THE TAX COURT DECIDES WHETHER MARIJUANA DISPENSED BY A LEGAL MEDICAL MARIJUANA FACILITY IS A CONTROLLED SUBSTANCE FOR DEDUCTIBILITY PURPOSES

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ABSTRACT
In Olive v. Commissioner, 139 T.C. 2, the Tax Court ruled that the owner of a California medical marijuana dispensary could not deduct his claimed business expenses. Although the business was legitimate under California law, Section 280E of the Internal Revenue Code precludes a deduction of any amount for a trade or business where the trade or business consists of the trafficking in controlled substances which is prohibited by federal law.

INTRODUCTION

The sale of medical marijuana has been legalized in over 15 states. Although local law has blessed the existence of medical marijuana facilities, the IRS has targeted the facilities for audits in the past few years using § 280E of the Internal Revenue Code of 1986, as amended (Code) as a weapon. Although a business may be legitimate under state law, a deduction for federal income tax purposes may be denied because of the existence of § 280E. The section disallows deductions prohibits taxpayers from deducting expenses incurred in trafficking in controlled substance. In the case at hand, a legal California medical marijuana dispensary was denied the deduction of expenses due to the existence of Code § 280E.

In *Olive v. Commissioner*, 139 T.C. 2, the Tax Court unanimously held that the owner of a California medical marijuana dispensary could not deduct his claimed expenses because Code § 280E prohibits taxpayers from deducting expenses incurred in trafficking in controlled substances even though the marijuana is sold through a legal medical marijuana dispensary.

RELEVANT SECTIONS OF THE INTERNAL REVENUE CODE

A tax is imposed on all taxable income of individuals. The starting point in the calculation of taxable income is the determination of gross income which is defined by Code § 61 as "all income from whatever source derived."

The taxpayer is allowed deductions from gross income under Code § 62 (a) in arriving at adjusted gross income. One of the most common and widely used deductions for adjusted gross income is the deduction of trade and business expenses as defined in Code § 162. Code § 162 provides that 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.

Although Code § 162 allows ordinary and necessary expenses, Code §280E, that provides that 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 … which is prohibited by

Federal law or the law of any State in which such trade or business is conducted. Although a business may be legitimate under state law, the deduction may be disallowed because of Code §280E.

FACTS

Martin Olive, the Petitioner, owned and operated a California facility named The Vapor Room as a sole proprietorship. Vapor Room's principal business was the retail sale of medical marijuana pursuant to the California Compassionate Use Act of 1996 (CCU) codified at California Health and Safety Code sec 11362.5. The sole source of revenue was its sale of medical marijuana. Patrons went to the Vapor Room to relax and smoke or inhale vaporized marijuana. Additionally, the Vapor Room provides minimal activities and services as part of its principal business although the patrons did not specifically pay for anything else connected with or offered by the facility. Olive sold the majority of the marijuana to his customers for cash.

After an audit, the IRS issued a notice of deficiency to Petitioner for the years 2004 and 2005. The notice asserted that the Petitioner understated the income of the Vapor Room, overstated the cost of goods sold and furthermore was precluded from deducting any cost of goods sold due to lack of substantiation, and was not entitled to *any* operating expenses under I.R.C. § 280E.

HOLDING AND ANALYSIS

The Tax Court unanimously held that the owner of a California medical marijuana dispensary could not deduct his claimed expenses because Code § 280E prohibits taxpayers from deducting expenses incurred in trafficking in controlled substances even though the marijuana is sold through a legal medical marijuana dispensary. In the related issue regarding the cost of goods sold, the Cohan rule was applied to determine the cost of goods sold based on industry average for medical marijuana dispensaries. The Tax Court was liable for accuracy –related penalties with respect to a failure to maintain sufficient records with respect to a failure to maintain sufficient records to substantiate the business income and expenses.

