added).

13. *See* Treas. Reg. § 1.993-6 (1977). Gross receipts also include gross income recognized from other sources, such as the furnishing of services, or the sale of any property that is not part of the ordinary course of business. *Id.* § 1.993-6(a)(2). For the purposes of this Comment, gross receipts will be defined as total income received from sales.

14. *See How to Compute Business Income*, WOLTERS KLUWER, <https://www.bizfilings.com/toolkit/research-topics/managing-your-taxes/federal-taxes/how-to-compute-business-income> [<https://perma.cc/YH3C-YH4W>] (last visited Mar. 31, 2021).

15. *See* I.R.C. § 162(a) (2018) (“There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . .”).

the applicable tax rate to ascertain how much income tax is due.<sup>16</sup> The following is a discussion on the “ability-to-pay” tax principle that has shaped the United States tax system, adjustments that businesses make to gross income when determining their taxable income, and the history of section 280E since its enactment.

#### A. *Harvesting the Green: Congress’s Power to Tax*

Before Congress can exercise its taxation powers, it must first consider what constitutes “income.”<sup>17</sup> Various policies and principles have influenced the way Congress taxes income, but only the ability-to-pay principle has withstood the test of time.<sup>18</sup>

##### 1. *What Exactly Is Income?*

Congress’s Sixteenth Amendment authority to collect taxes on “incomes” has been the basis of numerous legal controversies.<sup>19</sup> For example, what qualifies as income? Does having income require a finding that the taxpayer realized gain or profit? In *Eisner v. Macomber*,<sup>20</sup> the Supreme Court defined income as “the *gain* derived from capital, from labor, or from both combined.”<sup>21</sup> In tax, gain is recognized to the extent that a seller’s amount realized exceeds the seller’s adjusted basis in the property sold.<sup>22</sup> To illustrate: if A purchases a car for \$5,000, A’s basis in the car is \$5,000. If A then sells the car to B for \$6,000, A’s amount realized is \$6,000, which exceeds A’s basis in the car by \$1,000. Therefore, A recognizes a gain of \$1,000.

Nearly three decades after *Eisner*, the Supreme Court held in *Commissioner v. Glenshaw Glass Co.*<sup>23</sup> that *Eisner*’s definition of income “was not

16. See *How Do Federal Income Tax Rates Work?*, TAX POL’Y CTR., <https://www.taxpolicycenter.org/briefing-book/how-do-federal-income-tax-rates-work> [<https://perma.cc/QDR4-F5GF>] (last visited Mar. 31, 2021) (listing current and historical federal income tax rates and brackets).

17. For a further discussion regarding the definition of “income,” see *infra* Section II.A.1.

18. For a further discussion of the ability-to-pay principle, see *infra* Section II.A.2.

19. See, e.g., *Eisner v. Macomber*, 252 U.S. 189 (1920) (determining whether pro rata stock dividend could be taxed as “income” under the Sixteenth Amendment); see also *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426 (1955) (determining whether punitive damages awarded in lawsuit was income for tax purposes).

20. 252 U.S. 189 (1920).

21. *Id.* at 207 (emphasis added) (quoting *Stratton’s Indep., Ltd. v. Howbert*, 231 U.S. 399, 415 (1913)).

22. See I.R.C. § 1001(a) (2018). Amount realized is the sum of any money received plus the fair market value of any property received in an exchange of property. *Id.* § 1001(b). Basis, which is sometimes referred to as cost basis, is equal to what the seller originally paid to obtain ownership of the property. *Id.* § 1012(a). Basis can sometimes be adjusted upward or downward, however, the mechanics of adjusted basis are beyond the scope of this Comment. See generally *id.* § 1016.

23. 348 U.S. 426 (1955).

meant to provide a touchstone to all future gross income questions.”<sup>24</sup> The Court’s broadening of *Eisner* seems to give Congress unbridled power to classify any income as gross income, yet, whether “gain” is an essential ingredient of “income” is still up for debate.<sup>25</sup>

## 2. Ability-To-Pay Tax Principle

For over a century, policymakers have recognized that taxation should correspond to a taxpayer’s ability to pay.<sup>26</sup> The ability-to-pay principle is a fundamental standard of equitable taxation, and it is reflected in our progressive individual and corporate income tax system.<sup>27</sup> A progressive system taxes individuals on the amount of income they earn.<sup>28</sup> As a taxpayer’s income increases, they are taxed at a higher rate.<sup>29</sup>

Although no universally accepted measure of a taxpayer’s ability to pay exists, a logical and objective approach considers the net income of

24. *Id.* at 431 (finding that a taxpayer could not escape paying income tax on punitive damages award under *Eisner*).

25. *See, e.g.*, *N. Cal. Small Bus. Assistants, Inc. v. Comm’r*, 153 T.C. 65 (2019) (determining whether section 280E’s total disallowance of deductions was unconstitutional under the Sixteenth Amendment’s definition of “income” when business was taxed in a year that it operated at a loss). Although it is unclear what exactly constitutes “income,” one matter that is well-settled is Congress’s power to tax “illegal income.” *See Wood v. United States*, 863 F.2d 417, 419 (5th Cir. 1989) (holding illegal income is taxable when taxpayer has dominion and control). Section 61(a) of the Internal Revenue Code broadly provides that “gross income means all income from whatever source derived, including . . . income derived from business . . . [and] property . . . .” I.R.C. § 61(a)(2)–(3). “[G]ains from illegal activities are just as taxable as gains from legal activities.” *Wood*, 863 F.2d at 419 (upholding that gain is taxable income when its recipient has actual dominion and control over it).

26. *See Harry Silverston, Earned Income and Ability to Pay*, 3 TAX L. REV. 299, 299 (1948) (acknowledging ability to pay as “the fundament of justice in taxation”); *see also* JOEL SLEMRUD & JON BAKIJA, *TAXING OURSELVES* 94–95 (5th ed. 2017). *But see* Alice G. Abreu, *Tax 2018: Requiem for Ability to Pay*, 51 LOY. L.A. L. REV. 61, 88 (2018) (discussing how the TCJA abandoned the ability-to-pay principle). The Report of the House Ways and Means Committee for the Revenue Act of 1913 states: “The tax upon incomes is levied according to ability to pay, and it would be difficult to devise a tax fairer . . . .” Silverston, *supra*, at 299 n.3 (quoting H.R. REP. NO. 63-5, at XXXVII (1913)).

27. *See Are Federal Taxes Progressive?*, TAX POL’Y CTR., <https://www.taxpolicycenter.org/briefing-book/are-federal-taxes-progressive> [<https://perma.cc/XKL2-QPLN>] (last visited Mar. 31, 2021). Horizontal equity mandates that individuals who have the same level of economic well-being should be taxed equally. *See* SLEMRUD & BAKIJA, *supra* note 26, at 134.

28. *See Are Federal Taxes Progressive?*, *supra* note 27. As of 2020, there are seven income tax brackets for ordinary income (10%, 12%, 22%, 24%, 32%, 35%, and 37%). *How Do Federal Income Tax Rates Work?*, *supra* note 16. Capital gain income is taxed at different rates than ordinary income, but it is still a progressive tax. *See How Are Capital Gains Taxed?*, TAX POL’Y CTR., <https://www.taxpolicycenter.org/briefing-book/how-are-capital-gains-taxed> [<https://perma.cc/6Q6T-MHLQ>] (last visited Mar. 31, 2021).

29. *See How Do Federal Income Tax Rates Work?*, *supra* note 16.

the taxpayer.<sup>30</sup> Income represents an individual's earning power, and net income corresponds with how much income is at the taxpayer's disposal after "costs of subsistence" are deducted from gross income.<sup>31</sup> Congress would not accurately measure a taxpayer's ability to pay if it instead measured taxes by the amount of property the taxpayer holds.<sup>32</sup> Property is often encumbered by debts, so the fair market value of property is a poor indication of taxable capacity.<sup>33</sup> For property ownership to fairly reflect ability to pay, the taxing body would need to apply complicated adjustments for each taxpayer.<sup>34</sup> The administration of such a tax would be impracticable.<sup>35</sup> Likewise, a tax based on consumption alone (i.e., sales tax) would inequitably favor upper income groups.<sup>36</sup> Low-income groups spend nearly all of their income to meet their basic needs, while upper income groups comparatively spend a smaller proportion of their income and are able to divert a considerable amount of their income to savings.<sup>37</sup> Thus, low-income groups would bear a greater relative tax burden than

---

30. See Alfred G. Buehler, *Ability to Pay*, 1 TAX L. REV. 243, 243 (1946) ("Attempts have been made to measure ability in terms of the pain or sacrifice caused by taxation, others have resorted to such objective tests as net income, property, or consumer expenditures . . .").

31. See generally STEPHAN F. WESTON, PRINCIPLES OF JUSTICE IN TAXATION 179–83 (1903) (analyzing historical interpretations and characteristics of taxable income).

32. See Buehler, *supra* note 30, at 250 (recognizing shortcomings in methods of measuring taxable income). In addition to income tax, some states also impose *ad valorem* taxes on tangible personal property such as vehicles. See Garrett Watson, *States Should Continue to Reform Taxes on Tangible Personal Property*, TAX FOUND. (Aug. 6, 2019), <https://taxfoundation.org/tangible-personal-property-tax/> [<https://perma.cc/9HJ3-AV7H>] (providing overview of state taxes imposed on personal property). State and local taxation is beyond the scope of this Comment.

33. See Buehler, *supra* note 30, at 250 (summarizing complications with taxing personal property).

34. See *id.* at 251 (considering administrative burden of federal tax on personal property).

35. See *id.* For the past couple of decades, the severely underfunded IRS has struggled to collect unpaid taxes, issue timely refunds, and perform adequate customer service. Sarah Skidmore Sell, *Underfunded IRS Struggles to Send Refunds, Answer Calls*, ASSOCIATED PRESS NEWS (Jan. 8, 2020), <https://apnews.com/article/aad7a3baaf338272c157bae07668ed43> [<https://perma.cc/LC6C-VRJ7>]. The already overburdened IRS would likely experience great difficulty administering a federal tax on personal property, let alone one with complex adjustments to satisfy the ability-to-pay principle. See *id.*

36. Buehler, *supra* note 30, at 250. A consumption tax does not tax returns from capital investments, such as dividends or gains from the sale of stock. See *Who Bears the Burden of a National Retail Sales Tax?*, TAX POL'Y CTR., <https://www.taxpolicycenter.org/briefing-book/who-bears-burden-national-retail-sales-tax> [<https://perma.cc/38HX-T9TJ>] (last visited Mar. 31, 2021) (summarizing consumption tax). "[I]ncome from capital makes up a larger portion of the total income of high-income households." *Id.* Thus, a tax system based purely on consumption would unjustly benefit high-income households, while low-income households would carry a disproportional tax burden. See *id.*

37. See Buehler, *supra* note 30, at 250.

those in upper income groups.<sup>38</sup> Indeed, the ability of an individual to pay taxes can best be measured by net income from all sources after taking into account the taxpayer's economic obligations.<sup>39</sup>

Individuals and businesses are not entirely governed by the same tax code provisions, so the ability-to-pay principle faces different considerations when taxing business entities.<sup>40</sup> In the case of corporate taxation, where profits are taxed initially at the corporate level and again when dividends are distributed to shareholders, taxation on the basis of profit alone is inequitable.<sup>41</sup> Instead, the rate of the corporation's return would be a more accurate and fair representation of its ability to pay.<sup>42</sup> Taxation according to rates of return, however, requires significantly more administrative resources from both the taxpayer and the Internal Revenue Service (IRS), and is therefore highly impracticable.<sup>43</sup>

### B. *Trimming the Buds: Tax Deductions and Exclusions*

Businesses make numerous adjustments while “trimming” their gross income to determine their taxable income. In most instances, Congress can exercise “legislative grace” to allow or deny deductions from gross income.<sup>44</sup> In contrast, deducting Cost of Goods Sold (COGS) is constitutionally mandated and cannot be disallowed by Congress.<sup>45</sup> The method for calculating COGS differs between businesses that manufacture and produce goods, and businesses that merely resell goods.<sup>46</sup>

---

38. *See id.*

39. *See id.* at 243–44 (concluding that net income is the most accurate measure of taxpayers' ability to pay). This Comment argues section 280E disregards the ability-to-pay principle because by disallowing all deductions, it ignores net income and instead taxes marijuana companies on an amount that more closely resembles gross income. *See supra* Part I. As illustrated by the hypothetical in Part I, when a marijuana business is taxed on some measure of income other than net income, the business might not have the ability to pay its taxes after meeting its other economic obligations. *See id.*

40. *See* WESTON, *supra* note 31, at 284–85 (describing theories of equitable taxation of corporations).

