

# No Tax Relief For New Mexico's Marijuana Businesses

By **Patricia Heer** (June 1, 2017, 4:19 PM EDT)

"In this world nothing can be said to be certain, except death and taxes." — Benjamin Franklin

For businesses operating under state medical marijuana laws, the death part is not likely to be so certain, but the taxes certainly seem to be.

Medical cannabis is legal for use in 29 states and the District of Columbia, yet it remains a controlled substance on schedule I of the federal Controlled Substances Act (the "CSA"). Income generated from such sources must be included in gross income when computing a medical marijuana businesses' taxable income, because income from both legal and illegal sources is taxable. Typically, a business can deduct from its gross income all the ordinary and necessary expenses in carrying on the business, but there are certain exceptions to the allowed deductions. One such exception is Section 280E of the Internal Revenue Code (the "IRS Code") which disallows any deduction or credit for any amount paid or incurred in carrying on a business consisting of trafficking schedule I and II controlled substances (within the meaning of the CSA).



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The IRS has been applying Section 280E to medical marijuana businesses, establishing that such businesses are trafficking controlled substances as prohibited by the CSA and, thereby, precluded from deducting their ordinary and necessary business expenses. A recent decision from the District Court of New Mexico<sup>[1]</sup> held, in response to such business' challenges, that the IRS has the authority to investigate and make determinations regarding the legality of the business and apply Section 280E to preclude the business from taking necessary and ordinary business expenses.<sup>[2]</sup>

## High Desert Relief v. U.S.

In High Desert Relief, the IRS audited High Desert Relief ("HDR"), which operated a medical cannabis business in New Mexico (a state permitting medical marijuana). In connection with its investigation, the IRS issued summonses to HDR's bank, the New Mexico Department of Health and HDR's utility company for records related to HDR. The IRS stated that it issued the summonses in order to assess the accuracy of HDR's returns, determine if HDR had unreportable taxable income and substantiate the gross receipts reported in HDR's tax returns.

HDR sought to quash the summonses on the grounds that: (i) the IRS' investigations and determinations regarding violations of the CSA, which the IRS uses to trigger application of Section 280E, are akin to criminal investigations beyond its authority; (ii) the summonses were unnecessary because HDR offered to provide requested documents; (iii) HDR did not receive advance notice of the IRS contacting third parties; and (iv) the CSA is defunct in practice — a "dead letter" — with respect to state-compliant medical cannabis businesses.

First, the court held that the IRS' investigation and determinations regarding the CSA are within authority. It reasoned as follows: (i) it would be incongruent if the IRS could not enforce provisions placed in the IRS Code regarding the permissibility of deductions; (ii) nothing in Section 280E requires that a criminal investigation be pursued; and (iii) Section 280E does not apply only if a criminal conviction under the CSA has been obtained.

Second, the court found that HDR's offer to produce documents was contingent on the IRS' assurance that it would use the information only for the audit. The court held that the IRS was justified in

refusing to agree to such a condition since it may have been required under the IRS Code to turn the documents over to other agencies. In any event, HDR had not to date produced any documents whether before or after the summonses were issued.

Third, the court determined that HDR received sufficient notice before the IRS contacted third parties because, prior to the summonses being issued, HDR received notice from the IRS of the audit, which included an IRS publication indicating that the IRS occasionally communicates with other persons.

Lastly, the court rejected HDR's argument — that the CSA was "dead letter" given the lack of prosecution of the CSA by the Department of Justice — because under Section 280E, there is no language permitting a deduction for otherwise prohibited expenses of a business based on whether the prohibition is enforced or not by state law.

Having rejected HDR's arguments, the court concluded that "Congress did not intend to allow businesses violating the CSA to deduct their business expenses" and enforced the summonses.[3]

## **Conclusions and Considerations**

Recent challenges to the IRS' authority to investigate the legality under the CSA of a state-legal marijuana business triggering the application of Section 280E have been unsuccessful. Accordingly, such businesses should maintain accurate records of, at a minimum, their inventory in order to substantiate to the IRS the deductions that they are permitted to take, such as offsets for costs of goods sold, as well as deductions for necessary and ordinary expenses attributable to a separate business the entity may carry on (such as caregiving, social services, etc.), if any.

Further, although the businesses may not be able to completely preclude an IRS investigation, they may be able to limit the investigation. In High Desert Relief, the IRS sought from the New Mexico Department of Health information regarding, among other things, any persons and entities that had any interest in the property, building or other material used by HDR. It also requested information regarding HDR's policies and systems for transportation, safety, testing and tracking. Although HDR did not challenge the relevance of the requests, a business finding itself in a similar position may want to confirm the connection between the information sought and the purpose of the IRS' investigation, especially when the information pertains to other individuals and entities and where the responses to particular requests may have broader implications (i.e., compliance with state licensing requirements). While the information requested by the IRS need only be potentially relevant to the purpose of its investigation, the business being investigated may nevertheless seek to limit the extent of the IRS' reach in the event the information sought is found not to meet the required standard.

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[1] The Court of Appeals for the Tenth Circuit covers appeals from Wyoming, Utah, Colorado, New Mexico, Kansas and Oklahoma.

[2] High Desert Relief Inc. v. United States of America, No. 16-469, 2017 U.S. Dist LEXIS 50134 (D. N.M. Mar. 31, 2017) and The Green Solution Retail Inc. v. United States, et. al., No. 16-1281, 2017 U.S. App. LEXIS 7746 (10th Cir. 2017).

[3] Prior to the court's final enforcement of the summonses, it awaited a ruling from the Court of Appeals for the Tenth Circuit (which covers appeals from Wyoming, Utah, Colorado, New Mexico, Kansas and Oklahoma) in The Green Solution Retail Inc. v. United States, et. al., No. 16-1281, 2017 U.S. App. LEXIS 7746 (10th Cir. 2017), a case in which similar arguments regarding the IRS' authority and Section 280E were raised. In that case, Green Solution, a Colorado-based marijuana dispensary that was audited by the IRS, sued the IRS to prevent it from investigating whether the dispensary trafficked in a controlled substance violating federal law on the ground that such

investigations and determinations are outside the IRS' statutory authority. The Tenth Circuit ruled that Green Solution could not bring its action against the IRS because actions that seek to prevent the assessment or collection of taxes are barred by the Anti-Injunction Act (the "AIA") (actions regarding amounts owed for taxes must typically be determined in an action for a refund). The Tenth Circuit held that the AIA applies not only to the actual assessment or collection of a tax, but to (i) activities leading up to, and culminating in, such assessment and collection, and (ii) even actions whose purpose is to restrain the assessment or collection of taxes. Thus, even if Green Solution's action was to prevent the IRS from investigating into whether it trafficked in a controlled substance, which is a step removed from a suit to restrain the assessment or collection of a tax, it was still prohibited under AIA. Additionally, in determining whether the court could consider Green Solution's action, the Tenth Circuit similarly ruled that Section 280E does not require a criminal investigation or a conviction, and that permissibility of Section 280E deductions fall squarely within the IRS' authority under the IRS Code. Once the Tenth Circuit issued its ruling in Green Solution, the court in High Desert reaffirmed its ruling and enforced the summonses.