INTERNAL REVENUE CODE — MEDICAL MARIJUANA — NINTH CIRCUIT HOLDS MEDICAL MARIJUANA DISPENSARY INELIGIBLE FOR FEDERAL TAX DEDUCTIONS. — *Olive v. Commissioner*, 792 F.3d 1146 (9th Cir. 2015).

As of mid-2015, twenty-three states and the District of Columbia had legalized medical marijuana under varying restrictions and regulations.[1] For example, in 1996, California passed the Compassionate Use Act,[2] which legalized the use of medical marijuana in the state. By August 2006, over 200 dispensaries were providing medical marijuana to about 200,000 patients in California.[3] Perhaps surprisingly, federal criminal law[4] has not proven to be the most substantial hurdle for these dispensaries; instead "[t]he federal *tax* situation is the biggest threat to [state-sanctioned marijuana] businesses and could push the entire industry underground."[5] Under § 162 of the Internal Revenue Code (I.R.C.), "ordinary and necessary" business expenses are tax deductible.[6] However, I.R.C. § 280E specifically states that "[n]o 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 . . . consists of trafficking in controlled substances . . . which is prohibited by Federal law."[7] Thus, medical marijuana dispensaries, at least to the extent that they traffic marijuana, are excluded from the tax benefits of § 162.

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[1] *See State Marijuana Laws Map*, GOVERNING (June 19, 2015), http://www.governing.com/gov-data/state-marijuana-laws-map-medical-recreational.html [http://perma.cc/KY5Z-AKW7].

[2] CAL. HEALTH & SAFETY CODE § 11362.5(b)(1)(A) (Deering 2010) ("To ensure that seriously ill Californians have the right to obtain and use marijuana for medical purposes where that medical use is deemed appropriate and has been recommended by a physician . . . .").

[3] AMS. FOR SAFE ACCESS, MEDICAL CANNABIS DISPENSING COLLECTIVES AND LOCAL REGULATION 4–5 (2006), http://medicalmarijuana.procon.org/sourcefiles/dispensaries.pdf [http://perma.cc/823F-QW5R].

[4] *See* Controlled Substances Act, 21 U.S.C. §§ 801–904 (2012).

[5] Benjamin Moses Leff, *Tax Planning for Marijuana Dealers*, 99 IOWA L. REV. 523, 525 (2014) (alterations in original) (quoting *Marijuana Business Conference Wrapup: 36 Tips, Lessons & Takeaways for the Cannabis Industry*, MED. MARIJUANA BUS. DAILY (Nov. 15, 2012), http://www.mjbizdaily.com/marijuana-business-conference-wrapup-36-tips-lessons [http://perma.cc/2AJG-AG7B]).

[6] I.R.C. § 162(a) (2012) ("There 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 . . . ."). Generally, "ordinary and necessary [business] expenses" are tax deductible regardless of the legality of the business. Edward J. Roche, Jr., *Federal Income Taxation of Medical Marijuana Businesses*, 66 TAX LAW. 429, 433 (2013) ("The courts have consistently allowed an illegal business to deduct typical business expenses, such as rent, salaries, and legal fees.").

[7] I.R.C. § 280E (defining "controlled substance" according to schedules I and II of the Controlled Substances Act).

Commentators have suggested various methods for dispensaries to plan around this additional tax burden.[8] One suggestion that has been implemented is bundling together the provision of caregiving services with the sale of medical marijuana.[9] Since the expenses associated with these caregiving services are tax deductible under I.R.C. § 162, the dispensary might reduce its tax liability by allocating as much of its shared expenses as it can toward the caregiving services. Recently, the Ninth Circuit addressed the tax treatment of this particular method. In *Olive v. Commissioner*,[10] the court held that the owner of a medical marijuana dispensary was not entitled to any business tax deductions — even for expenses associated with caregiving services provided alongside the sale of marijuana — because his business consisted solely of trafficking marijuana and thus fell under the exception listed in I.R.C. § 280E.[11]

Despite this outcome, *Olive* suggests that the Ninth Circuit might endorse a previous U.S. Tax Court case, *Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner*[12] (*CHAMP*). If the Ninth Circuit were to adopt *CHAMP*'s framework, medical marijuana dispensaries would be able to deduct the business expenses associated with their caregiving services from their tax liability, as long as those caregiving services embody a "trade or business" that is separate from the sale of medical marijuana. While some unsettled questions would remain on the margins, *Olive*, together with *CHAMP*, would provide much guidance on what it means for caregiving services to constitute a separate "trade or business" in the medical marijuana dispensary context. The substance of this guidance, in turn, would discourage marijuana dispensaries from attempting to use caregiving services to circumvent their tax liability.

