University of Michigan Law School
University of Michigan Law School Scholarship Repository

Articles Faculty Scholarship

2017

Tax Treatment of a Marijuana Business

Douglas A. Kahn
University of Michigan Law School, dougkahn@umich.edu

Howard Bromberg
University of Michigan Law School, hbromber@umich.edu

Available at: https://repository.law.umich.edu/articles/1895

Follow this and additional works at: https://repository.law.umich.edu/articles

Part of the Business Organizations Law Commons, Food and Drug Law Commons, Taxation-Federal Commons, and the Tax Law Commons

Recommended Citation

Kahn, Douglas A., co-author. "Tax Treatment of a Marijuana Business." H. Bromberg, co-author. *Colum. J. Tax L. - Tax Matters* 8, no. 2 (2017): 23-4.

This Article is brought to you for free and open access by the Faculty Scholarship at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Articles by an authorized administrator of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

PROMPT ON THE TAX TREATMENT OF A MARIJUANA BUSINESS

By Douglas A. Kahn* and Howard Bromberg**

Currently, twenty-eight states and the District of Columbia allow the use of marijuana for medical purposes and permit the conduct of a business marketing of marijuana for that purpose. Eight of those states and the District of Columbia permit the recreational use of marijuana. There is reason to believe that more states will decriminalize the marketing of marijuana. However, marijuana is listed in Schedule 1 of the federal Controlled Substances Act of 1970 (CSA) which makes it illegal under federal law to manufacture or distribute marijuana even when it is legal to do so under local state law. In a series of memoranda promulgated by the Justice Department in the period from 2009 to 2014, the Department announced that it would not enforce the CSA prohibition against marijuana if certain requirements are met. Consequently, even the federal government has evidenced some ambivalence as to whether the conduct of a marijuana business for medical use should be illegal.

Section 162(c)(2) of the Internal Revenue Code denies a deduction for a business expense that is illegal under federal or state law. This provision is in accord with a number of administrative and judicial determinations denying deductions for illegal expenses. For example, medical expenses that are illegal under federal or state law are not deductible.[1] So, the IRS has ruled that the cost of purchasing marijuana for medical purposes, even if prescribed by a doctor and legal to purchase under state law, is not deductible because it violates the CSA.[2] The authors have published an article criticizing the denial of a deduction for illegal expenses that otherwise are deductible.[3] However, that is not the central issue with the marijuana business since its expenses typically are legal when conducted in a state that has decriminalized it.

In the absence of a statutory denial, the legal expenses of a business are deductible even if the business itself is illegal.[4] In the 1981 decision of the Tax Court in *Edmonson v. Commissioner*,[5] the court allowed the deduction of legal expenses of an illegal business. The taxpayer was engaged in the illegal business of selling cocaine and marijuana among other drugs. Congress was displeased with that decision and responded by adding § 280E to the Internal Revenue Code. That provision denies a deduction or credit for the business expenses of a business engaged in trafficking in a controlled substance that is listed in Schedule I or II of the CSA if that business is prohibited by either federal or state law. Marijuana is listed in Schedule I, and so the statute disallows all of the expenses of a

---

* Paul G. Kauper Professor of Law Emeritus, University of Michigan.
** Clinical Professor of Law, University of Michigan.

1 *See* Treas. Reg. § 1.213-1(e)(1)(ii), (2).

2 Rev. Rul. 97-9.

3 Douglas Kahn & Howard Bromberg, *Provisions Denying a Deduction for Illegal Expenses and Expenses of an Illegal Business Should Be Repealed*, 18 Florida Tax Review 207 (2016).

4 *See* Accardo v. Commissioner, 942 F.2d 444 (7th Cir. 1991).

5 Edmondson v. Commissioner, T.C. Memo. 1981-623, 42 T.C.M. (CCH) 1533 (1981).

marijuana business. For example, no deduction is allowed for the rent paid for the use of premises, for the wages paid to employees, and for the premiums paid for fire insurance.

It has been suggested that the reason Congress chose this path was to deter advertising of marijuana. If so, the provision is manifestly too broad since it reaches all other ordinary expenses shared by most businesses. Moreover, the authors see no reason to find advertising of purportedly legal businesses objectionable.

The disallowance of deductions for lawful expenses puts those businesses that are engaged in the marijuana business in a very difficult position. The denial of a deduction will greatly impinge on their net profits and may even produce a net loss. They are treated more harshly by the tax law than even illegal businesses are treated. The legal expenses of other illegal businesses are deductible. To postulate an extreme example, a business engaged in assassination for hire can deduct the cost of its bullets and depreciate the cost of its guns: while a lawful marijuana business cannot even deduct its rent or its telephone bill.

Recent cases have demonstrated another consequence of the enforcement of § 280E that some may find objectionable. Since the enforcement of § 280E occurs in the context of civil litigation, the government can use subpoenas to obtain information that could not be obtained in a criminal prosecution.[6] If the government subsequently decides to prosecute the operators of the business, it can then use the information obtained from the subpoena in that criminal case. It would not be surprising if the government were to use § 280E as an excuse to obtain information for a criminal prosecution.

While § 280E denies a deduction for business expenses, it does not prevent the capitalization of capital expenditures. So the capital expenditures of a marijuana business can be included in its cost of goods sold and thereby offset an amount realized on sales and reduce the gain recognized. Contrary to the usual preference to have ordinary deductions rather than capitalized expenditures, the tax treatment of marijuana businesses causes them to capitalize expenditures to the extent it is feasible for them to do so. Those expenditures can reduce its taxable income whereas an expenditure that is characterized as a business expense will have no tax benefit to the taxpayer at all.

Given the above considerations, should an exception for marijuana businesses be added to § 280E? Should § 280E itself be repealed?

---

[6] High Desert Relief, Inc. v. United States, No.16-CV-816 (D. Ct. N. M. Mar. 31, 2017) (Memorandum Opinion and Order denying a petition to quash subpoenas and enforcing the subpoenas); Alpenglow Botanicals, L.L.C. v. United States, No. 16-CV-00258-RM-CBS, 2016 WL 7856477 (D. Colo. Dec. 1, 2016).