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Some Progress In Battle For Cannabis Biz Tax Deductions

By **Jennifer Benda** (November 5, 2019, 5:33 PM EST)

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Last year brought considerable new guidance on the application of tax laws to the cannabis industry. While no case has provided new avenues for tax planning, and courts have rarely ruled favorably for the industry, a recent Tax Court opinion includes dissents and discussions that hint that some judges are open to considering a fulsome analysis of constitutional arguments that could provide relief from Section 280E. Further, states, most importantly California, are providing relief at the state tax level.

Tax Court Developments

In Northern California Small Business Assistants Inc. v. Commissioner,[1] on a motion for partial summary judgment filed by the taxpayer, the U.S. Tax Court addressed some of the arguments we have seen before, (e.g., that Section 280E does not apply to state legal cannabis businesses), but also analyzed, in more detail than we have seen in the past, constitutional arguments addressing whether Section 280E is unconstitutional. The majority opinion is 16 pages, but there are 33 pages of expansive concurring and dissenting opinions.

The extent of the discussion in the concurring and dissenting opinions highlights the "unique aspects of section 280E for further constitutional inquiry."[2] It is rare that a tax case generates constitutional debate, so the opposing views of the court in this case raise considerable intellectual considerations for tax scholars.

The majority of the court quickly disposed of the argument that Section 280E violates the Eighth Amendment's excessive fine and penalties clause based on Congress' broad tax powers and the existing rulings issued by the Tax Court and the U.S. Court of Appeals for the Tenth Circuit.[3] There was considerable debate among the judges about whether Section 280E is a penalty and what the impact of such a determination might be.

The dissent argued that Section 280E is penalty because it taxes something other than profits.[4] But another judge disagreed, reasoning that the denial of a deduction has never been found to be a violation of the Eighth Amendment.[5] Another opinion doubted that the petitioner could show that, even if Section 280E was a penalty, it was excessive, which is another prong that must be proven for a penalty to be ruled unconstitutional.[6]

While the majority opinion did not address whether Section 280E violates the 16th Amendment[7], a long dissent by U.S. Circuit Judge David Gustafson disagreed with the majority opinion that Section 280E does not violate the Eighth Amendment and set forth an expansive argument that Section 280E violates the 16th Amendment. These arguments may give the industry hope that (1) there is a path to a finding that Section 280E is unconstitutional, and (2) there are judges willing to entertain such theories.

The dissent reasons that the 16th Amendment could be violated by the denial of deductions, even though courts widely recognize that a foundational premise of our tax system is that deductions are a matter of legislative grace.[8] The dissent states that "Congress taxes something other than a taxpayer's 'income' when it taxes gross receipts without accounting for basis or COGS [cost of goods and services] — and, I would hold, when it taxes gross receipts without accounting for the ordinary and necessary expenses that are incurred in the course of business and must be paid before one can be said to have gain."[9]

In other words, the dissent reasons that gross income, which should exist before a tax can be owed, does not exist unless there is an overall profit from the business.

The dissent views the denial of all deductions and credits in Section 280E as a unique code provision distinguishable from other code sections denying deductions,[10] and, therefore, requiring careful constitutional consideration. The dissent takes issue with the notion that a cannabis company could owe a substantial amount of tax even though, from a financial perspective, the business did not generate profit or gain.

Generally, a company with operating losses will pay little or no tax, and will be able to carry forward or back operating losses to offset income in other years. Here, even if losses are incurred, those losses are ignored, and tax may be due. As a result, "Section 280E would fabricate gain where there was none and would impose a tax based on artificial income."[11] Because Section 280E ignores the amount of financial gain, and taxes profits that do not exist, the dissent concludes that Section 280E is an unconstitutional violation of the 16th Amendment. [12]