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[8] Suggestions have included taking advantage of the fact that cost of goods sold is excluded from the taxable income of the business by following Uniform Capitalization (UNICAP) inventory rules to increase the cost of goods sold as much as possible. *See* Roche, *supra* note 6, at 429. Another commentator has suggested forming medical marijuana dispensaries as § 501(c)(4) charity organizations. *See* Leff, *supra* note 5, at 533–37. *But see* Philip T. Hackney, *A Response to Professor Leff's Tax Planning "Olive Branch" for Marijuana Dealers*, 99 IOWA L. REV. BULL. 25, 26 (2014) (arguing that Professor Leff's suggestion is unrealistic).

[9] *See* Leff, *supra* note 5, at 533–34.

[10] 792 F.3d 1146 (9th Cir. 2015).

[11] *Id.* at 1149.

[12] 128 T.C. 173 (2007). In *CHAMP*, the plaintiff ran a nonprofit organization that provided members with caregiving services as well as medical marijuana. *Id.* at 174–75. For an all-inclusive membership fee, the plaintiff provided counseling, support groups, field trips, massages, and daily lunches, in addition to providing medical marijuana. *Id.* at 175. The Tax Court held that the business expenses associated with these caregiving services were tax deductible since these services consisted of a business that was separate from the medical marijuana business. *Id.* at 185–86.

In 2004, Martin Olive opened a medical marijuana dispensary, the Vapor Room Herbal Center ("Vapor Room"), in San Francisco, California.[13] In addition to selling medical marijuana, the dispensary provided vaporizers, games, books, and art supplies for customers to use and also held regular activities — such as yoga classes, massages, and movie showings — all free of charge.[14] The Internal Revenue Service (IRS) audited Olive's 2004 and 2005 tax returns and issued a notice of deficiency, stating that Olive was not allowed to deduct either the reported cost of goods sold (COGS) or the reported business expenses, both due to lack of substantiation.[15] The IRS later conceded that Olive's reported business expenses were substantiated but argued that § 280E precluded these expenses from being deductible.[16] Olive petitioned the U.S. Tax Court to review the IRS's audit determination.[17]

First, the Tax Court noted that Olive bore the burden of proof to show that the IRS's deficiency determination was incorrect.[18] On the issue of COGS, the Tax Court disagreed with both the IRS's and Olive's estimates and instead independently determined a COGS amount.[19] The Tax Court then turned to Olive's expenses. It agreed with the IRS that under § 280E, none of Olive's expenses were tax deductible.[20] The Tax Court rejected Olive's narrow reading of § 280E as precluding only "illegal underground businesses that have a single business of drug trafficking."[21] While admitting that a business can have multiple activities that are taxed differently, the Tax Court found that the Vapor Room's sale of medical marijuana was inseparable from the other services provided.[22] Thus, the Tax Court held that

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[13] Olive v. Comm'r, 139 T.C. 19, 21 (2012).

[14] *Id.* at 21, 23. Staff members at the Vapor Room also educated the customers on medical marijuana, *id.* at 23, and customers discussed and counseled one another on "various personal, legal or political matters related to medical marijuana" in the store, *id.* at 24.

[15] *Id.* at 28. The substantiation requirements are governed by 26 C.F.R 1.274-5 (2015), which requires that the taxpayer provide documentary evidence to support a claimed expenditure. *Id.*

[16] *Olive*, 139 T.C. at 28.

[17] *See id.* at 19.

[18] *Id.* at 29. The Tax Court also determined that the ledgers submitted by the plaintiff were reliable evidence of the gross amount that the Vapor Room made for 2004 and 2005. *Id.* at 31.

[19] *Id.* at 34–36. The Tax Court calculated the COGS based on expert testimony that the average COGS for several similar medical marijuana dispensaries equaled 75.16% of sales and the fact that the plaintiff gave away 6.5% of the business product. *Id.* at 35–36.

[20] *Id.* at 42.