41. *See* Buehler, *supra* note 30, at 255–56 (acknowledging shortcomings of ability-to-pay principle in corporate taxation).

42. *See id.* at 255.

43. *See id.* at 256 (acknowledging administrative burden of corporate tax based on rate of return). Unlike corporations, pass-through entities avoid ability-to-pay inequity because the owner of a pass-through entity is taxed at the same progressive income rates as individual wage earners. For a further discussion about ordinary income brackets, see *supra* note 28. For a further discussion of the taxation of pass-through entities, see *supra* note 1.

44. For a further discussion of Congress's ability to allow or deny deductions, see *infra* Section II.B.1.

45. For a further discussion of COGS, see *infra* Section II.B.2.

46. For a further discussion of various ways businesses calculate COGS, see *infra* Section II.B.3.



1. *Ordinary and Necessary Business Deductions and Legislative Grace*

Generally, taxpayers who carry on a trade or business may deduct ordinary and necessary business expenses from gross income under section 162 of the IRC.<sup>47</sup> Common business expenses include employee salaries, rental payments for retail or storage space, advertising, and travel expenses.<sup>48</sup> Even taxpayers who own and operate illegal enterprises may take ordinary and necessary business deductions, unless specifically forbidden by statute.<sup>49</sup> Absent a statute disallowing deductions, the Supreme Court has prohibited section 162 deductions in circumstances where the deductions would frustrate public policy.<sup>50</sup> Additionally, a taxpayer cannot deduct fines or penalties incurred by violating a federal or state statute.<sup>51</sup> Congress eventually codified these public policy concerns in the Tax Reform Act of 1969.<sup>52</sup> The amended section 162 forbids deductions for illegal payments such as bribes or kickbacks, amounts paid to lobby politicians, and payments of fines or penalties incurred from violating the law.<sup>53</sup>

---

47. I.R.C. § 162(a) (2018).

48. *See id.* § 162(a)(1)–(3) (stating allowable business expenses). IRS Schedule C of Form 1040 is used by sole proprietors to report income or losses from their business. *See 2020 Instructions for Schedule C*, IRS, <https://www.irs.gov/instructions/i1040sc> [<https://perma.cc/R7LE-7UV3>] (last updated Jan. 14, 2021). Schedule C demonstrates the breadth of business expenses that are deductible under section 162. *See id.* Sole proprietors can deduct expenses of operating their car or truck, contract labor, depletion, depreciation, costs of employee benefit programs, business insurance, professional fees charged by accountants and attorneys, office supplies and postage, rented or leased equipment, incidental repairs and maintenance, materials and supplies, certain taxes, travel and lodging expenses, business meals, utilities, and salaries and wages. *See id.* Section 280E prevents marijuana business owners from deducting any of these expenses. *See* I.R.C. § 280E. To view the statutory language of section 280E, see *supra* note 3 and accompanying text.

49. *See* *Comm'r v. Sullivan*, 356 U.S. 27, 29 (1958) (allowing deduction of rent and wages to an illegal gambling enterprise). *But see* *N. Cal. Small Bus. Assistants, Inc. v. Comm'r*, 153 T.C. 65, 74 (2019) (holding under section 280E petitioner is not entitled to deduct expenses for federally illegal medical marijuana business).

50. *See* Carrie F. Keller, Comment, *The Implications of I.R.C. § 280E in Denying Ordinary and Necessary Business Expense Deductions to Drug Traffickers*, 47 *ST. LOUIS U. L.J.* 157, 160 (2003) (describing the Supreme Court's public policy doctrine in disallowing deductions).

51. *See id.* at 160–61 (discussing *Tank Truck Rentals, Inc. v. Comm'r*, 356 U.S. 30, 34 (1958), which disallowed a trucking company's deductions for traffic fines incurred from driving overweight trucks).

52. *See id.* at 162 (“Although this amendment would coexist with the recognized, judicially-created public policy exception, Congress also intended ‘its codified version of the public policy doctrine to completely occupy this area of the tax law.’” (quoting Charles A. Boreck, *The Public Policy Doctrine and Tax Logic: The Need for Consistency in Denying Deductions Arising from Illegal Activities*, 22 *U. BALT. L. REV.* 45, 55–56 (1992))).

53. I.R.C. § 162(c), (e)–(f) (prohibiting deductions for payments of fines or penalties).

Notably, in the amended section 162 provisions, the denied deductions focus squarely on the illegality of the payment itself, completely ignoring the legality or illegality of the underlying business giving rise to the payment.<sup>54</sup> For example, an illegal brothel that pays a bribe to the local sheriff is prohibited from deducting the cost of the bribe from its gross income not because the brothel operates illegally, but because the bribe itself is an illegal payment.<sup>55</sup> Although the bribe is disallowed, the brothel can still deduct other business expenses under section 162.<sup>56</sup> Section 280E, on the other hand, disallows *all* deductions because of the underlying illegality of the marijuana businesses; a stark contrast to section 162's statutory scheme.<sup>57</sup>

The Supreme Court has recognized that “[d]eductions are a matter of grace and Congress can . . . disallow them as it chooses.”<sup>58</sup> Moreover, the Court seems to relinquish the matter entirely to Congress, saying that if deductions must be disallowed, “Congress should do it.”<sup>59</sup> But there are differences of opinion as to how far Congress’s grace extends.<sup>60</sup> In *Davis v. United States*,<sup>61</sup> the Second Circuit acknowledged Congress’s discretion to grant or allow deductions, but distinguished a nondiscretionary class of deductions that “are inherently necessary as a matter of computation to arrive at income.”<sup>62</sup> The Second Circuit viewed computationally necessary deductions as non-discretionary, but supported Congress’s discretion with regard to non-computational deductions,<sup>63</sup> so long as Congress’s discretion does not violate other constitutional provisions.

54. See Keller, *supra* note 50, at 163 (contrasting illegal payments with illegal businesses).

55. See, e.g., Toner v. Comm’r, Nos. 10826-80, 13639-80, 1990 WL 154691, at \*6–7 (T.C. Oct. 17, 1990) (finding illegal massage parlor and prostitution operation was permitted to deduct necessary business expenses from gross income).

56. See *id.* (citing case where illegal business was allowed to deduct business expenses).

57. Compare I.R.C. § 162(a) (“There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . .”), with § 280E (“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 . . . consists of trafficking in controlled substances . . . which is prohibited by Federal law . . .” (emphasis added)).

58. Comm’r v. Sullivan, 356 U.S. 27, 28 (1958).

59. See *id.* at 29.

60. Compare *Davis v. United States*, 87 F.2d 323, 324–25 (2d Cir. 1937) (asserting that deductions necessary for computing net income are not subject to Congress’s discretion), with *N. Cal. Small Bus. Assistants, Inc. v. Comm’r*, 153 T.C. 65, 70 (2019) (“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.”).

61. 87 F.2d 323 (2d Cir. 1937).

62. *Id.* at 324–25 (comparing computational deductions with purely gratuitous deductions).

63. See *id.* at 325 (declaring non-computational deductions such as state and local taxes paid or personal exemptions for taxpayers and their dependents not necessary to determine income). The Second Circuit’s distinction in *Davis* played

## 2. *Cost of Goods Sold: An Exception to Legislative Grace*

While *deductions* are a matter of legislative grace, Congress may not prevent the *exclusion* of COGS from gross receipts.<sup>64</sup> COGS is an accounting term that refers to the amount a business paid for the inventory it sells.<sup>65</sup> In the landmark decision of *Doyle v. Mitchell Bros.*,<sup>66</sup> the Supreme Court addressed the meaning of the word “income” in the context of a manufacturer converting its capital assets to cash.<sup>67</sup> The Court distinguished “capital” from “profit or income” and ruled that the return of capital was not income.<sup>68</sup> Therefore, when calculating gross profit, a business owner must be permitted to exclude the cost of their inventory.<sup>69</sup>

## 3. *Reseller or Producer: Different Ways Businesses Calculate COGS*

Businesses generally use the same equation to calculate their taxable income.<sup>70</sup> But the methods used to calculate COGS can vary depending on whether the business merely resells goods or whether the business pro-

---

an important role in Judge Gustafson’s dissenting opinion in *Northern California Small Business Assistants, Inc.* See *N. Cal. Small Bus. Assistants, Inc.*, 153 T.C. at 77–90 (Gustafson, J., dissenting). The majority brushed the *Davis* distinction off as dicta and refused to apply it to section 280E’s disallowance of all deductions. See *infra* Section III.B.

64. See Joseph W. Blackburn, *Fragmenting Cost of Goods Sold for Accounting Accuracy and Tax Profits*, 31 ST. LOUIS U. L.J. 295, 300 (1987) (explaining that exclusion of COGS from gross receipts is constitutionally mandated).

65. Diana Novak Jones, *How 280E Became the Pot Industry’s Boogeyman*, LAW360 (Oct. 18, 2019, 2:46 PM), <https://www.law360.com/tax-authority/articles/1209206/how-280e-became-the-pot-industry-s-boogeyman> [<https://perma.cc/D8EY-3LHS>].

66. 247 U.S. 179 (1918).

67. See *id.* at 184–85 (analyzing differences between return of capital and income). The plaintiff in *Doyle* was a lumber manufacturer that acquired timber lands for approximately \$20 per acre in 1903. *Id.* at 181. By 1908, the market value of the land had increased to \$40. *Id.* The plaintiff was subject to the Corporate Excise Tax Act of 1909, which placed a 1% tax upon a corporation’s net income in excess of \$5,000 from all sources derived. *Id.* at 181–82. The plaintiff calculated its net income as the difference between the original cost of the timber and the sum it received from selling the timber. *Id.* at 181. The IRS insisted that the plaintiff include the entire sum received for the timber as income for the purposes of the Act. *Id.* at 184.

68. *Id.* at 183–85. Instead of including the entire amount received in gross income and later deducting the cost of the timber, the Court held that the cost of the timber should be excluded from the outset, before gross income is calculated. See *id.* at 185. The Court observed that the same result is obtained through either method, but the case importantly distinguishes the exclusion of cost of goods sold, which is constitutionally mandated, from other deductible expenses, which may be subject to legislative grace. See *id.* at 187–88.

69. See Blackburn, *supra* note 64, at 299 (restating holding of *Doyle*).

70. See *id.* at 300 (“Retail merchants generally compute taxable income as follows: Gross Sales (less) Cost of Goods Sold (equals) Gross Profit; Gross Profit (plus) Other Income (equals) Gross Income; and Gross Income (less) Deductions (equals) Taxable Income.”).

duces and manufactures goods.<sup>71</sup> COGS is determined using a three-variable formula: beginning inventories plus current-year purchases (in the case of a reseller) or current-year production costs (in the case of a producer) less ending inventories.<sup>72</sup>

Marijuana resellers include the invoice price of marijuana in their COGS, less any discounts, plus any necessary costs of acquiring the marijuana (i.e., transportation).<sup>73</sup> Marijuana producers calculate COGS more expansively using a different subsection of the tax code than resellers.<sup>74</sup> A marijuana producer's COGS includes the cost of direct materials (i.e., marijuana plants or seeds), direct labor costs (i.e., planting, cultivating, harvesting), plus certain indirect production costs (i.e., utilities, rent, tools and equipment not capitalized, costs of quality control, and inspection).<sup>75</sup> Under current Treasury regulations, producers may also include some other costs in COGS if they appear on the business's GAAP financial statements.<sup>76</sup>

### C. *Take a Hit: The Added Strain of Section 280E*

In the early 1980s, the United States Tax Court held that a drug dealer could deduct expenses related to a drug business, which prompted Congress to enact section 280E.<sup>77</sup> As states began to legalize marijuana, marijuana companies petitioned the courts to limit the application of section 280E.<sup>78</sup>

---

71. Compare Treas. Reg. § 1.471-3(b) (as amended in 2018) (referring to merchandise purchased by a reseller), with § 1.471-3(c) (referring to merchandise produced by a manufacturer).