The analysis of the Tax Court began with the determination of gross receipts. Petitioner reported that the gross receipts were $1,068,830 for 2004 and $3,131,605 for 2005. The respondent did not adjust those amounts although the amounts were not substantiated. The petitioner later gave the respondent ledgers that revealed that the gross receipts were larger than the reported amounts. Although there was a discrepancy regarding a 79-day period that was missing from the ledger, the amount of gross receipts was resolved.

The larger issue that was a source of contention was the cost of goods sold (COGS). In the deficiency notice, the responded stated that the Vapor Room's COGS was zero for 2004 and 2005. With regards to the cost of goods sold, the Tax Court refused to side with the Service's assertion that because Olive's records were lacking, he wasn't entitled to *any* deduction for cost of goods sold. Instead, the court looked to the testimony of industry insiders to determine that on average, the cost of goods sold of medicinal marijuana facilities were approximately 75.16% of revenue. The court then reduced Olive's COGS to account for the fact that he gave away some of his product for free, reasoning that because he gave it away, it wasn't held for sale and thus couldn't be included in cost of goods *sold*.

Lastly, in the issue that the entire industry will be analyzing for a long time if the decision is upheld, the Tax Court agreed with the IRS that the Vapor Room was not entitled to deduct any of its operating expense pursuant to I.R.C. § 280E.

The Petitioner relied on *Californians Helping to Alleviate Med. Problems*, Inc., Dec. 56,935, 128 TC 173 (2007) which was a case of first impression holding that Code § 280E precludes a deduction of any amount for a trade or business where the trade or business consists of the trafficking in controlled substances which is prohibited by federal law. In *Californians,* a medical marijuana facility enjoyed a partial victory in defending itself against the application of I.R.C. § 280E by bifurcating its business into two parts: one in which the facility bought and sold marijuana, and another in which they provided counseling to customers as to which type of marijuana worked best for which ailment. The taxpayers were allowed a deduction for business expenses for their care giving business which was separate for the medical marijuana dispensary.

The Tax Court refused to afford Olive the wiggle room it showed the taxpayer in *Californians (CHAMP)*. Despite the petitioner's contention that his business was similar to the one in *Californians* – two separate businesses , one which comprised of the sale of goods and a separate equal business for the provision of counseling services . In *Olive*, the Tax Court was unconvinced with the petitioner's argument that there were two separate businesses.

Petitioner asserted that the Vapor Room's overwhelming purpose was to provide care giving services and that the Vapor Room's expenses are almost entirely related to the care giving business. He also went as far as to state that the Vapor Room would continue to operate even if he did not sell medical marijuana. The Tax Court held that the Vapor Room was a single business, the dispensing of medical marijuana. Any care giving services was part of that business. The record established that the Vapor Room is not the same type of operation as the medical marijuana dispensary in CHAMP that we found to have two businesses.

In reaching its decision, the Tax Court established a precedent that it will hold a medicinal marijuana facility to a strict standard in establishing that it offers multiple lines of business.

CONCLUSION

The medical marijuana industry has found itself in a predicament of sorts. It is governed by a dichotomy of authority. It is blessed by state law and persecuted by the IRS. Unless a medical marijuana facility can clearly establish that they offer a line of business separate and apart from buying and selling marijuana, it faces the very real possibility that it will be denied deductions which result in a tax on most, if not all, of their revenues. Although the Vapor Room did offer some incidental services as well as marijuana sales, the Tax Court was not convinced that they offered a separate line of business and disallowed all of the deductions.

Although Olive was not a case of first impression, it definitely sets the tone for future decisions. Its decision will be far reaching. The burden on the taxpayer to establish a separate line of business will be "high" if not impossible to meet. If this decision is upheld, the medical marijuana industry is burnt.

REFERENCES

Code § 1
Code § 61
Code § 162
Code § 280E

Californians Helping to Alleviate Med. Problems, Inc., Dec. 56,935, 128 T.C. 173 (2007)
Olive v. Commissioner, 139 T.C. 2