[21] *Id.* at 39. Both parties, as well as the Tax Court, agreed that medical marijuana qualified as a controlled substance under § 280E. *Id.* at 38 (citing Gonzalez v. Raich, 545 U.S. 1 (2005); United States v. Oakland Cannabis Buyers' Coop., 532 U.S. 483 (2001); Californians Helping to Alleviate Med. Problems, Inc. v. Comm'r, 128 T.C. 173 (2007)).

[22] *Id.* at 40–42 ("We perceive his claim now that the Vapor Room actually consists of two businesses as simply an after-the-fact attempt to artificially equate the Vapor Room with the medical marijuana dispensary in *CHAMP* so as to avoid the disallowance of all of the Vapor Room's expenses under section 280E." *Id.* at 42.).

Olive was not entitled to any deduction for business expenses.[23] Lastly, because the application of § 280E to medical marijuana businesses was decided after Olive filed tax returns in 2004 and 2005, the Tax Court reduced the IRS's accuracy-related penalty by the amount Olive underpaid as a result of deducting business expenses.[24]

Olive appealed to the Ninth Circuit the Tax Court's decision that the business expenses were not deductible.[25] Writing for the three-judge panel, Judge Graber[26] affirmed the Tax Court's decision.[27] First, to determine whether Olive's ordinary and necessary business expenses would be tax deductible under § 280E, the court considered whether Olive's Vapor Room was a "trade or business" that "consisted of" trafficking marijuana.[28] Taking these contested phrases in turn, the court stated that "[t]he test for determining whether an activity constitutes a 'trade or business' is 'whether the activity was entered into with the dominant hope and intent of realizing a profit.'"[29] Applying this test, the court found that the only "trade or business" of the Vapor Room consisted of the selling of medical marijuana, because although the Vapor Room provided other services — such as food, drink, movies, and counseling — the selling of medical marijuana was the only income-generating activity of the business.[30]

Next, the court examined whether the Vapor Room's business "consisted of" drug trafficking. Olive argued that since medical marijuana was not the sole service offered by the Vapor Room, business tax deductions should be recognized for the other services provided because those services were a separate "trade or business."[31] The court rejected Olive's argument and distinguished the case from *CHAMP*, on which Olive had relied.[32] While the court accepted that Olive could have been involved in more than one "trade or business," the court noted that his situation was different from that of the taxpayer in *CHAMP* because Olive "d[id] not provide counseling, caregiving,

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[23] *Id.* at 42.

[24] *Id.* at 44. A taxpayer may be liable for a twenty percent penalty on any underpayment amount that is due to negligence with regard to the rules and regulations of the tax code. *See* I.R.C. § 6662(a) (2012). For example, if a taxpayer underpaid by $1000 due to negligence, the IRS may assess a $200 penalty.

[25] *Olive*, 792 F.3d at 1147.

[26] Judge Graber was joined by Judge Kozinski and Judge Benson, sitting by designation from the District of Utah.

[27] *Olive*, 792 F.3d at 1147.

[28] *Id.* at 1149.

[29] *Id.* (quoting United States v. Am. Bar Endowment, 477 U.S. 105, 110 n.1 (1986)).

[30] *Id.* ("The only activity, then, that the Vapor Room 'entered into with the dominant hope and intent of realizing a profit,' was the sale of medical marijuana." (citation omitted) (quoting *Am. Bar Endowment*, 477 U.S. at 110 n.1)).

[31] *Id.*

[32] *Id.*

snacks, and so forth for a separate fee; the only 'business' in which he engages is selling medical marijuana."[33] The court proceeded to provide an analogy: comparing one bookstore that sells books and provides food for free with another bookstore that sells books and has a café area selling food.[34] The court noted that the first bookstore would be in the "trade or business" of selling books only, while the latter would have two different "trade[s] or business[es]": that of selling books and that of selling food.[35]

Lastly, the court rejected Olive's argument that section 538 of the Consolidated and Further Continuing Appropriations Act of 2015,[36] which provides that certain funds cannot be used to prevent states "from implementing their own State laws that authorize the use, distribution, possession, or cultivation of medical marijuana,"[37] prevented the government from pursuing this litigation.[38] Given that these arguments were unavailing, the court affirmed the decision of the Tax Court.[39]

