Taxation Of Medical Marijuana Dispensaries -- Part One Of A Three-Part Series

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Eighteen states and the District of Columbia have enacted laws permitting the sale and use of medical marijuana.[4] Medical marijuana, however, remains a "controlled substance" under federal law. This puts medical marijuana businesses in a "Catch 22" situation, where their operations are legal under state law but violate federal law. The Obama administration has taken a permissive stance with respect to enforcement of these activities under the Title 18 context. However, this stance appears inconsistent with the administration's position under Title 26. Because medical marijuana remains illegal under federal law, section 280E of the Internal Revenue Code denies medical marijuana dispensaries the ability to deduct their ordinary and necessary business expenses.

The issue concerning how the taxation of the medical marijuana dispensaries actually works seems to be a topic of "growing" discussion among tax professionals in California and beyond. This is the first article in a three-part series regarding a compilation of the research I have conducted on the subject. The first part discusses the federal income tax laws applicable to medical marijuana dispensaries in California. The second part will discuss the California income tax laws applicable medical marijuana dispensaries doing business in California. The third part will discuss tax reporting issues and concerns for tax professionals who are assisting or representing clients with these types of matters and collecting fees from clients who are engaged in these activities.

Federal Income Tax Law Applicable to Medical Marijuana Dispensaries

Under Federal law, the general rule is that salaries and other ordinary and necessary expenses incurred in carrying on an illegal business are NOT deductible unless they frustrate a sharply defined public policy. No expenses incurred in connection with the trafficking of controlled substances, or illegal drugs, may be deducted. This rule is derived from §280E of the Internal Revenue Code.

Section 280E of the Internal Revenue Code states:

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.

In the context of §280E, marijuana is a Schedule I controlled substance. This is the case even when the marijuana is medical marijuana recommended by a physician as appropriate to benefit the health of the user. The Tax Court first set down this rule in *Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner*, 128 T.C. 173 (2007) (CHAMP).

In *CHAMP*, however, the dispensary was allowed to deduct expenses associated with providing general care because the dispensary was operated as an adjunct to a significantly larger enterprise of providing overall care for extremely sick individuals. The CHAMP organization provided its members with medical marijuana pursuant to the California Compassionate Use Act of 1996, codified at Cal. Health & Safety Code §11362.5. The IRS proposed to disallow all of the petitioner's deductions and costs of goods sold, determining that those items were "Expenditures in Connection with the Illegal Sale of Drugs" within the meaning of §280E. According to the IRS, the Petitioner had a single trade or business of trafficking in medical marijuana.

Confronted with the reality of the Federal Tax Code, the taxpayer, at the advice of competent tax counsel no less, argued that in reality the Petitioner was engaged in two separate and distinct trades or businesses even though they were under one corporate umbrella. CHAMP asserted that its primary business was the provision of caregiving services and that its secondary trade or business was the supplying of medical marijuana to its members. As a result, the taxpayer argued the deductions for those trades or businesses were not precluded by §280E in that the trades or businesses did not involve "trafficking" in a controlled substance. On the other hand, the IRS asserted that §280E of the Internal Revenue Code precludes petitioner from benefiting from any of its deductions regardless.

Case Facts

It is extremely important to understand the facts behind this case:

CHAMP was organized on December 24, 1996 pursuant to the California Nonprofit Public Benefit Corporation Law, California Corporations Code §§5110-6910. Its articles of incorporation stated that it was "organized and operated exclusively for charitable, educational and scientific purposes" and "[t]he property of this corporation [was] irrevocably dedicated to charitable purposes". CHAMP did not have Federal tax-exempt status, and it operated as an approximately break-even (i.e., the amount of its income approximated the amount of its expenses) community center for members with debilitating diseases. Approximately forty-seven percent of the taxpayer's members suffered from Acquired Immune Deficiency Syndrome (AIDS); the remainder suffered from cancer, multiple sclerosis and other serious illnesses. Before joining CHAMP, its executive director had thirteen years of experience in health services as a coordinator of a statewide program that trained outreach workers in AIDS prevention work.

CHAMP operated with a dual purpose. Its primary purpose was to provide caregiving services to its members. Its secondary purpose, not unrelated to the primary, was to provide its members with medical marijuana pursuant to the California Compassionate Use Act of 1996 and to instruct those individuals on how to use medical marijuana to benefit their health. Petitioner required that each member have a doctor's letter recommending marijuana as part of his or her therapy and an unexpired photo identification card from the California Department of Public Health verifying the authenticity of the doctor's letter. Petitioner required that its members not resell or redistribute the medical marijuana received from petitioner, and petitioner considered any violation of this requirement to be grounds to expel the violator from membership in petitioner's organization.

