

Medical Marijuana Dispensaries Persist Despite Tax Obstacles

By William Hoffman — whoffman@tax.org

The IRS is playing a supporting role in a nationwide crackdown on legalized medical marijuana dispensaries, but that's not stopping aspiring "ganjapreneurs" from opening new businesses in defiance of federal law.

There are about 2,300 medical marijuana dispensaries across the United States, with more opening every week, "and every one of them is in violation of federal law and international treaties," according to Allen St. Pierre, executive director at the National Organization for the Reform of Marijuana Laws.

The IRS's involvement stems from enforcement of a little-known addition to the tax code from the 1980s, section 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 (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."

Henry G. Wykowski, a San Francisco attorney famed for his role in one of the few court victories for medical marijuana advocates, said section 280E unfairly deprives medical cannabis dispensaries of the ability to deduct their ordinary and necessary business expenses. "By so doing, the dispensary winds up paying tax on its entire net profit, making it impossible to stay in business," he said.

Wykowski said section 280E unfairly deprives medical cannabis dispensaries of the ability to deduct their ordinary and necessary business expenses.

And yet there is no shortage of what St. Pierre called ganjapreneurs — advocates ready to finance cultivation centers, dispensaries, and other support services in states that have made medical marijuana legal. The District of Columbia in April approved four dispensary-license applicants (of 17 total) seeking to open in neighborhoods around the nation's capital. Legislatures in Connecticut and New Hampshire advanced medical marijuana bills in May.

So who will yield first — the IRS, Justice Department, and Drug Enforcement Administration, or the ganjapreneurs and the states that harbor them?

The Section 280E Problem

The IRS has made its position on state-sanctioned medical marijuana clear: Until Congress acts to change the code or the law, the Service must enforce both as they are.

House members in 2010 asked IRS Deputy Associate Chief Counsel Andrew Keyso why the Service didn't provide tax guidance for medical marijuana businesses like it does for most other industries.

"Because neither section 280E nor the Controlled Substances Act make exceptions for medically necessary marijuana, we lack the authority to publish the guidance that you request," wrote Keyso. "The request you seek would require the Congress to amend either the Internal Revenue Code or the Controlled Substances Act." (For the IRS letters, see *Doc 2011-19066* or *2011 TNT 177-23*. For prior coverage, see *Tax Notes*, Sept. 26, 2011, p. 1345, *Doc 2011-19896*, or *2011 TNT 182-6*.)

Those changes may be in the works. Twenty representatives are cosponsoring the Ending Federal Marijuana Prohibition Act of 2011 (H.R. 2306), introduced by Rep. Barney Frank, D-Mass., which would amend the Controlled Substances Act to remove marijuana from its Schedule 1 classification. Fourteen cosponsors signed on to the Small Business Tax Equity Act of 2011 (H.R. 1985), introduced by House Ways and Means Committee member Fortney Pete Stark, D-Calif., which would amend the tax code to allow a medical marijuana business deduction. (For H.R. 1985, see *Doc 2011-12380* or *2011 TNT 110-28*.)

Still, advocates in the medical marijuana community don't place much hope in congressional efforts. Steve Fox, director of public affairs for the National Cannabis Industry Association (NCIA), recalled recently bringing his members to Congress for a lobbying day. "They were productive conversations," Fox said. "But I think more work needs to be done before Congress will be willing to reform the law on its own."

CHAMP's Hollow Victory

Wykowski believes his victory in the Tax Court set a standard that the IRS should follow in assessing taxes while fully complying with section 280E. (For *Californians Helping to Alleviate Medical Problems Inc. (CHAMP) v. Commissioner*, 128 T.C. 173 (2007), see *Doc 2007-11902* or *2007 TNT 95-7*. For a viewpoint on the CHAMP case, see *Tax Notes*, Sept. 3, 2007, p. 887, *Doc 2007-18776*, or *2007 TNT 172-39*.)

Under CHAMP, the Tax Court bifurcated the expenses of a California dispensary that provided both medical marijuana and caregiving services such as counseling, social events, and massage services. The court allowed the deduction of many of the organization's caregiving expenses despite section 280E.

"The decision in CHAMP by the Tax Court made it very clear that if a dispensary is engaged in activities in addition to providing medical cannabis to its patients, they are entitled to take those expenses as deductions," Wykowski said. "In many instances where I'm involved, the IRS is not honoring that decision, and they continue to disallow all expenses of the dispensary and assess a tax based on the profit without the benefit of the expenses, which of course is onerous and not consistent with CHAMP."

Fox said the CHAMP decision "is important to us because it explained that the medical marijuana business didn't have an absolute bar on developing our business." By spelling out which expenses could be deducted (wages, rent, utilities, and so on) and which could not (those directly related to sales), the decision seemed to have laid out a roadmap for the IRS to instruct dispensary operators on how to file their tax returns.

