Marijuana Series: How Profitable is the Business of Cannabis? For Now, the IRS may Decide

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A Colorado based marijuana business recently petitioned the Supreme Court to determine whether the IRS exceeded its authority through an independent investigation and subsequent determination that the company was trafficking in a controlled substance. As a reminder, cannabis is still placed in Schedule I of the Controlled Substances Act. That Federal classification holds firm even though states across the U.S. are increasingly permitting forms of medicinal and recreational marijuana use. An enduring national proscription creates a major hurdle for businesses operating lawfully at the state level. The reason, aside from the numerous risks inherent to operating any business that flouts the laws of the United States, comes down to profit.

During the course of an audit, the IRS found deductions for business expenses were disallowed, because the company was trafficking drugs. The IRS applied Section 280E of the Tax Code, which forbids a company trafficking in a controlled substance from taking tax deductions and credits. The practical effect is the prevention of state-legal marijuana companies from deducting otherwise ordinary business expenses from their total income. Needless to say, application of 280E raises federal tax bills. At best, this challenges profitability, and for some cannabis operations it may determine the viability of their continued operations after-tax.

In this particular instance, the cannabis company alleges the IRS has no authority under the law to determine whether they violated criminal drug laws. Notably, there is no genuine dispute operations are not prohibited by the Federal Government, because that would be plainly false. The business simply asserts the IRS lacks authority to determine its criminal culpability. This distinction is notable, but also emblematic of the type of form over substance positions and arguments state-legal cannabis business owners are forced to utilize.

Cannabis based businesses and entrepreneur are like any other taxpayers. That means reporting income and paying income tax, and it is certainly true the U.S. Treasury collected millions, in cash payments, from state-legal cannabis companies in 2017. Not surprisingly, those companies are seeking ways to minimize their tax burdens by challenging the IRS' authority to apply 280E.

The Supreme Court may decide to consider whether the IRS exceeded its authority to unilaterally determine who is trafficking in a controlled substance. However, the Court may also decline to weigh in on that issue. Certainly, the IRS has

defended its authority, and said further review by the Supreme Court is not warranted. In another case, the Tenth Circuit found the IRS' investigation was not criminal and simply an appropriate determination of the company's entitlement to a deduction or credit under 280E.

In any event, the quest for profit by state-legal cannabis businesses remains challenging, and tax counsel is required to navigate disparate State and Federal laws. The case is The Green Solution Retail Inc. et al. v. U.S. et al., docket no. 17-663, before the U.S. Supreme Court.