Each of petitioner's members paid petitioner a membership fee in consideration for the right to receive caregiving services and medical marijuana from petitioner. Petitioner's caregiving services were extensive. First, petitioner's staff held various weekly or biweekly support group sessions that could be attended only by petitioner's members. The "wellness group" discussed healing techniques and occasionally hosted a guest speaker; the HIV/AIDS group addressed issues of practical and emotional support; the women's group focused on women-specific issues in medical struggles; the "Phoenix" group helped elderly patients with lifelong addiction problems; the "Force" group focused on spiritual and emotional development.

Second, petitioner provided its low-income members with daily lunches consisting of salads, fruit, water, soda, and hot food. Petitioner also made available to its members hygiene supplies such as toothbrushes, toothpaste, feminine hygiene products, combs, and bottles of bleach. Third, petitioner allowed its members to consult one-onone with a counselor about benefits, health, housing, safety, and legal issues. Petitioner also provided its members with biweekly masseuse services.

Fourth, petitioner coordinated weekend social events for its members including a Friday night movie or guest speaker and a Saturday night social with live music and a hot meal. Petitioner also coordinated for its members monthly field trips to locations such as beaches, museums, or parks. Fifth, petitioner instructed its members on yoga and on topics such as how to participate in social services at petitioner's facilities and how to follow member guidelines. Sixth, petitioner provided its members with online computer access and delivered to them informational services through its website. Seventh, petitioner encouraged its members to participate in political activities.

Petitioner furnished its services at a main facility in San Francisco, California, and at an office in a community church in San Francisco. The main facility was approximately 1,350 square feet and was the site of the daily lunches, distribution of hygiene supplies, benefits counseling, Friday and Saturday night social events and dinners, and computer access. This location also was the site where petitioner's members received their distribution of medical marijuana. The medical marijuana was dispensed at a counter of the main room of the facility, taking up approximately tenpercent of the main facility. The peer group meetings and yoga classes were usually held at the church, where petitioner rented space. Pursuant to the rules of the church, petitioner's members were prohibited from bringing any marijuana into the church. Petitioner also maintained a storage unit at a third location in San Francisco. Petitioner used the storage unit to store confidential medical records. No medical marijuana was distributed or used there.

Petitioner paid for the services it provided to its members by charging a membership fee that covered and, in the judgment of CHAMP's management, approximated both the cost of petitioner's caregiving services and the cost of the medical marijuana that petitioner supplied to its members. Petitioner notified its members that the membership fee covered both of these costs, and petitioner charged its members no additional fee. Members received from CHAMP a set amount of medical marijuana; they were not entitled to unlimited supplies.

The Court's Opinion

The Court first addressed the question of whether section 280E prevented a taxpayer from deducting business expenses of a legitimate business if that same taxpayer had a separate trade or business of trafficking in controlled substances. The Court held that section 280E and its legislative history express a congressional intent to disallow deductions attributable to a trade or business of trafficking in controlled substances, but does not express an intent to deny the deduction of all of a Petitioner's business expenses simply because the Petitioner was involved in trafficking in a controlled substance. Basically, if a taxpayer has more than one business, just because one business is engaged in an illegal activity, it does not mean the taxpayer is tainted, so as not to be allowed to deduct his expenses related to the other legitimate business.

Thus, the Court held that §280E does not preclude petitioner in CHAMP from deducting expenses attributable to a trade or business other than that of illegal trafficking in controlled substances simply because petitioner also is involved in the trafficking in a controlled substance. So the good news is that if someone owns a medical marijuana dispensary and also owns another business, she will still be allowed to deduct her expenses related to the other business.

Next, the Court in CHAMP analyzed whether petitioner's furnishing of its caregiving services was a trade or business that is separate from its trade or business of providing medical marijuana. The IRS had argued that the "evidence indicates that petitioner's principal purpose was to provide access to marijuana, that petitioner's principal activity was providing access to marijuana, and that the principal service that petitioner provided was access to marijuana and that all of petitioner's activities were merely incidental to petitioner's activity of trafficking in marijuana."

The Court disagreed and found that its executive director testified credibly and without contradiction that petitioner's primary purpose was to provide caregiving services for terminally ill patients. As the executive director's testimony he stated: "Right from the start we considered our primary function as being a community center for seriously ill patients in San Francisco. And only secondarily as a place where they could access their medicine." The evidence supported that Petitioner's operations were conducted with that primary function in mind, not with the principal purpose of providing marijuana to members.