Fox said the CHAMP decision 'is important to us because it explained that the medical marijuana business didn't have an absolute bar on developing our business.'

"Yet in many cases it seems as if the IRS is ignoring the CHAMP case," Fox said. Wykowski said he's repeatedly asked IRS officials for guidance that medical marijuana dispensaries can follow when filing their tax returns. "It's not like [the IRS] said, 'We won't do it for this reason,' or 'We won't do it for that reason' — they just don't respond," Wykowski said.

The IRS responded to a Tax Analysts request for more information by sending its 2010 letters from Keyso to Stark and other members of Congress reiterating its position under existing law, and with a reference to Publication 502, *Medical and Dental Expenses (Including the Health Coverage Tax Credit)*. (For Publication 502, see *Doc 2012-3248* or *2012 TNT 33-59*.)

'What About the Feds?'

Even without their section 280E problem, medical marijuana promoters have the deck stacked against them.

Marijuana remains illegal under the federal Controlled Substances Act of 1970. The Single Convention on Narcotic Drugs (1961) makes marijuana illegal (with a few medical exceptions) in every signatory country. The Supreme Court held in *Gonzalez v. Raich*, 545 U.S. 1 (2005), that the federal government could criminalize production and use of medical marijuana even when states allow it. The

federal government also may resort to laws, such as the Drug-Free School Zones Act of 1994, that influence zoning regarding the placement of marijuana dispensaries.

Last fall, the DEA started raiding medical marijuana dispensaries in California, where the movement started in 1996 after voters approved a ballot initiative. The crackdown intensified after federal prosecutors warned Washington state employees that they could be held responsible under federal law if they implemented new regulations for state-sanctioned medical marijuana dispensaries. Similar cautions dissuaded Maryland from proceeding with its own plans for medical marijuana outlets.

Richard M. Evans, a Massachusetts attorney who maintains a website that monitors marijuana taxation and regulation (cantaxreg.com), said potential investors are keenly aware of the crackdown. "The disparity between state law and federal law is often cited as an excuse to be opposed to medical marijuana operations," Evans said. "The question that constantly comes up is, what about the feds?"

In the District of Columbia, medical marijuana dispensaries have already picked out locations for their operations, which await approval by neighborhood advisory committees. Yet Rabbi Jeffrey Kahn of the Takoma Wellness Center, which is planned to open in a brick storefront in the north end of the city, said, "We are not prepared to discuss the issues pertaining to 280E at this time."

Advice for Dispensaries

Medical marijuana advocates aren't waiting for the IRS and Congress to catch up with their operations.

Wykowski said he believes *CHAMP* provides some guidance. "One of the things that I encourage dispensaries to do now is to very carefully allocate their expenses between the services they are providing versus the sale of the medical cannabis," he said.

The NCIA last year released a worksheet to aid medical marijuana dispensaries in minimizing the effect of denials of deductions under section 280E when filing their federal tax returns. The worksheet warns: "This tax planning tool has not yet been litigated; please consult your tax advisor." (For the worksheet, see *Doc 2011-19905* or *2011 TNT 182-45*.)

Wykowski said he'd be happy to represent new dispensary operators who run afoul of the law. In fact, he is now litigating a multimillion-dollar section 280E case the IRS filed against one of the largest California medical marijuana dispensaries, Harbor-side Health Center. "I'm committed to this cause," he said. "I want to see these guys prevail."

Wykowski also advised dispensaries to pay attention to "substantiation issues" raised in section

6001, which requires taxpayers to maintain records to support their tax returns.

"That's kind of tricky for people that are engaged in a business or industry that's illegal on the federal level but legal on the state level," Wykowski said. Marijuana growers, for example, don't want to be paid by check and tend to be wary of providing employer identification numbers, names, and street addresses that might be used later by federal prosecutors, he said. "This makes it very challenging to maintain records, to show how much you're paying for your cost of goods sold," Wykowski added.

Fox noted that one organization, 280E Reform, has set up a legal defense fund to fight the issue. The NCIA is concentrating on a lobbying campaign, he said. In the meantime, "businesses are just doing what they can and hoping for fair treatment — at the very least hoping that the *CHAMP* standard will apply and hoping that they will be treated like any other business after the repeal of 280E," he said.

What's important is that dispensaries 'want to be taxed,' Fox said. 'If these businesses are forced to shut down, there will be zero tax revenue.'

Medical marijuana faces many obstacles, but money for its struggles with the government probably won't be among them. Indeed, money may be the leading reason why, despite intense federal opposition, so many proponents are still willing to stake new claims in the fraught but expanding market. St. Pierre said medical marijuana dispensaries post 200 to 400 percent profit margins; some dispensaries serve thousands of people each day. That can offset most of the dispensaries' denied business expenses, advocates said.

"What's important to know is that these [dispensaries] want to be taxed," Fox said. "This is the IRS cutting off their nose to spite their face. If these businesses are forced to shut down, there will be zero tax revenue." ■