72. See Ronald Marcuson et al., *The Evolving Taxation of the Marijuana Industry*, 95 TAXES 7, 8 (2017).

73. See generally Treas. Reg. § 1.471-3(b).

74. Compare *id.* (discussing cost for merchandise purchased), with Treas. Reg. § 1.471-3(c) (discussing cost for merchandise produced).

75. See Treas. Reg. § 1.471-3(c); see also Treas. Reg. § 1.471-11(c)(2)(i) (as amended in 1993) (stating indirect production costs included in inventoriable costs).

76. See Marcuson et al., *supra* note 72, at 10 (describing benefits of producing GAAP financial statements); see also Treas. Reg. § 1.471-11(c)(2)(iii) (as amended in 1993) (listing inventoriable costs). Costs pertinent to marijuana companies under Reg. § 1.471-11(c)(2)(iii) include spoilage, administrative expenses related to production, and insurance costs related to production. See Treas. Reg. § 1.471-11(c)(2)(iii). GAAP, which stands for “generally accepted accounting principles,” are accounting standards companies use to prepare their financial statements. *US GAAP: Generally Accepted Accounting Principles*, CFA INST., <https://www.cfainstitute.org/en/advocacy/issues/gaap> [<https://perma.cc/YP58-PX3R>] (last visited Mar. 31, 2021). GAAP ensures that financial reporting is consistent from one organization to another. *Id.*

77. For a further discussion and analysis of the legislative history of section 280E, see *infra* Section II.C.1.

78. For a further discussion of cases challenging section 280E, see *infra* Section II.C.2.

1. Edmondson v. Commissioner—*The Case That Sparked Section 280E and Its Repercussions on the Marijuana Industry*

One year before Congress enacted section 280E, the United States Tax Court decided *Edmondson v. Commissioner*.<sup>79</sup> Lacking an express statutory denial to the contrary, the court's holding permitted the petitioner, a drug dealer, to deduct numerous "ordinary and necessary" expenses associated with dealing amphetamines, cocaine, and marijuana under section 162.<sup>80</sup> The petitioner was able to exclude \$105,300 for the COGS and deducted business expenses, which included the purchase of a small scale, packaging expenses, phone expenses, car expenses, and one-third of the rental expense for the petitioner's home, where they primarily sold the drugs.<sup>81</sup>

Congress responded to *Edmondson* by enacting section 280E under the Tax Equity and Responsibility Act of 1982.<sup>82</sup> Section 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.<sup>83</sup>

Congress enacted section 280E amidst the notoriously unsuccessful war on drugs.<sup>84</sup> The legislative history of section 280E reveals Congress considered public policy in light of America's renewed anti-drug stance of the '70s and '80s.<sup>85</sup> Congress anticipated constitutional challenges to section

79. 42 T.C.M. (CCH) 1533 (1981).

80. *See id.* (holding deductions associated with drug dealing business deductible). For a discussion of section 162, see *supra* notes 47–59 and accompanying text.

81. *See Edmondson*, 42 T.C.M. (CCH) at 1533 (listing various expenses that petitioner was entitled to deduct).

82. David Bronfein, Comment, *Maryland State Bank: The Responsible Solution for Fostering the Growth of Maryland's Medical Cannabis Program*, 47 U. BALT. L.F. 28, 34 (2016).

83. I.R.C. § 280E (2018) (denying deductions for drug trafficking); *see also* S. REP. NO. 97-494, at 309 (1982) (reporting changes to law in order to prevent drug dealers from deducting business expenses from gross income).

84. *See* Michael Nabeel Alsharaiha, Comment, *Smoking out the Criminals: How Federal Tax Policy Can Reduce Illegal Drug Crime by Supporting the Legal Marijuana Industry*, 48 U. TOL. L. REV. 319, 324 (2017) (highlighting Congress's attempts to deter drug supply through section 280E).

85. *See* S. REP. NO. 97-494, at 309.

There is a sharply defined public policy against drug dealing. To allow drug dealers the benefit of business expense deductions at the same time that the U.S. and its citizens are losing billions of dollars per year to such persons is not compelled by the fact that such deductions are allowed to other, legal, enterprises. Such deductions must be disallowed on public policy grounds.

280E, and the Senate Finance Committee Report preemptively explained that “the adjustment to gross receipts with respect to effective costs of goods sold is not affected by this provision of the bill.”<sup>86</sup> Consequently, marijuana companies have the unencumbered right to deduct COGS, but all other deductions and credits are prohibited under section 280E.<sup>87</sup>

## 2. *Early Challenges to Section 280E in State-Legalized Marijuana Markets*

One of the earliest challenges to section 280E, *Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner (CHAMP)*,<sup>88</sup> was argued before the United States Tax Court by “CHAMP,” a caregiving facility that provided medical marijuana to its members legally under state law.<sup>89</sup> CHAMP operated a community center where members with debilitating diseases such as AIDS, cancer, and multiple sclerosis could receive caregiving services.<sup>90</sup> In addition to caregiving services, CHAMP also provided medical marijuana to members whose doctors recommended it as part of therapy.<sup>91</sup>

The IRS disallowed all of CHAMP’s deductions, claiming they were incurred in connection with the illegal sale of drugs.<sup>92</sup> CHAMP argued it engaged in two trades or businesses, and only the expenses related to its secondary business of supplying medical marijuana to its members should

---

*Id.* Between the presidential terms of Richard Nixon and Barack Obama, the federal government has allocated over \$1 trillion to the war on drugs. See Alsharaiha, *supra* note 84, at 324 n.46 (illustrating costs of the war on drugs).

86. See S. REP. NO. 97-494, at 309. In other words, the cost of goods sold exclusion that was mandated by the Supreme Court in *Doyle* is unchanged by section 280E. See *id.*; see also *supra* notes 64–69 and accompanying text (describing mandatory nature of COGS exclusions).

87. See *supra* notes 83–86 and accompanying text explaining section 280E’s differential application to marijuana companies.

88. 128 T.C. 173 (2007).

89. See *id.* at 174–75. California Proposition 215, also known as the Compassionate Use Act, was passed in 1996, making California the first state to permit patients and caregivers to possess medicinal marijuana. See *California Proposition 215, the Medical Marijuana Initiative*, BALLOTPEdia, [https://ballotpedia.org/California\\_Proposition\\_215\\_the\\_Medical\\_Marijuana\\_Initiative\\_\(1996\)](https://ballotpedia.org/California_Proposition_215_the_Medical_Marijuana_Initiative_(1996)) [https://perma.cc/5CZD-DYTP] (last visited Mar. 31, 2020).

90. See *CHAMP*, 128 T.C. at 174. CHAMP’s extensive caregiving services included various support group sessions, daily lunches for low-income members, hygiene supplies, one-on-one counseling with social workers, massage services, social events, field trips, yoga classes, and more. *Id.* at 175–76.

91. *Id.* at 174–75. CHAMP charged a membership fee, which covered both the cost of caregiving services and the medical marijuana. *Id.* at 175. Members were provided a fixed amount of medical marijuana and were not entitled to unlimited supplies. *Id.* at 176.

92. See *id.* at 177. The disallowed deductions, which totaled \$212,958, included employee salaries, repairs and maintenance, rents, payroll taxes, depreciation of property, advertising, employee health insurance plan, accountant fees, property insurance, office expenses, telephone services, and several other expenses. *Id.* at 178–80.

be disallowed under section 280E.<sup>93</sup> The Tax Court agreed, finding that section 280E does not intend to deny all of a taxpayer's business deductions when some expenses are attributable to a trade or business other than the illegal trafficking in controlled substances.<sup>94</sup> The court held CHAMP's characterization of caregiving services and medical marijuana distribution as separate business activities was not artificial or unreasonable. It apportioned CHAMP's overall expenses and permitted CHAMP to deduct expenses attributable to its caregiving services.<sup>95</sup>

Years later, another California dispensary attempted to claim separate trades or businesses under *CHAMP*, but was rejected by both the Tax Court and the Ninth Circuit Court of Appeals.<sup>96</sup> The petitioner in *Olive v. Commissioner*<sup>97</sup> operated the Vapor Room, a dispensary that sold medical marijuana and also regularly provided complimentary on-site activities and amenities such as yoga classes, chair massages, movie screenings, snacks, and beverages.<sup>98</sup> The IRS precluded the petitioner from deducting its businesses expenses under section 280E.<sup>99</sup> The petitioner argued that the Vapor Room provided substantial caregiving services, and it should be permitted to deduct the business expenses incurred for the on-site activities.<sup>100</sup>

The Tax Court distinguished the Vapor Room from CHAMP, noting that seventy-two percent of CHAMP's employees worked exclusively in the caregiving practice, whereas the Vapor Room employees' responsibilities spanned both sides of the business.<sup>101</sup> The court rejected the petitioner's

93. *See id.* at 180.

94. *See id.* at 181–82 (finding that section 280E does not prohibit deductions for separate non-marijuana business). For a further discussion of section 280E's legislative history, see *supra* notes 85–86 and the accompanying text.

95. *See CHAMP*, 128 T.C. at 183–85 (approving CHAMP's two separate trades or businesses). The court allocated expenses on the basis of the number of CHAMP's employees who exclusively provided caregiving services and the portion of CHAMP's facilities devoted to each activity. *See id.* at 185. Eighteen of CHAMP's twenty-five employees worked exclusively as caregivers. *Id.* Additionally, CHAMP dispensed medical marijuana at only one of three facilities that it operated. *Id.*

96. *See Olive v. Comm'r*, 792 F.3d 1146, 1149 (9th Cir. 2015) (rejecting recognition as separate trades or businesses). *See generally Olive v. Comm'r*, 139 T.C. 19, 42 (2012) (same), *aff'd*, 792 F.3d 1146 (9th Cir. 2015).

97. 139 T.C. 19 (2012).

98. *Id.* at 23–24 (describing petitioner's business model). The petitioner did not collect a fee to participate in the Vapor Room's activities or services. *Id.* at 22. Patrons were also allowed to use the Vapor Room's marijuana vaporizers, regardless of whether they purchased medical marijuana from the Vapor Room. *Id.* at 23–34. A vaporizer extracts the active component from the marijuana and allows the user to inhale vapor instead of smoke. *Id.* at 21 n.5.

99. *Id.* at 36–37.

100. *See id.* at 38–39 (detailing petitioner's arguments in seeking application of *CHAMP* to their business).

101. *See id.* at 40 (comparing CHAMP's and Vapor Room's employees' duties). The court even compared the names of the two organizations. *Id.* “‘Californians Helping To Alleviate Medical Problems,’ stresses the dispensary's caregiving

claim that the on-site activities constituted a separate trade or business and explained that “to be engaged in a trade or business . . . the taxpayer’s primary purpose for engaging in the activity must be for income or profit.”<sup>102</sup> Here, the Vapor Room’s only source of revenue was from the sale of medical marijuana; the additional services and activities were merely incidental to its main business of selling marijuana.<sup>103</sup> The Ninth Circuit affirmed the Tax Court’s holding that the only “business” the petitioner engaged in was selling medical marijuana.<sup>104</sup>

Unlike *CHAMP* and *Olive*, which sought to merely carve out exceptions to section 280E, *Alpenglow Botanicals, LLC v. United States*<sup>105</sup> attempted to overturn section 280E altogether.<sup>106</sup> The plaintiffs in *Alpenglow* owned a Colorado medical marijuana dispensary that was formed as a pass-through entity, meaning Alpenglow’s income tax liabilities “passed through” to the owners’ personal tax returns.<sup>107</sup> When the IRS disallowed Alpenglow’s deductions under section 280E and issued a notice of deficiency, the owners paid the increased tax liability under protest and filed claims for a refund, which the IRS denied.<sup>108</sup> Alpenglow argued that to calculate taxable income under the Sixteenth Amendment, ordinary and necessary business expenses must, in the same vein as COGS,

---

mission. The name of the dispensary here, “The Vapor Room Herbal Center,” stresses the sale and consumption (through vaporization) of marijuana.” *Id.*

102. *Id.* at 41.