The IRS further argued that "petitioner's only income was from marijuana-related matters, except for a couple of small donations". However, the record did not support that assertion and the Court found that the aspect of the business's caregiving services generated income attributable to those services. In making this finding, the Court relied on the testimony of the executive director who testified that its members paid their membership fees as consideration for both caregiving services and medical marijuana, and the IRS opted not to challenge the substance of that testimony. While a member may have acquired, in return for his or her payment of a membership fee, access to all of petitioner's goods and services without further charge and without explicit differentiation as to the portion of the fee that was paid for goods versus services did not establish that petitioner's operations were simply one trade or business. In so holding, the Court found it important that the management set the total amount of the membership fees as the amount that management consciously and reasonably judged equaled petitioner's costs of the caregiving services and the costs of the medical marijuana.

By conducting its recurring discussion groups, regularly distributing food and hygiene supplies, advertising and making available the services of personal counselors, coordinating social events and field trips, hosting educational classes, and providing other social services, the Court held that the Petitioner's caregiving business stood on its own, separate and apart from petitioner's provision of medical marijuana. Given petitioner's separate trades or businesses, the Court found that it was required to apportion its overall expenses accordingly.

In a manner that was most consistent with CHAMP's breakdown of the disputed expenses, the Court allocated to the caregiving services 18/25 of the expenses for salaries, wages, payroll taxes, employee benefits, employee development training, meals and entertainment, and parking and tolls (eighteen of CHAMP's twenty-five employees did not work directly in dispensing medical marijuana), all expenses incurred in renting facilities at the church (petitioner did not use the church to any extent to provide medical marijuana), all expenses incurred for "truck and auto" and "laundry and cleaning" (those expenses did not relate to any extent to petitioner's provision of medical marijuana), and 9/10 of the remaining expenses (90% of the square footage of petitioner's main facility was not used in petitioner's provision of medical marijuana).

Given CHAMP's facts and circumstances, the Court recognized that it is possible for a California medical marijuana dispensary to deduct expenses associated with providing general care because the dispensary was operated as an adjunct to a significantly larger enterprise of providing overall care for extremely sick individuals. Note, it was very apparent from the facts of this case that a separate business line did exist.

Contrast the facts of CHAMP to a more recent case in which a California medical marijuana dispensary argued that it too had a dual business purpose and should be allowed to deduct expenses associated with providing services which were primary to the provision of marijuana. See *Martin Olive v. Commissioner*, 139 T.C. No. 2 (2012) (Olive).

In *Olive*, the petitioner was a sole proprietor of a legal California medical marijuana dispensary in Northern California named the "Vapor Room." Petitioner asserted that the Vapor Room's overwhelming purpose was to provide "caregiving services," that the Vapor Room's expenses are almost entirely related to the caregiving business and that the Vapor Room would continue to operate even if petitioner did not sell medical marijuana.

In distinguishing CHAMP from petitioner Olive's facts, the Court held that in CHAMP the dispensary was operated exclusively for charitable, educational and scientific purposes and its income was slightly less than its expenses. The director there was well experienced in health services and he operated the dispensary with caregiving as the primary feature and the dispensing of medical marijuana (with instructions on how to best consume it) as a secondary feature. Moreover, 72% of the CHAMP dispensary's employees (eight out of twenty-five) worked exclusively in its caregiving business, and the dispensary provided its caregiving services "regularly, extensively and substantially" independent of its providing medical marijuana. CHAMP rented space at a church for peer group meetings and yoga classes and the church did not allow marijuana on the church's premises. It provided its low-income members with hygiene supplies and with daily lunches consisting of salads, fruit, water, soda and hot food. Its members, almost fifty percent of whom suffered from AIDS, paid a single membership fee for the right to receive caregiving services and medical marijuana from the taxpayer.

The names of the dispensaries were even diametrically different. The name of the dispensary there, "Californians Helping To Alleviate Medical Problems," stressed the dispensary's caregiving mission. The name of the dispensary here, "The Vapor Room Herbal Center," stressed the sale and consumption (through vaporization) of marijuana.

