

Business Deductions Up In Smoke

The following three cases published this past summer provide guidance to cannabis businesses and their owners in preparing their federal income tax returns. These cases turn on the application of IRC Section 280E, which precludes taxpayers from deducting any expense relating to a business that consists of trafficking in cannabis. The application of Section 280E is generally discussed here. Set forth below are the key takeaways from these cases and a general summary of each case,

Keep Detailed Records of Non-cannabis Business Expenses

The Tax Court recently held that Altermeds, LLC (Altermeds) did not have adequate records to prove that it was entitled to non-cannabis business expense deductions or an accurate cost of goods sold (COGS) exclusion. *Alterman v. Commissioner*, T.C. Memo 2018-83. On audit, the IRS disallowed Altermeds' business expense deductions pursuant to Section 280E and decreased Altermeds' exclusion from gross income for COGS. In this case, the taxpayers argued that some of the business expenses were deductible because they were part of a non-cannabis business; **however**, the Tax Court held that they did not adequately brief the issue or provide records of expenses to prove that Altermeds was operating a separate non-cannabis business and the amount of expenses related to it. The Tax Court upheld the IRS' adjustment to COGS finding that Altermeds did not correctly calculate COGS because it did not include its beginning and ending inventories in the calculation and did not provide documentation of beginning and ending inventories that could be used to estimate those amounts to increase the COGS adjustment.

Wages Paid by S Corporation Cannabis Businesses Are Not a Deductible Expense

In *Loughman v. Commissioner*, T.C. Memo 2018-85, the Tax Court held that a Colorado S corporation (Palisades) that grew and sold cannabis could not deduct wages it paid to its officers. In that case, the taxpayers were S corporation shareholders and officers of Palisades and were assessed tax based on their income from their ownership interests in Palisades. On audit, the IRS disallowed Palisades' business expense deductions pursuant to Section 280E, including its deduction for wages paid to the taxpayers as its officers of Palisades. The taxpayers argued that since S corporations are required to pay a reasonable wage to officers, Palisades should be allowed to deduct wages paid to its shareholders as officers; to do otherwise would be discriminatory against S corporation shareholders and effectively double tax the wages. The Tax Court disagreed. It reasoned that the application of Section 280E was not discriminatory because Section 280E applies equally, whether the taxpayers or third parties received the wages. Further, the Tax Court provided that, to the extent the taxpayers believed they received disparate tax treatment as a result of operating their marijuana business as an S corporation, they chose an S corporation and were responsible for the tax consequences of their decision.

No Criminal Conviction for Trafficking is Needed for Section 280E to Apply

Neither a criminal conviction nor proof of trafficking cannabis is required for the IRS to apply Section 280E. In *Alpenglow Botanicals, LLC v. United States*, 894 F.3d 1187 (10th Cir. 2018), the IRS disallowed Alpenglow Botanicals LLC's business deductions pursuant to Section 280E. On appeal before the 10th Circuit, the taxpayer argued that the IRS does not have authority to deny business deductions under Section 280E without a criminal conviction for trafficking cannabis. The court held that since Section 280E is not a criminal law, a criminal conviction is not required to apply it; the unlawfulness of an activity does not prevent its taxation. Further, the court held that the IRS does not need proof that the taxpayer was trafficking cannabis. Rather, the taxpayer had the burden of proving that the assessment was incorrect if he was not trafficking cannabis.



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The taxpayer also raised constitutional challenges to Section 280E. The taxpayer argued that Section 280E is unconstitutional because it is a penalty, which is prohibited by the 8th Amendment, and because it effectively allows the federal government to tax its gross receipts instead of its income, in violation of the 16th Amendment. The court reasoned that deductions are a matter of legislative grace, not a punishment or an exclusion from income. So Congress may limit them if it chooses.

If you want to learn more about the issues discussed in this Alert, please contact a member of Cozen O'Connor's Cannabis Industry Team.

Marijuana is still classified as a Schedule I controlled substance by the U.S. Drug Enforcement Agency, and as such, it remains a federal crime to grow, sell and/or use marijuana. Any content contained herein is not intended to provide legal advice to assist with violation of any state or federal law.