103. *See id.* at 42 (finding petitioner ineligible for separate trade or business treatment). “The Vapor Room did not spawn a second business simply by occasionally providing the patrons with snacks, a massage, or a movie . . . .” *Id.*

104. *See Olive v. Comm’r*, 792 F.3d 1146, 1149–50 (9th Cir. 2015). The Ninth Circuit offered an analogy to illustrate the difference between the Vapor Room, a single trade or business that offered free amenities, and *CHAMP*, an organization that consisted of two separate trades or businesses:

Bookstore A sells books. It also provides some complimentary amenities: Patrons can sit in comfortable seating areas while considering whether to buy a book; they can drink coffee or tea and eat cookies, all of which the bookstore offers at no charge; they can obtain advice from the staff about new authors, book clubs, community events, and the like . . . . The “trade or business” of Bookstore A “consists of” selling books. Its many amenities do not alter that conclusion . . . . By contrast, Bookstore B sells books but also sells coffee and pastries, which customers can consume in a cafe-like seating area. Bookstore B has two “trade[s] or business[es],” one of which “consists of” selling books and the other of which “consists of” selling food and beverages.

*Id.* at 1150 (third and fourth alterations in original).

105. 894 F.3d 1187 (10th Cir. 2018).

106. *Compare* *Californians Helping to Alleviate Med. Problems, Inc. v. Comm’r (CHAMP)*, 128 T.C. 173, 180 (2007) (seeking partial exception from section 280E by establishing caregiving and medical marijuana as separate trades or businesses), *and Olive*, 139 T.C. 19, 38–39 (2012) (seeking recognition as separate trade or business under *CHAMP*), *with Alpenglow*, 894 F.3d at 1192 (seeking repeal of section 280E for constitutional violations).

107. *Alpenglow*, 894 F.3d at 1193. For a further discussion of pass-through entities and how they are distinct from corporations, see *supra* note 1.

108. *Alpenglow*, 894 F.3d at 1193.



be treated as *exclusions* from gross income, as opposed to *deductions*, which is how the Tax Code categorizes business expenses.<sup>109</sup> Alpenglow also asserted that section 280E results in an excessive fine in violation of the Eighth Amendment.<sup>110</sup>

While the court acknowledged similarities between expenses that are included in COGS and other ordinary and necessary business expenses, it distinguished the two from one another.<sup>111</sup> The court explained that COGS “relates to [the] 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.”<sup>112</sup> Citing precedent from the Supreme Court, the court maintained that Congress has discretion to allow or deny deductions.<sup>113</sup> Regarding Alpenglow’s Eighth Amendment claim, the court found that Alpenglow lacked evidentiary support for the public policy arguments it attempted to raise in its amended complaint to the district court.<sup>114</sup> The court concluded that section 280E did not violate the Sixteenth or Eighth Amendments.<sup>115</sup>

### III. HIGH STAKES: CONTEMPORARY CHALLENGES TO SECTION 280E

No marijuana company has had success disputing section 280E, except for CHAMP.<sup>116</sup> Despite this dismal track record, two California marijuana dispensaries recently challenged sizable IRS tax deficiency notices.<sup>117</sup> First, the petitioner in *Patients Mutual Assistance Collective Corp.*

109. *See id.* at 1198.

110. *See id.* at 1202. Alpenglow failed to include its Eighth Amendment claim in its original complaint to the United States District Court for the District of Colorado. *Id.* at 1205. When Alpenglow attempted to amend its complaint to include the Eighth Amendment claim, the District Court denied the motion, holding the Eighth Amendment claim was not plausible. *See id.* The Eighth Amendment prohibits the imposition of excessive fines. U.S. CONST. amend. VIII.

111. *See Alpenglow*, 894 F.3d at 1199 (drawing distinction between COGS and ordinary and necessary business expenses).

112. *Id.* at 1200.

113. *See id.* at 1201. For a further discussion of “legislative grace” and Congress’s power with regard to deductions, see *supra* notes 58–63 and accompanying text.

114. *See Alpenglow*, 894 F.3d at 1205.

115. *Id.* at 1206.

116. *See* Vince Sliwoski, *Why We Love the Harborside IRC § 280E Appeal*, CANNA L. BLOG (June 10, 2020), <https://harrisbricken.com/cannalawblog/why-we-love-the-harborside-irc-280e-appeal> [<https://perma.cc/2MXP-R29A>] (discussing recent challenge to section 280E on appeal before the Ninth Circuit in *Harborside v. Commissioner*). The Ninth Circuit recently rejected Harborside’s appeal of an unfavorable Tax Court decision regarding section 280E’s applicability. *See Patients Mut. Assistance Collective Corp. v. Comm’r of Internal Revenue*, No. 19-73078, 2021 WL 1570288 (9th Cir. Apr. 22, 2021).

117. *See* *N. Cal. Small Bus. Assistants, Inc. v. Comm’r*, 153 T.C. 65, 66 (2019) (challenging \$1.2 million income tax deficiency); *Patients Mut. Assistance Collective Corp. v. Comm’r*, 151 T.C. 176, 184 (2018) (challenging nearly \$11 million income tax deficiency).

*v. Commissioner*<sup>118</sup> argued section 280E's qualifying language excluded the company from its scope. The petitioner contended it was a producer, rather than a reseller, and it should have the ability to include certain indirect costs in its COGS calculation.<sup>119</sup> Second, the petitioner in *Northern California Small Business Assistants v. Commissioner*<sup>120</sup> challenged the constitutionality of section 280E under the Eighth Amendment.<sup>121</sup>

#### A. Patients Mutual Assistance Collective Corp. v. Commissioner

The petitioner, Harborside Health Center, is one of the largest marijuana dispensaries in the world.<sup>122</sup> In compliance with California law, Harborside operates as a nonprofit,<sup>123</sup> but for federal tax purposes, it files tax returns as a C corporation.<sup>124</sup> The IRS audited Harborside's tax returns from 2007 to 2012, disallowed its deductions under section 280E, and issued notices of deficiency that alleged over \$10 million in penalties and deficiencies.<sup>125</sup> Harborside argued that section 280E should not pre-

118. 151 T.C. 176 (2018).

119. *Id.* at 188.

120. 153 T.C. 65 (2019).

121. *Id.* at 66 (discussing petitioner's argument that section 280E as-applied results in excessive fines).

122. *See About Harborside*, HARBORSIDE, <https://shopharborside.com/about/> [<https://perma.cc/T7DL-FFAG>] (last visited Mar. 31, 2021). Founded in 2006, Harborside currently operates four retail locations throughout California as well as a forty-seven-acre farm in Monterey County. *Id.* Notably, Harborside has more than 250,000 registered customers. *Id.* After California voters adopted Proposition 64, which made recreational marijuana legal under California law, Steve DeAngelo, one of Harborside's founders, marked the historic event by selling the first gram of legal cannabis in California. *Id.*; *see also* California Proposition 64, Marijuana Legalization (2016), BALLOTPEdia, [https://ballotpedia.org/California\\_Proposition\\_64\\_Marijuana\\_Legalization\\_\(2016\)](https://ballotpedia.org/California_Proposition_64_Marijuana_Legalization_(2016)) [<https://perma.cc/3TVD-QKKW>] (last visited Mar. 31, 2021).

123. *Patients Mut. Assistance Collective Corp.*, 151 T.C. at 178 (introducing the petitioner's business structure). "California laws decriminalizing medical marijuana specifically stated that they did not 'authorize any individual or group to cultivate or distribute cannabis for profit.'" *Id.* at 178 n.8 (quoting CAL. HEALTH & SAFETY CODE § 11362.765(a) (West 2007)). Harborside's bylaws required it to use any excess revenue for the benefit of the community and its patients. *Id.* at 182. To that end, Harborside provided free therapeutic services such as reiki and acupuncture, as well as group classes in yoga, tai chi, and the Alexander technique. *Id.* Patients were not required to buy marijuana to use the services. *Id.*

124. *Id.* at 182 n.7 (noting marijuana companies cannot qualify as tax-exempt entities under federal law). Section 501(c)(3) of the Internal Revenue Code exempts charitable organizations from federal income tax. *See* I.R.C. § 501(c)(3) (2018). Nevertheless, the IRS has determined that charities cannot be created for illegal purposes. *See* Rev. Rul. 75-384, 1975-2 C.B. 204 (determining that criminal enterprises cannot obtain federal tax-exempt status). Because medical marijuana is regarded as a criminal enterprise under federal law, Harborside's nonprofit status is not recognized for federal tax purposes. *See Patients Mut. Assistance Collective Corp.*, 151 T.C. at 182 n.7.

125. *See Patients Mut. Assistance Collective Corp.*, 151 T.C. at 184 (detailing the nearly \$11 million in deficiencies plus accuracy-related penalties the IRS asserted in 2012). The accuracy-related penalties were dismissed in a separate ruling by the

clude deductions for ordinary and necessary businesses expenses because Harborside operated legally under California law and therefore was not “trafficking.”<sup>126</sup> In the alternative, Harborside argued that it should be recognized as a producer rather than a reseller, so that it can capitalize its indirect costs and exclude those costs from its gross receipts under COGS.<sup>127</sup>

The court acknowledged that in *Olive* it held that a marijuana company operating legally under state law was still “trafficking” under section 280E.<sup>128</sup> Nevertheless, the court addressed Harborside’s novel argument that the words “consists of” immediately preceding “trafficking” in section 280E suggests that only businesses that *exclusively* traffic controlled substances are subject to the provision, and those that engage in other legal business activities are exempt.<sup>129</sup> Considering various principles of statutory interpretation, the court analyzed dictionary definitions, other tax code provisions, and case law before ultimately rejecting Harborside’s interpretation, concluding Harborside’s use of “consists of” as an exhaustive list would “render section 280E ineffective and absurd.”<sup>130</sup> Harborside also argued there is interplay between literal meaning and statutory pur-

---

United States Tax Court. See *Patients Mut. Assistance Collective Corp. v. Comm’r*, Nos. 29212-11, 30851-12, 14776-14, 2018 WL 6720665, at \*2 (T.C. Dec. 20, 2018) (finding Harborside acted with reasonable cause and in good faith when taking its tax positions in years 2007 through 2012).

126. See *Patients Mut. Assistance Collective Corp.*, 151 T.C. at 190–98 (analyzing petitioner’s arguments regarding meaning of “trafficking” under section 280E).

127. See *generally id.* at 204–13 (analyzing petitioner’s arguments regarding its status as manufacturer as opposed to solely retail operation). Harborside also sought CHAMP tax treatment for the portions of its business that were non-marijuana related. *Id.* at 198 (citing *Californians Helping to Alleviate Med. Problems, Inc. v. Comm’r (CHAMP)*, 128 T.C. 173, 184–85 (2007); *Olive v. Comm’r*, 792 F.3d 1146, 1149 (9th Cir. 2015)). The court, however, found Harborside to be more like the dispensary in *Olive*, where non-marijuana services were incidental, and therefore Harborside did not constitute separate trades or businesses under CHAMP. See *id.* at 202. Whereas eighteen of CHAMP’s twenty-five employees exclusively provided caregiving services, Harborside paid independent contractors less than 1% of its sales revenue to lead therapeutic sessions and classes. Compare *id.* at 202–03, with *CHAMP*, 128 T.C. at 185.

128. *Patients Mut. Assistance Collective Corp.*, 151 T.C. at 191 (emphasizing *Olive* decision rejecting petitioner’s argument for 280E exemption).

129. *Id.* at 190–91 (analyzing whether “consists of” in section 280E introduces non-exhaustive list).