The Court held that the Vapor Room's dispensing of medical marijuana and its providing of services and activities share a close and inseparable organizational and economic relationship. Put another way, the activities were one and the same business. Olive formed and operated the Vapor Room to sell medical marijuana to the patrons and to advise them on what he considered to be the best marijuana to consume and the best way to consume it. Petitioner provided the additional services and activities incident to, and as part of, the Vapor Room's dispensing of medical marijuana. Olive and the Vapor Room's employees were already in the room helping the patrons receive and consume medical marijuana and the entire site of the Vapor Room was used for that purpose. The record did not establish that the Vapor Room paid any additional wages or rent to provide the incidental services and activities. Nor did the record establish that the Vapor Room made any other significant payment to provide the incidental activities or services. Petitioner also oversaw all aspects of the Vapor Room's operation and the Vapor Room had a single bookkeeper and a single independent accountant for its business. These facts further supported the Court's conclusion that the Vapor Room had only one trade or business.

That petitioner may have sometimes overcharged patrons for marijuana to subsidize the cost of the Vapor Room's limited services or activities did not change the Court's view. Petitioner's payment of the Vapor Room's expenses to dispense medical marijuana allowed the Vapor Room to fulfill its business purpose of selling medical marijuana that in turn allowed the Vapor Room to offer its incidental services and activities in support of that purpose. Moreover, the Vapor Room's only revenue was from patrons' purchase of marijuana. The Vapor Room would not have had any revenues at all (and could not have operated) if none of the patrons had purchased marijuana from petitioner. The Vapor Room did not spawn a second business simply by occasionally providing the patrons with snacks, a massage, or a movie, or allowing the patrons to play games in the room and to talk there to each other.

In *Olive*, the petitioner failed to establish that the Vapor Room's activities or services independent of the dispensing of medical marijuana were extensive. At trial, Olive's counsel repeatedly asked Olive's patrons who testified as witnesses to describe "caregiving" services that petitioner provided at the Vapor Room. The witnesses strained to come up with any such service, other than through their rehearsed statements that fell short of establishing caregiving services of the type and extent described in CHAMP. Petitioner's actions spoke loudly when he filed the tax returns for 2004 and 2005, reporting that the Vapor Room's principal business was the retail sale of "herbal" (which the Court discerned meant marijuana). The Court basically perceived Olive's claim that the Vapor Room actually consisted of two businesses as simply an after-thefact attempt to artificially equate the Vapor Room with the medical marijuana dispensary in CHAMP, in order to avoid the disallowance of all of the Vapor Room's expenses under section 280E.

Although *Olive* failed on one hand, it carved out a rather favorable exception on the other, mostly as a result of being able to hire credible expert witnesses to testify at trial. When it came time to determine cost of goods sold (COGS) Olive -- like others who own and operate medical marijuana dispensaries - had sparse and limited records to substantiate COGS. In order to claim these items, all taxpayers are required to keep extensive records and receipts. The Tax Court stated that medical marijuana dispensaries are no different. Moreover, just because the marijuana industry operates in cash and shuns formal substantiation does not mean that a more lenient substantiation rule applies for marijuana dispensaries.

That said, the Tax Court went on to allow Olive to claim COGS even though he had no reliable records. Olive called witnesses to testify at the trial about the medical marijuana industry; the Court deemed them qualified as experts. One such expert opined that the average COGS of three of his medical marijuana dispensary clients was 75.16% of their sales for 2005, and that part of his opinion comported with Olive's other expert's opinion that the COGS of medical marijuana dispensaries ranged from 70% to 85% of sales during the years at issue. The Court allowed Olive's COGS to be estimated based on the industry average for medical marijuana dispensaries (minus the cost of marijuana given away for free) and determined that 75.16% of sales were a reasonable measure of the Vapor Room's COGS!

I believe the Tax Court made a significant gift with respect to COGS. Olive put on a good show at trial. Perhaps the Court felt sympathy because the law required the Court to disallow 100% of the business expenses that a normal business is entitled to claim. Although the Court in Olive allowed the dispensary to estimate of COGS, the Court normally requires taxpayers to keep adequate documents and records.

However, the Court felt moved to exercise its broad discretion under the Cohen rule.

In Summary --

Section 280E prevents medical marijuana dispensaries from deducting ordinary and necessary business expenses for federal tax purposes. It effectively causes medical marijuana dispensaries to be taxed on their gross income rather than their net income. Medical marijuana dispensaries are, however, allowed to reduce their gross revenue by cost of goods sold (compared to California tax law, discussed in Part 2 of this three-part series) in arriving at gross income. This puts medical marijuana dispensaries in the unusual position of having to characterize (and capitalize) as many of their otherwise deductible expenses as possible as inventory, unlike most businesses which would prefer a current deduction. Legislation has been proposed to address this issue; however, currently the status of Federal tax law means no necessary and ordinary business deductions are allowed to these businesses. It is clear that "public policy" is shifting on this issue. Given the fact that eighteen states and the District of Columbia have enacted laws permitting the sale and use of medical marijuana and two others have made it legal for recreational use, the question of whether application of §280E in this situation frustrates a "sharply defined public policy" is a serious one.