In *Olive*, the Ninth Circuit seemed to suggest that dispensaries, under some circumstances, might be allowed to reduce their tax liability by tying together caregiving services with marijuana sales. The court did so by distinguishing, rather than contradicting, the Tax Court's decision in *CHAMP*. Since Tax Court decisions are not binding on circuit courts,[40] the Ninth Circuit did not need to carefully distinguish *CHAMP* from *Olive*. However, in not calling into question the *CHAMP* decision, the court implied that it would find the expenses associated with the caregiving services of a dispensary similar to the one in *CHAMP* to be tax deductible. Thus, the *Olive* court's passive acceptance of *CHAMP* suggests that for dispensaries in California, tax

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[33] *Id.*

[34] *Id.* at 1150.

[35] *Id.* The court was also not persuaded by Olive's argument that § 280E should not apply because the statute was enacted before medical marijuana dispensaries were legalized. The court noted that "[i]t is common for statutes to apply to new situations" and that only Congress can change the statute. *Id.*

[36] Pub. L. No. 113-235, § 538, 128 Stat. 2130, 2217 (2014).

[37] *Id.*

[38] *Olive*, 792 F.3d at 1150. The court reasoned that (1) "statements by a later Congress do not inform us about the intent of a previous Congress"; (2) "a decision not to expend funds to enforce a particular statute says nothing about the meaning of that statute"; and (3) "section 538 does not apply" because "the government is enforcing only a tax, which does not prevent people from using, distributing, possessing, or cultivating marijuana in California." *Id.* at 1150–51.

[39] *Id.* at 1151. The court also dismissed the petitioner's public policy argument that § 280E was not meant to encompass medical marijuana when it was passed. The court steadfastly held that it was up to Congress to change the text of § 280E to not cover medical marijuana. *Id.* at 1150.

[40] *See* Dobson v. Comm'r, 320 U.S. 489, 502 (1943) ("While [Tax Court] decisions may not be binding precedents for courts dealing with similar problems, uniform administration would be promoted by conforming to them where possible.").

deductions may be allowed for caregiving services if these services embody a separate "trade or business" from that of selling medical marijuana.

Therefore, marijuana dispensaries should look to both *Olive* and *CHAMP* for direction on what they would need to do to be eligible for such a tax deduction. First, dispensaries would need to ensure that their caregiving services are first and foremost a "trade or business." Under *Olive*, the Ninth Circuit used the established definition of "trade or business" as something that is "entered into with the dominant hope and intent of realizing a profit."[41] Applying this definition, the court held that the Vapor Room's caregiving services did not constitute a "trade or business" since they were free and generated no profit.[42] However, *CHAMP* clarified that the caregiving services would not need to necessarily charge a separate fee in order to be generating a profit, since in *CHAMP* the dispensary charged a membership fee that covered both the medical marijuana and the caregiving services.[43] Consequently, dispensaries would need to ensure that their caregiving services do realize — or at least are intended to realize — a profit, but these services would not necessarily have to be sold separately from the medical marijuana.[44]

Second, the caregiving services would not only need to be a "trade or business," but also separate from the medical marijuana sales. Under *CHAMP*, "whether an activity is a trade or business separate from another trade or business is a question of fact that depends on . . . the degree of economic interrelationship between the two undertakings."[45] The *CHAMP* court determined that it was reasonable to find that the caregiving services were a separate business because they were so regular and extensive that the business "stood on its own" apart from the sale of marijuana.[46] Furthermore, *CHAMP* cited *Collins v. Commissioner*,[47] which found that the existence of separate records and employees was probative of whether the taxpayer had two separate

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[41] *Olive*, 792 F.3d at 1149 (quoting United States v. Am. Bar Endowment, 477 U.S. 105, 110 n.1 (1986)).

[42] *Id.*

[43] *CHAMP*, 128 T.C. 173, 174–75 (2007).

[44] In *CHAMP*, the Tax Court determined the allocation of expenses between the caregiving services and marijuana sales by noting that eighteen of twenty-five employees did not work directly with medical marijuana and ninety percent of the facility was not used to provide marijuana. *Id.* at 185. However, this allocation of expenses would be more clear-cut if fees were separately charged for the medical marijuana and the caregiving services. *See generally* Paul L.B. McKenney, *Practical Purchase Price Allocation Problems and Their Solutions*, MICH. B.J., Jan. 1991, at 80 (discussing the difficulty of separating out what each asset costs when a sale transaction consists of many tangible and intangible assets for one price).