130. See *id.* at 190–98. The court considered Harborside’s arguments about the ordinary meaning of “consists of.” See *id.* at 191. The court’s opinion cited several secondary sources that Harborside included in its brief, including: Antonin Scalia and Bryan A. Garner’s *READING LAW: THE INTERPRETATION OF LEGAL TEXTS* (contrasting “includes,” which sets off a non-exhaustive list, with “consists of” or “comprises,” each of which generally introduces an exhaustive list) and *BLACK’S LAW DICTIONARY* (explaining that “consisting” “is not synonymous with ‘including’” because “including,” when used in connection with a number of specified objects, always connotes incompleteness). See *id.* Ultimately, the court was more persuaded by another fundamental canon of statutory construction: to “prefer textually permissible readings that don’t render a statute ineffective.” *Id.* at 192. Harborside’s reading of section 280E would produce an absurd scenario where a

pose, but the court gave deference to the Ninth Circuit's holding in *Olive*, which addressed the same arguments a few years earlier.<sup>131</sup>

Lastly, the court considered Harborside's contention that it was not merely a reseller, but actually a producer.<sup>132</sup> The court found that Harborside was a reseller when it sold marijuana edibles and non-marijuana products it purchased from third parties.<sup>133</sup> The question is more complex with regard to the marijuana bud Harborside sold.<sup>134</sup> In its analysis, the court cited a Ninth Circuit case that held that a "producer" retains title to items throughout the contract-production process.<sup>135</sup> Although Harborside bought marijuana only from its members who "used Harborside's clones . . . , took Harborside's growing class, followed Harborside's best practices, and met Harborside's quality-control standards," growers who used Harborside's clones had no obligation to sell buds that the clones produced back to Harborside, and Harborside had no ownership interest in the marijuana plants after the clones left their possession.<sup>136</sup>

---

drug dealer could circumvent the provision by selling any single item that was not a controlled substance, such as a lighter or rolling papers. *See id.*

131. *See id.* at 207–08 (describing statutory difference between producer and reseller). Harborside reminded the court that state-sanctioned marijuana dispensaries did not exist in 1982 when Congress enacted section 280E. *See id.* In fact, since 2015, Congress has prohibited the Department of Justice from prosecuting marijuana dispensaries operating legally under state law. *See, e.g.*, H.R. Con. Res. 31, 116th Cong. § 537 (2019) (enacted); H.R. Con. Res. 1625, 115th Cong. § 538 (2018) (enacted); H.R. Con. Res. 244, 115th Cong. § 537 (2017) (enacted) ("None of the funds made available in this Act to the Department of Justice may be used . . . to prevent any [state] from implementing their own laws that authorize the use, distribution, possession, or cultivation of medical marijuana." (emphasis added)). The Ninth Circuit addressed this same argument in *Olive* and held that enforcing section 280E as a tax does not change whether the use, distribution, possession, or cultivation of marijuana is authorized in the states. *See Olive*, 792 F.3d at 1151 (holding section 280E did not violate Consolidated Appropriations Act).

132. *See Patients Mut. Assistance Collective Corp.*, 151 T.C. at 206. Different rules apply to resellers and producers when determining what to include in COGS. *Compare* Treas. Reg. § 1.471-3(b) (as amended in 2018) (applying to merchandise *purchased and resold* by the taxpayer), *with* § 1.471-3(c) (applying to merchandise *produced* by the taxpayer). For a further discussion of the differences between resellers and producers, see *supra* notes 70–76 and accompanying text.

133. *See Patients Mut. Assistance Collective Corp.*, 151 T.C. at 210.

134. For a further discussion of Harborside's labor in preparing marijuana buds for sale, see *infra* note 137.

135. *See Patients Mut. Assistance Collective Corp.*, 151 T.C. at 211–12 (examining precedent for the meaning of "produce" versus "manufacture"). "The only requirement for being a 'producer' . . . is that the taxpayer be 'considered an owner of the property produced' . . . . A taxpayer can be a 'producer' . . . even if it uses contract manufacturers to do the actual production." *Id.* at 211 (internal quotation marks omitted) (quoting *Suzy's Zoo v. Comm'r*, 273 F.3d 875, 880 (9th Cir. 2001)).

136. *Id.* at 179, 212–13 (analyzing petitioner's practices for acquiring marijuana). "Clones are cuttings from a female cannabis plant that can be transplanted and used to cultivate marijuana." *Id.* at 179.

Therefore, the court held that Harborside is a reseller, rather than a producer, for the purposes of calculating COGS under IRC section 471.<sup>137</sup>

B. Northern California Small Business Assistants, Inc. v. Commissioner

Within a year of the *Harborside* decision, another marijuana dispensary challenged a \$1.2 million tax deficiency.<sup>138</sup> The petitioner asserted section 280E “imposes a gross receipts tax as a penalty in violation of the Eighth Amendment” by disallowing *all* deductions and should therefore be invalidated.<sup>139</sup> The majority rejected the petitioner’s argument and instead reinforced that deductions are acts of legislative grace, which Congress is free to grant, restrict, and deny at its discretion.<sup>140</sup> The court cited numerous cases where the denial of a deduction did not violate the Eighth Amendment and reiterated that section 280E had never been considered a penalty in its forty-year history.<sup>141</sup> Thus, the majority held that the peti-

137. *Id.* at 213. Harborside has appealed this issue to the Ninth Circuit. *See generally* Opening Brief for Appellant, Patients Mut. Assistance Collective Corp. v. Comm’r, No. 19-73078 (9th Cir. May 26, 2020). In its Opening Brief, Harborside analogizes itself to a grocery store butcher who prepares cuts of meat and packages them before they reach the retail floor. *Id.* at 60. Harborside had an extensive procurement process whereby dedicated employees sourced marijuana clones, flowers, marijuana-containing products, and non-marijuana containing products. *See Patients Mut. Assistance Collective Corp.*, 151 T.C. at 179 (detailing Harborside’s inventory acquisition process). At least four employees spent all of their time purchasing and caring for the clones. *Id.* More than eight employees procured, inspected, and readied the bulk marijuana flowers for sale. *Id.* at 180. Harborside was selective about the marijuana flowers it purchased, ensured they contained the right “cannabinoid profile,” and inspected the buds for pathogenic mold. *See id.* Harborside sent marijuana samples to a third-party laboratory for testing, and if all went well, the marijuana was reinspected, manicured, and trimmed, and then weighed, packaged, and labeled before it reached the retail floor. *Id.*

138. *See N. Cal. Small Bus. Assistants, Inc. v. Comm’r*, 153 T.C. 65, 65–66 (2019) (challenging section 280E on constitutional grounds).

139. *Id.* at 66–67. The Eighth Amendment states: “Excessive bail shall not be required, nor excessive fines imposed, nor cruel and unusual punishments inflicted.” U.S. CONST. amend. VIII. The petitioner also argued that because it operates a medical marijuana dispensary legally under California law, its business does not consist of “trafficking” a controlled substance within the meaning of section 280E. *See N. Cal. Small Bus. Assistants, Inc.*, 153 T.C. at 72. The majority rejected the argument, citing many holdings to the contrary. *See, e.g.*, *Olive v. Comm’r*, 139 T.C. 19, 38 (2012); *Californians Helping to Alleviate Med. Problems, Inc. v. Comm’r (CHAMP)*, 128 T.C. 173, 182–83 (2007) (finding trafficking within the scope of section 280E to include sale of medical marijuana).

140. *See N. Cal. Small Bus. Assistants, Inc.*, 153 T.C. at 69–70. “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.” *Id.*

141. *Id.* at 71–72 (first citing *Alpenglow Botanicals, LLC v. United States*, 894 F.3d 1187, 1202 (10th Cir. 2018); then citing *Murillo v. Comm’r*, No. 18163-96, 1998 WL 6462, at \*3 (T.C. Jan. 12, 1998); and then citing *Birmingham v. Comm’r*, No. 24897-90, 1994 WL 52352, at \*12 (T.C. Feb. 23, 1994); *King v. United States*, 949 F. Supp. 787, 791 (E.D. Wash. 1996)) (holding that denial of deductions under section 280E not penalty under Eighth Amendment).

tioner's inability to deduct ordinary and necessary business expenses did not violate the Eighth Amendment.<sup>142</sup>

In contrast, two dissenting opinions illustrated how the constitutionality of section 280E is still in question.<sup>143</sup> Judge Gustafson began a lengthy dissent by considering the meaning of "income" under the Sixteenth Amendment.<sup>144</sup> Both the majority and dissenting opinions agreed that "income" must exclude COGS because return of capital shall not be taxed.<sup>145</sup> But Judge Gustafson's dissent went further, emphasizing that "income" means gain, and that ordinary and necessary expenses must be accounted for before one can be said to have gain.<sup>146</sup> In Judge Gustafson's eyes, section 280E results in a tax on something other than "income" because it prohibits marijuana companies from deducting any expense besides COGS.<sup>147</sup> As support, Judge Gustafson cited *Davis*, a Second Circuit

---

142. *N. Cal. Small Bus. Assistants, Inc.*, 153 T.C. at 71–72.

143. *See id.* at 77–90 (Gustafson, J., dissenting) (concluding that taxing income where there is no gain violates Sixteenth Amendment); *see also id.* at 90–94 (Copeland, J., dissenting) (concluding that section 280E is a penalty that raises Eighth Amendment concerns).

144. *See id.* at 77 (Gustafson, J., dissenting). The Sixteenth Amendment grants Congress the power to tax incomes. *See* U.S. CONST. amend. XVI.

145. *See N. Cal. Small Bus. Assistants, Inc.*, 153 T.C. at 65 (recognizing distinction between return of capital and gross income). For a discussion of return of capital versus gross income that was established in *Doyle*, *see supra* notes 67–69 and accompanying text.

146. *See N. Cal. Small Bus. Assistants, Inc.*, 153 T.C. at 80–81 (Gustafson, J., dissenting) (asserting that income without gain must not be taxed). "Income may be defined as the *gain* derived from capital, from labor, or from both combined." *Id.* at 80 (internal quotation marks omitted) (quoting *Eisner v. Macomber*, 252 U.S. 189, 206–07 (1920)).

147. *See id.* at 77–90 (explaining why section 280E results in inaccurate measure of income). Judge Gustafson illustrated why "income" must account for a taxpayer's cost of goods sold:

A taxpayer who purchased 100 widgets at a cost of \$10 each and sold them at a price of \$9 each would have gross receipts or sales of \$900, which after being reduced by the "cost of goods sold" . . . of \$1,000 . . . would yield a loss of \$100. Given that obvious loss, Congress could not tax the gross receipts of \$900 as if it were "income."

*Id.* at 80. Judge Gustafson then changed the facts of the hypothetical to demonstrate how section 280E's prohibition of *all* deductions fabricates gain where there may not be any:

Suppose he purchased 100 widgets at a cost of \$6 per widget . . . and suppose that for his business he leased a retail space for \$200 and paid wages of \$200 to employees, yielding additional expenses of \$400, so that his out-of-pocket expenditures for COGS (\$600) and additional expenses (\$400) totaled \$1,000. If he then sold the 100 widgets at a price of \$9 each . . . after being reduced by his total costs of \$1,000 (the sum of COGS and total expenses), [he would] yield a loss of \$100. No one would propose that this seller had any gain. And if his product had been . . . illegal drugs costing the same amount, he would have the same . . . loss of \$100. But despite this obvious loss, section 280E would disallow any deduction for his rent and wage expenses totaling \$400, leaving him with gross receipts of \$900, less COGS . . . yielding a supposed taxable "income" of \$300—despite his having incurred not gain but loss.

decision that distinguished necessary expenses, which are “inherently necessary as a matter of computation to arrive at income,” from deductions of another sort that Congress has allowed as a matter of legislative grace.<sup>148</sup> Despite *Alpenglow*, which arguably contradicts his assertions, Judge Gustafson maintained that gain is an “indispensable ingredient of income.”<sup>149</sup>

Judge Gustafson further observed that “[e]ven if deductions are a matter of legislative grace, the disallowance of deductions must pass muster . . . under all other constitutional standards.”<sup>150</sup> To that end, Judge Gustafson analyzed the Eighth Amendment and maintained that section 280E results in a “fine” under the Eighth Amendment’s Excessive Fines Clause.<sup>151</sup> Judge Gustafson acknowledged that before the petitioner could prevail, the court would have to also determine whether the Eighth

---

*Id.* at 83.