In Part 2 of this series of articles, I will discuss how California handles the income taxation of medical marijuana dispensaries. I have a feeling many practitioners will be concerned and alarmed given the current status of the California tax laws applicable to medical marijuana dispensaries. The third part of this series will review the problems and concerns that all practitioners need to know before "dispensing" legal advice or representing a medical marijuana dispensary with its reporting requirements or before a taxing authority. I will address several dilemmas, including how filing a tax return may constitute an admission by the taxpayer that he or she is engaged in illegal drug trafficking and how practitioners who assist these taxpayers may by in technical violation of Circular 230, State Bar Rules, and arguably considered to be "aiding and abetting" the taxpayer in the commission of a federal offense. While enforcement of these concerns might seem tenuous giving the status of the current administration, who knows what will happen down the road.

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4 The eighteen states permitting the use and sale of medical marijuana are Alaska, Arizona, California, Colorado, Connecticut, Delaware, Hawaii, Maine, Massachusetts, Michigan, Montana, Nevada, New Jersey, New Mexico, Oregon, Rhode Island, Vermont, and Washington. See Colo. Const. art. XVIII, §14; Medical Uses of Marijuana for Persons Suffering from Debilitating Medical Conditions Act, Alaska Stat. Ann. §§17.37.010--.080 (West 2012); Arizona Medical Marijuana Act, Ariz. Rev. Stat. Ann. §§36- 2801 to -2819 (West 2012); Compassionate Use Act of 1996, Cal. Health And Safety Code §11362.5 (West 2012); Conn. Gen. Stat. Ann. §21a-253 (West 2012); The Delaware Medical Marijuana Act, Del. Code. Ann. tit. 16, §§4901A-- 26A (West 2012); Uniform Controlled Substances Act, Haw. Rev. Stat. Ann. §§329-121 to -128 (West 2012); Maine Medical Use of Marijuana Act, Me. Rev. Stat. Ann. tit. 22, §§2421 to 2430-B (West 2012); Mass. Med. Marijuana Initiative, Question 3 (2012); Michigan Medical Marihuana Act, Mich. Comp. Laws §§333.26421--30 (West 2012); Montana Marijuana Act, Mont. Code Ann. §§50-46- 301 to -323 (2012); Nev. Rev. Stat. Ann. §§453A.010--.810 (West 2012); New Jersey Compassionate Use Medical Marijuana Act, N.J. Stat. Ann. §§24:6I-1 to -16 (West 2012); Lynn and Erin Compassionate Use Act, N.M. Stat. Ann. §§26-2B-1 to -7 (West 2012); Oregon Medical Marijuana Act., Or. Rev. Stat. Ann. §§475.300--.346 (West 2012); The Edward O. Hawkins and Thomas C. Slater Medical Marijuana Act, R.I. Gen. Laws Ann. §§ 21- 28.6-1 to -13 (West 2012); Vt. Stat. Ann. tit. 18, §§4472--74L (West 2012); Washington Medical Use of Marijuana Act, Wash. Rev. Code Ann. §§ 69.51A.005--.903 (West 2012). The District of Columbia also permits its use. See D.C. Code §§7-1671.01 to .13 (Lexis 2012). Maryland allows medical marijuana use as an affirmative defense to prosecution for marijuana possession. See Darrell Putman Compassionate Use Act, Md. Code Ann., Crim. Law § 5-601(c)(3)(II) (West 2012). Virginia permits a physician to write a "prescription" for the use of medical marijuana. Va. Code Ann. §§18.2--251.1 (1979). However, the use of the term "prescription" rather than "recommendation" makes the statute unworkable. See Steve Elliott, Medical Marijuana Bill Goes Before Virginia House Committee, Toke of the Town (Jan. 24, 2012), www.tokeofthetown.com/2012/01/medical_marijuana_bill_ goes_ before_virginia_house.php. Wyoming had allowed medical use of marijuana under the "prescription or order" of a medical practitioner, Wyo. Stat. Ann. §35-7-1031(c) (2009), but this provision was repealed in 2011. Wyo. Stat. Ann. §35-7-1031(c) (2011). The voters in Colorado and Washington have recently voted to "legalize" the sale and use of marijuana for recreation as well as for medicinal purposes. See Colo. Const. amend. LXIV; Wash. Initiative 502 (2012). Any business selling marijuana under these laws

would be subject to the same rules as those applicable to medical marijuana businesses discussed in this Article. Back