The dissent also takes issue with the majority view that Congress' broad authority to tax precludes the determination that Section 280E is a fine. The dissent's view is that the Eighth Amendment provides a second basis for finding Section 280E unconstitutional because Section 280E imposes a fine when it imposes an increased tax liability for the purpose of punishing and deterring the sale of unlawful behavior. [13] The dissenting judges indicated there was insufficient evidence in the record to address whether, if a penalty, Section 280E would be an excessive penalty in violation of the Eighth Amendment.[14]

Therefore, further proceedings would be required to determine whether the penalty imposed by Section 280E is excessive and to determine whether the Eighth Amendment provided protections for corporate taxpayers. None of the opinions address any considerations that would need to be made in order to find that, as a fine, Section 280E is excessive, so it is impossible to speculate what might tip the scales on that issue. Further, the U.S. Supreme Court has previously declined to decide whether the Eight Amendment protects corporations. [15]

Because the taxpayer in this case is a corporation, this issue would need to be fully addressed to resolve the Eight Amendment challenges to Section 280E.

State-Level Treatment of Section 280E

The dissimilar treatment of individuals and corporations is also relevant to how some states apply Section 280E for state income tax purposes. Some states which have legalized marijuana have been slow to address the impact of Section 280E for state income tax purposes. To date, only five states (Arkansas, California, Colorado, Hawaii and Oregon) have removed the impact of Section 280E for state income tax purposes. Until recently, there were five states (Arkansas, California, New Hampshire, New Jersey and Pennsylvania) where the impact of Section 280E for state income tax purposes depended upon whether the taxpayer was an individual or a corporation.

With the passing of A.B. 37,[16] California recently modified its state income tax code to permit individuals to deduct for state income tax purposes any deductions disallowed under Section 280E for federal income tax purposes. A similar provision was not needed for corporations because California state income tax laws base the determination of individual gross income on federal taxable income, while providing for a completely separate starting point for corporate taxable income.

Thus, cannabis corporate taxpayers have been able to deduct Section 280E costs for state tax purposes all along. To date, 21 states have legalized marijuana but have not provided provisions to remove the impact of Section 280E for state income tax purposes.

What's Next?

The industry has a long way to go in reducing the impact of Section 280E at the state level. Also, further case development will be needed before a court can fully address the constitutional concerns raised in Northern California Small Business Assistants Inc. v. Commissioner.

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[1] Northern California Small Business Assistants Inc. v. Commissioner, 153 T.C. No. 4 (2019).

[2] Id. at 44 (Copeland, J., concurring in part and dissenting in part).

[3] See e.g., Alpenglow Botanicals, LLC v. U.S., 894 F.3d 1187, 1202 (10th Cir. 2018), cert. denied 139 S. Ct. 2745 (2019).

[4] 153 T.C. No. 4 at 31–33 (Gustafson, J., concurring in part and dissenting in part).

[5] Id. at 17-20 (Lauber, J. concurring).

[6] Id. at 21 (Morrison, J., concurring).

[7] Id. at 13.

[8] Id. at 24-26 (Gustafson, J., concurring in part and dissenting in part).

[9] Id. at 28-29 (Gustafson, J., concurring in part and dissenting in part).

[10] See, e.g., I.R.C. §§ 162(c)(1), 162(f).

[11] 153 T.C. No. 4 at 33 (Gustafson, J., concurring in part and dissenting in part).

[12] Id.

[13] Id. at 36. The dissent's view is contrary to the Tenth Circuit holding that Section 280E is not a fine. The dissent argues that the Tenth Circuit relied on the wrong authorities in reaching its conclusion. Alpenglow Botanicals, LLC v. U.S., 894 F.3d 1187, 1202 (10th Cir. 2018), cert. denied 139 S. Ct. 2745 (2019).

[14] 153 T.C. No. 4 at 43 (Gustafson, J., concurring in part and dissenting in part).

[15] Id. at 6 n.4 (citing Browning-Ferris Indus. Of Vt., Inc. v. Kelco Disposal, Inc., 492 U.S. 257, 276 n.22 (1989)).

[16] Assem. Bill 37, 2019-2020 Reg. Sess., ch. 792, 2019 Cal. Stat.