148. *Id.* at 82 (citing *Davis v. United States*, 87 F.2d 323 (1937)). For a further discussion of *Davis*, see *supra* note 61–63 and accompanying text.

149. See *N. Cal. Small Bus. Assistants, Inc.*, 153 T.C. at 82 (Gustafson, J., dissenting) (asserting *Davis* is still persuasive despite contrary holding in *Alpenglow*). For a further discussion of *Alpenglow*, see *supra* notes 105–15 and accompanying text. Judge Gustafson conceded the Tenth Circuit’s opinion in *Alpenglow* set the Second Circuit’s *Davis* decision aside as dicta and noted that the Supreme Court in *Glenshaw Glass Co.* held that *Eisner* “was not meant to provide a touchstone to all future gross income questions.” See *N. Cal. Small Bus. Assistants, Inc.*, 153 T.C. at 82 (Gustafson, J., dissenting) (internal quotation marks omitted) (quoting *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955)). Nevertheless, Judge Gustafson asserted that the court’s findings in *Alpenglow* are unpersuasive because the court relied on a prior opinion that only addressed whether, under the Anti-Injunction Act, the IRS could be enjoined from investigating whether the petitioner was trafficking in a controlled substance, which, if true, would invalidate its deductions under section 280E. See *id.* The Tenth Circuit did not address whether section 280E fails as a penalty under the Eighth Amendment in *Alpenglow*. See *id.* at 89.

150. *Id.* at 85. Congress would clearly violate constitutional provisions if, for example, Congress allowed tax exemptions for one religious organization but denied them for another. See, e.g., *Golden Rule Church Ass’n v. Comm’r*, 41 T.C. 719, 729 (1964) (first citing *Niemothko v. Maryland*, 340 U.S. 268, 272–73 (1951); then citing *Fowler v. Rhode Island*, 345 U.S. 67, 69 (1953)) (noting that discriminating between religious organizations violates First Amendment). Similarly, it would be unconstitutional if individuals of one sex were allowed deductions, but those same deductions were denied to individuals of another sex. See, e.g., *Moritz v. Comm’r*, 469 F.2d 466, 469 (10th Cir. 1972) (“[I]f the Congress determines to grant deductions of a general type, a denial of them to a particular class may not be based on an invidious discrimination.”).

151. See *N. Cal. Small Bus. Assistants, Inc.*, 153 T.C. at 85–90 (Gustafson, J., dissenting) (concluding that application of section 280E results in a fine, which may be prohibited under Eighth Amendment). The Eighth Amendment provides, “[e]xcessive bail shall not be required, nor excessive fines imposed, nor cruel and unusual punishments inflicted.” U.S. CONST. amend. VIII (emphasis added). Judge Gustafson’s argument is supported by a second dissenting opinion by Judge Copeland, which asserted that, for the purposes of the Eighth Amendment, “fines” are “payments ‘to a sovereign as punishment for some offense.’” See *N. Cal. Small Bus. Assistants, Inc.*, 153 T.C. at 91 (Copeland, J., dissenting) (quoting *United States v. Bajakajian*, 524 U.S. 321, 327 (1998)).

Amendment extends to corporate taxpayers and whether the section 280E penalty is “excessive.”<sup>152</sup>

Judge Copeland’s dissent emphasized that the intent of section 280E’s prohibition on deductions was to punish drug traffickers.<sup>153</sup> Judge Copeland argued that a tax loses its character and becomes a sheer penalty “with the characteristics of regulation and punishment” when imposed to influence conduct.<sup>154</sup> Judge Copeland characterized section 280E as a penalty provision because it operates to deter marijuana sales by broadly denying *every* deduction that would otherwise be allowed.<sup>155</sup> Judge Copeland finished by stating Congress cannot evade the Eighth Amendment simply by labeling something a tax.<sup>156</sup>

#### IV. DELVING INTO THE WEEDS: A CRITICAL ANALYSIS OF SECTION 280E

The Tax Court’s consistency in upholding section 280E should not warrant a hasty conclusion that section 280E is beyond reproach.<sup>157</sup> On the contrary, section 280E masquerades as a mere tax, but given a closer look at the provision’s effect, it becomes clear section 280E is, in fact, a penalty.<sup>158</sup> Moreover, by taxing marijuana companies on gross income rather than net income, section 280E blatantly ignores the ability-to-pay principle, which is one of the longest standing pillars of a just and equitable tax system.<sup>159</sup> Since section 280E was enacted, public opinion has shifted to favor marijuana, and a majority of states have legalized medicinal marijuana.<sup>160</sup> In states where medicinal or recreational marijuana is

---

152. *Id.* at 90 (Gustafson, J., dissenting) (emphasizing need for further proceedings to address outstanding questions relating to case).

153. *See id.* at 91–93 (Copeland, J., dissenting).

154. *Id.* at 92 (quoting *Bailey v. Drexel Furniture Co.*, 259 U.S. 20, 37 (1992)) (examining threshold between tax and penalty). Similarly, Judge Gustafson cited the Supreme Court, noting “if the concept of penalty means anything, it means punishment for an unlawful act or omission.” *Id.* at 87 (Gustafson, J., dissenting) (internal quotation marks omitted) (quoting *Nat’l Fed’n of Indep. Bus. v. Sebelius*, 567 U.S. 519, 567 (2012)).

155. *See id.* at 93 (Copeland, J., dissenting) (describing section 280E as punitive in its sweeping application to all deductions).

156. *See id.* at 92 (citing *Bailey*, 259 U.S. at 37) (holding exaction for employment of minor children, which was labeled tax, functioned as penalty).

157. *See, e.g., id.* at 93 (“Section 280E is punitive and requires further analysis under the Eighth Amendment.”).

158. *See id.* (“[E]ven if section 280E was not written as a penalty provision, it operates as such.”). For a further discussion of how section 280E operates as a penalty, see *supra* notes 138–56 and accompanying text.

159. *See Buehler, supra* note 30, at 243. (“To many persons ability to pay is synonymous with justice in taxation.”). For a further discussion of the ability-to-pay principle, see *supra* notes 26–43 and accompanying text. For a further discussion on how section 280E specifically frustrates the ability-to-pay principle, see *infra* notes 177–83 and accompanying text.

160. *See infra* notes 184–85 for supporting data.



legal, dispensaries provide many economic and social benefits.<sup>161</sup> To preserve these benefits, harmful legislation like section 280E must be repealed or amended; otherwise, medical marijuana companies may be forced to close up shop and go underground.<sup>162</sup>

A. *Blunt Trauma: Section 280E Undeniably Penalizes Marijuana Companies*

Although section 280E was intended to deter drug trafficking, its application results in something that resembles a punishment more than a tax.<sup>163</sup> The Tax Equity and Responsibility Act of 1982, which promulgated section 280E, plainly identifies public policy against drug trafficking as the driving force behind the provision.<sup>164</sup> Reflecting this legislative intent, the provision does not seek to merely levy a tax on drug traffickers, rather, it strives to bolster the war on drugs and serve as a weapon in the government's arsenal.<sup>165</sup>

Under the guise of a tax, section 280E punishes marijuana companies by levying a high tax burden based on gross income, diminishing profits, and making it more difficult to remain in business.<sup>166</sup> Section 280E enables the IRS to disallow deduction after deduction from marijuana company tax returns.<sup>167</sup> Research suggests the IRS singles out marijuana companies, which are over five times more likely to be audited than other businesses.<sup>168</sup> Congress, the IRS, and the courts have all ignored the fact that taxing a business on gross income without taking into account ordi-

---

161. See, e.g., *How Do Marijuana Taxes Work?*, TAX POL'Y CTR., <https://www.taxpolicycenter.org/briefing-book/how-do-marijuana-taxes-work> [<https://perma.cc/2XKS-LY94>] (last visited Mar. 31, 2021) (explaining how different states tax recreational marijuana). For a further discussion of how marijuana companies benefit the states and communities in which they operate, see *infra* notes 188–99 and accompanying text.

162. See Alsharaiha, *supra* note 84, at 335–36.

163. See *id.* at 335 (explaining how section 280E was enacted specifically to punish criminals who illegally buy and sell drugs because of link between drugs and violence); see also *N. Cal. Small Bus. Assistants, Inc.*, 153 T.C. at 92–93 (2019) (Copeland, J., dissenting) (characterizing section 280E as penalty disguised as tax).

164. See S. REP. NO. 97-494, at 309 (1982) (showing connectivity between section 280E and drug deterrence).

165. See generally Alsharaiha, *supra* note 84, at 324–25 (contextualizing section 280E's enactment during war on drugs).

166. See *id.*

167. See I.R.C. § 280E (2018).

168. See Becky Olson, *Chart of the Week: IRS Audit Rate for Existing Marijuana Businesses*, MARIJUANA BUS. DAILY (June 15, 2015), <https://mjbizdaily.com/chart-of-the-week-irs-audit-rate-for-existing-marijuana-businesses/> [<https://perma.cc/3CMM-35XT>]. The IRS audited about 1.4% of all United States businesses in 2014. *Id.* Yet, surveys show that marijuana retail businesses have an 8% chance of being audited. *Id.* The likelihood of a business being audited fluctuates based on a number of factors such as corporate structure, gross income, and the nature of the business. *Id.* Marijuana business owners are being audited at the same rate of frequency as some of America's largest corporations with over \$100 million in assets. See *id.*

nary and necessary business expenses does not accurately reflect the business's profits.<sup>169</sup>

Rather than remedying this disparity, the Supreme Court declined to rule on the issue, instead punting the issue back to Congress to decide whether to bestow its “legislative grace” upon marijuana companies to allow deductions.<sup>170</sup> The Court could have addressed whether deductions that are mathematically necessary for taxpayers to compute their actual income are distinguishable from deductions that, by legislative grace, grant taxpayers a felicitous tax break.<sup>171</sup>

Judge Gustafson's dissent in *North California Small Business Assistants, Inc.* breaks the judicial silence on the matter and posits that the penalty section 280E doles out is not the disallowance of deductions per se.<sup>172</sup> Rather, the penalty is the oppressive tax burden that results from the disallowance.<sup>173</sup> Take Harborside, for example: in 2007, Harborside operated at a loss of \$26,407.<sup>174</sup> Yet, Harborside was liable for \$628,516 in federal income tax because the IRS asserted that its ordinary and necessary business expenses were disallowed under section 280E.<sup>175</sup> Foisting a hefty tax burden on a marijuana company that operated at a financial loss illustrates section 280E's penalizing effect.<sup>176</sup>

---

169. See, e.g., *N. Cal. Small Bus. Assistants, Inc. v. Comm'r*, 153 T.C. 65, 77–84 (2019) (Gustafson, J., dissenting) (arguing that Congress taxes something other than “income” under section 280E).

170. See *Comm'r v. Sullivan*, 356 U.S. 27, 28 (1958) (“If we enforce as federal policy the rule espoused by the Commissioner in this case, we would come close to making this type of business taxable on the basis of its gross receipts, while all other business would be taxable on the basis of net income. If that choice is to be made, Congress should do it.”).

171. See *Davis v. United States*, 87 F.2d 323, 324–25 (2d Cir. 1937) (distinguishing computational deductions from other deductions). Before Congress enacted the 2017 Tax Cuts and Jobs Act, taxpayers could claim personal tax exemptions for themselves and their dependents. See *What Are Personal Exemptions?*, TAX POL'Y CTR., <https://www.taxpolicycenter.org/briefing-book/what-are-personal-exemptions> [<https://perma.cc/6Q2S-UN6X>] (last visited Mar. 31, 2021). The exemption reduced the amount of taxes a taxpayer owed, and personal exemptions were especially beneficial to families with more dependents. See *id.* Personal exemptions are distinguishable from deductions from gross income because personal exemptions are unrelated to the activities that resulted in income, whereas ordinary and necessary business expenses under section 162 can be directly attributed to the taxpayer's earned income. See *id.*; see also I.R.C. § 162(a).