[45] *CHAMP*, 128 T.C. at 183.

[46] *Id.*

[47] 34 T.C. 592 (1960).

businesses.[48] This conclusion suggests that if a dispensary keeps separate business records for its caregiving services and also hires separate employees to provide these services, then it is likely that the caregiving services would be considered a separate business. However, *CHAMP* shows that separate books and records would not be necessary to find separate businesses.[49] Although there is no hard and fast rule for determining whether businesses are separate, *CHAMP* indicates that dispensaries would probably need to establish robust and regular caregiving services, and probably have some employees tasked solely with caregiving services, to be eligible for any tax deductions.

Given that the caregiving services would have to be a separate "trade or business" in order to receive any business expense tax deductions, marijuana dispensaries would be greatly constrained in using caregiving services as a method of circumventing tax liability. Both *CHAMP* and *Collins* were concerned with whether it is possible for a court to reasonably separate out which expenses are from one business and which expenses are from the other. In *Collins*, separate accounting books were considered evidence in favor of the existence of two separate businesses,[50] and *CHAMP* relied on the separately employed personnel and segregated use of the facility for the expense allocation.[51] If medical marijuana dispensaries structured their operations such that a court could readily observe a separation of expenses, they would be mostly unable to artificially inflate their business-expense deductions by masking expenses associated with their medical marijuana operations as expenses associated with their caregiving services.

The Ninth Circuit, in *Olive*, suggested that dispensaries might be able to receive tax deductions for expenses associated with the caregiving services that are a separate "trade or business" from the marijuana sales. If the Ninth Circuit were to accept the *CHAMP* framework, dispensaries would benefit from the guidance *CHAMP*, as interpreted by *Olive*, would provide. For now though, the only certain result of *Olive* is to close one avenue by which medical marijuana dispensaries have attempted to reduce their tax liability. In the absence of certainty from the courts, the U.S. Treasury could issue either general regulations[52]

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[48] *Id.* at 597–98.

[49] *CHAMP*, 128 T.C. at 185.

[50] *Collins*, 34 T.C. at 597–98.

[51] *CHAMP*, 128 T.C. at 185.

[52] Under I.R.C. § 7805(a) (2012), the Secretary of the Treasury can prescribe regulations needed to enforce the Internal Revenue Code. *See* 6 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 110.4, at 110-33 to -41 (2d ed. 2012). However, like other executive agencies, the Treasury also needs to comply with the Administrative Procedure Act when issuing any regulations. *See id.*

or rulings on particular fact situations,[53] and Congress could even change § 280E or write an additional statute addressing medical marijuana in particular. Thus, there is ample opportunity for the law to change and develop in this area, especially since legal marijuana is a large and growing market.[54] How tax law is applied to this industry will have profound consequences, not just on dispensaries, but also on state and federal governments.[55]

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[53] The Treasury Department issues two types of rulings: revenue and private letter. These rulings answer inquiries by taxpayers about the possible tax effects of their specific fact situations. For more background on the two types of rulings and their precedential weight, see generally MICHAEL I. SALTZMAN & LESLIE BOOK, IRS PRACTICE & PROCEDURE ¶ 3.03, at 3-44 to -40 (Thomson Reuters rev. 2d ed. 2014).

[54] As of November 2013, the legal marijuana market in the United States was estimated to be worth $1.53 billion, and was estimated to grow to $10.2 billion in the next five years. Hunter Stuart, *If You Support Legal Marijuana, Memorize These 13 Stats*, HUFFINGTON POST (Apr. 19, 2014, 3:39 PM), http://www.huffingtonpost.com/2014/04/19/benefits-legalizing-weed-by-the-numbers_n_5173785.html [http://perma.cc/2HC8-FG94].

[55] According to a 2010 study conducted by Harvard University Professor Jeffrey Miron and Katherine Waldock, marijuana prohibition costs state and federal governments $8.7 billion a year in tax revenue. *See* JEFFREY A. MIRON & KATHERINE WALDOCK, THE BUDGETARY IMPACT OF ENDING DRUG PROHIBITION 1 (2010), http://object.cato.org/sites/cato.org/files/pubs/pdf/DrugProhibitionWP.pdf [http://perma.cc/U2N3-CG8L].