172. See *N. Cal. Small Bus. Assistants, Inc.*, 153 T.C. at 88 (Gustafson, J., dissenting).

173. See *id.* (declaring aspect of section 280E that makes it penalty); see also *id.* at 90–93 (Copeland, J., dissenting).

174. See Opening Brief for Appellant, *supra* note 137, at 28.

175. See *id.*

176. See *N. Cal. Small Bus. Assistants, Inc.*, 153 T.C. at 92–93 (Copeland, J., dissenting). “A ‘penalty’ is a ‘punishment, whether corporal or pecuniary, imposed and enforced by the State, for a crime or offen[s]e against its laws.” *Id.* at 91 n.1 (alteration in original) (quoting *Kokesh v. SEC*, 137 S. Ct. 1635, 1642 (2017)).

B. *Up in Smoke: Taxing Income Absent Gain Causes Ability-To-Pay Burnout*

By prohibiting ordinary and necessary expense deductions by marijuana companies, the tax code frustrates the long-standing principle that taxes should reflect the taxpayer's ability to pay.<sup>177</sup> To accurately represent a taxpayer's ability to pay, tax must be measured by net income, which takes into account deductions for business expenses.<sup>178</sup> Section 280E taxes marijuana companies on their *gross* income rather than their net income by forbidding them from taking deductions.<sup>179</sup>

Although Congress has lawfully disallowed deductions for certain expenditures such as bribe payments and traffic tickets, section 280E does not merely disallow *some* deductions; it sweepingly disallows *all* deductions, which can result in a tax bill that exceeds a company's actual profits.<sup>180</sup> What's more egregious is that a marijuana company operating at a loss can face an enormous tax bill, where other profitless non-marijuana businesses would not have income tax and can even carry forward losses to offset income in future years.<sup>181</sup> By taxing the marijuana company's gross income, Congress taxes the company on an inflated representation of the company's gain, ignoring the ability-to-pay principle.<sup>182</sup> Consequently, marijuana companies are forced to somehow find a way to pay their taxes during unprofitable years, or else become extinguished.<sup>183</sup>

---

177. See Frank M. Keesling, *Illegal Transactions and the Income Tax*, 5 UCLA L. REV. 26, 35 (1958) (discussing how disallowing deductions for illegal items frustrates ability-to-pay principle as matter of public policy).

178. See *id.* (asserting that net income is the only accurate way to measure taxpayer's ability to pay, rather than gross income).

179. See *N. Cal. Small Bus. Assistants, Inc.*, 153 T.C. at 84 (Gustafson, J., dissenting).

180. See I.R.C. § 280E (2018) (declaring "no deduction" whatsoever for a trade or business engaged in trafficking in controlled substances as is prohibited by federal law).

181. See James V. Baker, *IRS War on Cannabis Companies Must End*, SEEKING ALPHA (July 8, 2020, 8:07 AM), <https://seekingalpha.com/article/4357511-irs-war-on-cannabis-companies-must-end> [<https://perma.cc/KH6K-ST3X>] (reporting losses sustained by marijuana companies due to section 280E). Harborside is not the only marijuana company to have income tax in a year when it operated at a loss. See *id.* Five of the largest multi-state-operating marijuana companies faced net losses but were taxed as having net gains. *Id.*

Curaleaf lost \$45.8 million but had a current tax of \$17.1 million, Green Thumb lost \$50.2 million but had a current tax of \$22.8 million, Cresco lost \$50.8 million but had a current tax of \$13.3, Harvest Health lost \$171.8 million but had a current tax of \$5.7 [million], and MedMen lost \$263.2 million but had a current tax liability of \$18.8 million.

*Id.* (citations omitted).

182. See *N. Cal. Small Bus. Assistants, Inc.*, 153 T.C. at 83–84 (Gustafson, J., dissenting) ("Section 280E would fabricate gain where there was none and would impose a tax based on artificial income.").

183. See Baker, *supra* note 181 (explaining how marijuana companies sustain exorbitant losses due to section 280E). Marijuana companies who carry a sizeable tax balance must either sell assets, borrow money, or issue stock to pay their taxes. See *id.*

C. *Flower to the People: Congress Should Amend Section 280E in Light of Widespread State Legalization*

Congress should tune into recent societal attitude changes regarding marijuana usage and eliminate the harm that section 280E causes to states where recreational and medical marijuana is legal. Congress never imagined a legalized marijuana industry when it enacted section 280E in 1982, and undeniably, the public opinion of marijuana has radically shifted since then.<sup>184</sup> State legislatures have responded to this shift in opinion, and now medical marijuana is legal in thirty-nine states and the District of Columbia, and fifteen of those jurisdictions also permit the sale of recreational marijuana.<sup>185</sup> Today, marijuana is an ever-growing industry that creates jobs and generates a significant amount of state tax reve-

---

184. See Brief of Amicus Curiae Nat'l Cannabis Indus. Ass'n Supporting Appellant in Favor of Reversal at 5, *Patients Mut. Assistance Collective Corp. v. Comm'r*, No. 19-73078 (9th Cir. June 2, 2020) (providing evidence that Americans favor marijuana legalization). "Recent polling reveals that 93% of Americans favor legalizing medical marijuana for public use, and 63% support legalization for non-medical use." *Id.* (citing Quinnipiac Univ. Poll, *U.S. Voters Believe Comey More than Trump, Quinnipiac University National Poll Finds; Support for Marijuana Hits New High* 2 (Apr. 26, 2018), <https://poll.qu.edu/national/release-detail?ReleaseID=2539> [<https://perma.cc/2F5J-G9RF>]). In the 1980s, only 25% of Americans supported marijuana legalization. See Liam McKillop, Comment, *Pass the Revenue: How Section 280E Is Harming the Medical Marijuana Industry*, 2 INT'L COMP., POL'Y & ETHICS L. REV. 849, 868 (2019) (providing historical data on public perception of marijuana).

185. See *Map of Marijuana Legality by State*, DISA GLOB. SOLS., <https://disa.com/map-of-marijuana-legality-by-state> [<https://perma.cc/72MZ-WCMJ>] (last visited Dec. 18, 2020). During the Obama presidency, the Department of Justice even issued memoranda directing federal prosecutors to deprioritize enforcement of federal marijuana laws in states where marijuana was legal. See 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, 263 (2016) (describing actions taken by federal agencies to stop prosecution of marijuana businesses). The first memorandum was issued in 2009 by David W. Ogden, and the second was issued in 2013 by James M. Cole. See *id.* at 262–63 (first citing Memorandum from David W. Ogden, Deputy Attorney Gen., to Selected U.S. Attorneys 1 (Oct. 19, 2009), <http://www.justice.gov/sites/default/files/opa/legacy/2009/10/19/medical-marijuana.pdf> [<https://perma.cc/LA4P-EZJB>]; then citing Memorandum from James M. Cole, Deputy Attorney Gen., to U.S. Attorneys 1 (Aug. 29, 2013), <http://www.justice.gov/iso/opa/resources/3052013829132756857467.pdf> [<https://perma.cc/K2JL-AYC3>]).

During the Trump administration, then-Attorney General Jeff Sessions repealed these memoranda. See Memorandum from Jefferson B. Sessions, III, Attorney Gen., to U.S. Attorneys (Jan. 4, 2018), <https://www.justice.gov/opa/press-release/file/1022196/download> [<https://perma.cc/8T4V-ST5K>] (striking Ogden and Cole memoranda). Nevertheless, more states have since legalized marijuana, and citizens have demonstrated support for the cannabis industry through a steady increase in sales since 2016. See KACEY MORRISSEY ET AL., NEW FRONTIER DATA, THE U.S. CANNABIS REPORT 2019 INDUSTRY OUTLOOK 8 (2019), <https://equio.newfrontierdata.com/reports> [permalink unavailable] (providing market data on marijuana industry). Since 2016, legal marijuana sales have seen a steady 16% or more increase year-to-year. *Id.* at 7.

nue.<sup>186</sup> The continued enforcement of section 280E against marijuana companies operating legitimately under state law incentivizes those companies to go underground and jeopardizes the societal benefits resulting from the legal marijuana industry.<sup>187</sup>

1. *Jackpot: Legal Marijuana Provides Considerable Societal Benefits*

The legal marijuana industry provides jobs, tax revenue, and high-quality alternative medicines to chronically ill patients.<sup>188</sup> Early in 2020, over 243,000 individuals were employed full-time by the marijuana industry, representing a 15% growth rate since 2019.<sup>189</sup> Even more impressive is the marijuana industry's 100% job growth rate between 2016 and 2020, a feat practically unheard of in other industries.<sup>190</sup> Researchers believe that if all fifty states legalized marijuana, the industry would generate 1.63 million jobs by 2025.<sup>191</sup>

The marijuana industry is a major source of revenue in states that have legalized marijuana.<sup>192</sup> Excise and sales taxes on marijuana raised

186. See *infra* Section IV C.1.

187. See *infra* Section IV C.2.

188. See Brief of Amicus Curiae, *supra* note 184, at 6. “[M]arijuana provides relief to patients suffering from ‘cancer, anorexia, AIDS, chronic pain, spasticity, glaucoma, arthritis [and] migrane[s].’” *Id.* (alterations in original) (quoting CAL. HEALTH & SAFETY CODE § 11362.5(a)(b)(1)(A) (West 2007)); see also Paul J. Larkin, Jr., *Introduction to a Debate: ‘Marijuana: Legalize, Decriminalize, or Leave the Status Quo in Place?’*, 23 BERKLEY J. CRIM. L. 72, 74–75 (2018) (describing medical uses of marijuana).

189. See Bruce Barcott et al., *Cannabis Jobs Report: Legal Cannabis Now Supports 243,700 Full-Time American Jobs*, LEAFLY (Feb. 7, 2020), <https://www.leafly.com/news/industry/243700-marijuana-jobs-how-many-in-america> [<https://perma.cc/ZQ9N-SXZ7>].

190. See BRUCE BARCOTT ET AL., LEAFLY, LEAFLY JOBS REPORT 2020 3 (2020), <https://leafly-images.imgix.net/Leafly-2020-Jobs-Report.pdf> [<https://perma.cc/47RA-YL46>]. “Massachusetts now has more legal cannabis workers than hair stylists and cosmetologists. Nevada has as many cannabis workers as bartenders. Illinois has twice as many cannabis workers as meat packers.” *Id.*

191. *U.S. Federal Cannabis Legalization Could Be Worth \$128.8 Billion in Taxes and 1.6 Million Jobs*, BUS. WIRE (Oct. 2, 2019, 10:32 AM), <https://www.businesswire.com/news/home/20191002005609/en/U.S.-Federal-Cannabis-Legalization-Worth-128.8-Billion> [<https://perma.cc/5QRC-GADA>].

192. See generally Carl Davis, *State and Local Cannabis Tax Revenue Jumps 33%, Surpassing \$1.9 Billion in 2019*, INST. ON TAX’N & ECON. POL’Y (Mar. 10, 2020), <https://itep.org/state-and-local-cannabis-tax-revenue-jumps-33-surpassing-1-9-billion-in-2019/> [<https://perma.cc/5SAD-WCP2>] (reporting tax revenue from eight states that legalized sale of marijuana surpassed \$1.9 billion); see also Kenneth W. Boyd, *Deep Dive: Recreational Marijuana Tax Revenue in the United States*, CPA ACCT. INST. FOR SUCCESS, <https://www.ais-cpa.com/deep-dive-recreational-marijuana-tax-revenue-in-the-united-states/> [<https://perma.cc/VJ2J-VRF2>] (last visited Mar. 31, 2021) (reporting tax revenue data from recreational marijuana in eleven states); see also *Marijuana Taxes*, URB. INST., <https://www.urban.org/policy-centers/cross-center-initiatives/state-and-local-finance-initiative/state-and-local-backgrounders/marijuana-taxes> [<https://perma.cc/L2YZ-YYGV>] (last visited Mar. 31, 2021) (comparing various state tax systems for marijuana taxes).

over \$1.9 billion in 2019, even without accounting for other revenue streams such as income taxes and license fees that states also collect from marijuana business owners.<sup>193</sup> In a number of states, marijuana excise and sales tax revenues are equal to or in excess of revenues from similar taxes on alcohol.<sup>194</sup> States use marijuana tax revenue to fund public assistance programs for education, substance abuse, criminal justice reform, and health care.<sup>195</sup>

In addition to supporting communities at-large, legalized marijuana helps over 2.3 million medical marijuana patients in the United States.<sup>196</sup> Although the FDA has not yet issued a ruling on the safety and efficacy of medical marijuana, extensive clinical research supports the use of marijuana as an effective treatment for a number of conditions.<sup>197</sup> Medical marijuana can relieve symptoms of patients with conditions such as cancer, nausea, epilepsy, HIV/AIDS, and glaucoma.<sup>198</sup> State-regulated marijuana businesses are subject to strict testing, labeling, and packaging standards, which ensures that both medical marijuana patients and recreational users obtain high-quality, safe products.<sup>199</sup> Excluding legally operating marijuana companies from section 280E will help preserve these societal benefits.

2. *Under Section 280E, Underground Drug Trafficking Grows Like a Weed, While Legitimate Business Goes to Pot*

Marijuana legalization attempts to redirect income from illegal drug dealers and direct it to legitimate business owners.<sup>200</sup> In contrast, section

193. See Davis, *supra* note 192.

194. See CARL DAVIS ET AL., INST. ON TAXATION & ECON. POLICY, TAXING CANNABIS 20–22 (2019), [https://itep.sfo2.digitaloceanspaces.com/012319-TaxingCannabis\\_ITEP\\_DavisHillPhillips.pdf](https://itep.sfo2.digitaloceanspaces.com/012319-TaxingCannabis_ITEP_DavisHillPhillips.pdf) [<https://perma.cc/PZ48-EJNR>] (comparing marijuana excise tax revenue to other excise taxes). Excise taxes on alcohol, tobacco, and marijuana are referred to as “sin taxes.” *Id.* at 20. Excise taxes on tobacco generate the largest “sin tax” revenue in all states, except Colorado. *Id.* at 21. In Colorado, excise taxes on marijuana surpassed excise taxes on tobacco. *Id.*

195. See *How Do Marijuana Taxes Work?*, *supra* note 164 (discussing how states utilize marijuana tax revenue). Where marijuana has been legalized recreationally, state and local governments tax marijuana in three ways: as a percentage of the price, based on weight, and based on the potency of the marijuana. *Id.* The tax laws vary state to state, and Vermont, Maine, and Washington D.C. do not tax marijuana at all, but do collect income taxes from the marijuana business entities. See *id.*; see also DAVIS ET AL., *supra* note 194, at 15–17.

196. See MORRISSEY ET AL., *supra* note 185, at 18.

197. See Kathleen A. Russell, *Caring for Patients Using Medical Marijuana*, 10 J. NURSING REG. 47, 50 (2019) (discussing varied use of medical marijuana in clinical settings).

198. See *id.* at 51. In jurisdictions that permit medical marijuana, more than sixty qualifying medical conditions are treated with medical marijuana. *Id.*

199. See Amicus Brief of Marijuana Indus. Grp. and Cannabis Trade Fed’n Action in Support of Appellant Supporting Reversal at 9, *Patients Mut. Assistance Collective Corp. v. Comm’r*, No. 19-73078 (9th Cir. June 2, 2020) (citing California and Colorado marijuana regulations).

200. See Alsharaiha, *supra* note 84, at 335.

280E hinders the legal marijuana industry from doing just that.<sup>201</sup> The Tax Court acknowledged that section 280E “make[s] it more costly to run a dispensary.”<sup>202</sup> State-legal marijuana businesses are punished by the IRS’ application of section 280E, while black market drug dealers often evade paying income tax altogether to avoid detection of their illegal trafficking.<sup>203</sup>

By penalizing businesses that traffic controlled substances, section 280E attempts to suppress the *supply* of drugs, but it does nothing to eliminate the *demand* for drugs.<sup>204</sup> Americans spend billions of dollars per year on legal marijuana products.<sup>205</sup> Consumer demand for marijuana will not simply vanish if legitimate marijuana companies are taxed out of business by section 280E. Instead, consumers will turn to unregulated street dealers and strengthen the very criminal enterprises that the government intended to eradicate.<sup>206</sup> Amending section 280E to exclude legally operating marijuana companies will support states’ efforts to eradicate illegal drug trafficking.<sup>207</sup>

---

201. *See id.* (discussing how section 280E impedes states from reducing illegal drug trade).

202. *Patients Mut. Assistance Collective Corp. v. Comm’r*, 151 T.C. 176, 197 (2018) (quoting *Olive v. Comm’r*, 793 F.3d 1146, 1150 (9th Cir. 2015)).

203. *See Keller*, *supra* note 50, at 177 (arguing that section 280E impacts legitimate businesses more than it does illegal drug dealers).

204. *See id.* at 172–73. In the 1960s and 1970s, drug policy in the United States was created to suppress the supply of drugs, but policy focus has since shifted to suppress demand. *Id.* (citing Peter H. Smith, *The Political Economy of Drugs: Conceptual Issues and Policy Options*, in *DRUG POLICY IN THE AMERICAS* 6 (Peter H. Smith ed., 1992)). Section 280E, which was enacted in 1982 when the government was focused on suppressing drug supply, “no longer has an effective role in the American drug initiative.” *Keller*, *supra* note 50, at 173.

205. *See MORRISSEY ET AL.*, *supra* note 185, at 7. Combined, recreational and medical marijuana sales were \$7.9 billion in 2017 and rose to \$10.3 billion in 2018. *Id.* It is estimated that marijuana sales will steadily grow at a rate of approximately 16%. *Id.* Researchers project that sales will reach \$29.7 billion in 2025. *Id.* To put these numbers into perspective, the NFL generates approximately \$15 billion in annual revenue. *See* Eli McVey, *Chart: Retail Marijuana Sales Surpass Fortnite Video Game, Closing in on Taco Bell, NFL*, *MARIJUANA BUS. DAILY* (June 4, 2019), <https://mjbizdaily.com/retail-marijuana-sales-rival-taco-bell-nfl/> [<https://perma.cc/E9GE-Z9X7>].

206. *See Alsharaiha*, *supra* note 84, at 335–36. “The courts’ application of 280E to the legal marijuana industry hinders [a] market takeover [by the legal marijuana industry] because legal marijuana ‘stores that might not even be profitable can end up being taxed out of business,’ basically dooming the legal marijuana industry while protecting drug dealers.” *Id.* at 335 (quoting Ariel Shearer, *IRS Targets Medical Marijuana Businesses in Government’s Ongoing War on Pot*, *HUFFINGTON POST* (May 29, 2013, 12:01 PM), [https://www.huffpost.com/entry/irs-medical-marijuana\\_n\\_3346801](https://www.huffpost.com/entry/irs-medical-marijuana_n_3346801) [<https://perma.cc/Z2GG-K4Q8>]).

207. *See id.* at 335.

V. REEFER GLADNESS OR REEFER MADNESS: SECTION 280E RISKS LEAVING STATES HIGH AND DRY

If section 280E is not repealed, or at least amended to exclude legal marijuana companies, states may see a decrease in the number of dispensaries because exorbitant federal taxes makes yielding a profit much more difficult than other enterprises.<sup>208</sup> According to one of the leading publications for the marijuana industry, section 280E is the greatest threat to marijuana businesses and could force many in the industry, growers and retailers alike, to close completely or move underground.<sup>209</sup> As dispensaries close, states will see a sharp decline in tax revenue and a reciprocal rise in unemployment.<sup>210</sup> Shuttered marijuana dispensaries will drive consumers back to the illegal drug marijuana market, which will result in little tax revenue for state and federal governments.<sup>211</sup> After all, drug traffickers have little incentive to accurately report their income to the IRS.<sup>212</sup>

The public perception of marijuana has dramatically changed since Congress passed section 280E in 1982.<sup>213</sup> Now, marijuana is prescribed to help patients manage a range of chronic medical conditions.<sup>214</sup> If dispensaries close, patients who rely on medical marijuana would have fewer options for obtaining medicinal marijuana products. With less competition,

---

208. See generally NAT'L CANNABIS INDUS. ASS'N, INTERNAL REVENUE CODE SECTION 280E: CREATING AN IMPOSSIBLE SITUATION FOR LEGITIMATE BUSINESSES (2015), <https://thecannabisindustry.org/uploads/2015-280E-White-Paper.pdf> [<https://perma.cc/L62N-H9U5>] (describing section 280E's harmful impact on legitimate marijuana businesses). Because section 280E disallows all deductions, marijuana companies pay effective tax rates of 70% or higher. See *id.* In 2015, a marijuana dispensary in Seattle paid nearly 87% of its profits in taxes. See *id.*; see also 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> [<https://perma.cc/XVE5-ZJ82>]. In contrast, corporations not subject to section 280E pay an income tax rate of only 21%. See H.R. REP. NO. 115-466, at 343 (2017) (establishing flat corporate tax rate of 21%).

209. See *Marijuana Business Conference Wrapup: 36 Tips, Lessons & Takeaways for the Cannabis Industry*, MARIJUANA BUS. DAILY (Nov. 15, 2012), <https://mjbizdaily.com/marijuana-business-conference-wrapup-36-tips-lessons-take-aways-for-the-cannabis-industry/> [<https://perma.cc/5C9C-YP5H>] (noting section 280E is "looked at as a tax cut for drug dealers" among industry insiders).

210. See, e.g., BARCOTT ET AL., *supra* note 190 (reporting increase in employment opportunities as more states legalize marijuana).

211. See Alsharaiha, *supra* note 84, at 335–36 (explaining how legal marijuana industry can help minimize illegal drug sales).

212. See Keller, *supra* note 50, at 177 (noting drug dealers do not accurately report income to IRS).

213. For a further discussion of surveys measuring public support for marijuana legalization, see *supra* note 184.

214. See Russell, *supra* note 197, at 51 (listing more than sixty qualifying medical conditions that are treated with medical marijuana in jurisdictions that have legalized medical marijuana).



marijuana merchants may take advantage of consumers in a market yielding few options to obtain medical marijuana.<sup>215</sup>

One must jump through hoops to justify the tax policy behind section 280E. Section 280E fails to reflect the ability-to-pay principle.<sup>216</sup> Regardless of Congress's "legislative grace," the fact of the matter is that some marijuana businesses are subject to tax in years where they actually operated at a loss.<sup>217</sup> The effect section 280E has on legitimate marijuana businesses could not be further from the intent of the ability-to-pay principle. To preserve the benefits that legalized marijuana provides to states and citizens alike, and in the name of the long-standing ability-to-pay tax principle, Congress should repeal or amend section 280E so legally operating marijuana companies are taxed like other legitimate businesses: according to their gains.

---

215. Cf. 2019 Recreational Marijuana Supply and Demand Legislative Report, OR. LIQUOR CONTROL COMM'N 7 (Jan. 31, 2019), [https://www.oregon.gov/olcc/marijuana/Documents/Bulletins/2019%20Supply%20and%20Demand%20Legislative%20Report%20FINAL%20for%20Publication\(PDFA\).pdf](https://www.oregon.gov/olcc/marijuana/Documents/Bulletins/2019%20Supply%20and%20Demand%20Legislative%20Report%20FINAL%20for%20Publication(PDFA).pdf) [https://perma.cc/YQ2X-93SW] (discussing impact of supply and demand on price of marijuana). An increased supply of marijuana that outgrew consumer demand resulted in a price decrease. See *id.*

216. See I.R.C. § 280E (2018). For further discussion of the ability-to-pay principle, see *supra* notes 26–43 and accompanying text.

217. For a further discussion of marijuana companies that sustained net losses but still owed taxes, see *supra* note 181; see also *N. Cal. Small Bus. Assistants, Inc. v. Comm'r*, 153 T.C. 65, 84 (2019) (discussing restraints of Congress's "legislative grace").