

Marijuana Legalization and Taxes: The Impact of Section 280E

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Key Findings

- 26 U.S.C. § 280E denies the deduction of business expenses to those selling drugs on Schedules I and II of the Controlled Substances Act.
- Section 280E singles out legal marijuana retailers for a significantly higher income tax burden relative to other types of legal businesses.
- Section 280E causes hugely disproportionate tax bills for these businesses authorized by state law but treated as criminal by the IRS.
- Section 280E was not written with state-legal marijuana in mind, and modernizing it would restore neutrality to the tax code and level the playing field.
- Congress has several options for modernizing Section 280E.

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Introduction

Four states and the District of Columbia have legalized the sale of retail marijuana by popular vote, with an additional 25 states permitting medical marijuana or decriminalizing marijuana possession.¹ Beginning in 2011, polls consistently show a majority of Americans supportive of legalizing marijuana,² and a number of states are likely to consider legalization ballot initiatives or legislative measures in the next few years.

Federal law remains an obstacle to these state efforts in two major ways. First, marijuana remains on Schedule I of the Controlled Substances Act, the category reserved for dangerous drugs with a high potential for abuse and no accepted medical use. Because federal law trumps state law, those selling and possessing marijuana would get no protection from state legalization as long as those activities violate federal law.³ In August 2013, however, the Deputy Attorney General issued guidance to U.S. attorneys (federal prosecutors) to focus marijuana enforcement efforts on criminal trafficking, use by minors, and activities on federal land; a second memo in 2014 added financial crimes such as money laundering.⁴ Beginning with its Fiscal Year 2015 appropriations law, Congress has now prohibited the Justice Department from interfering with state laws implementing medical marijuana.⁵ However, the continued status of marijuana being illegal under federal law has resulted in state-authorized marijuana retailers encountering difficulty accessing banking services, mailing customers, and securing and enforcing lease agreements.⁶

1 **Legalization:** Colorado (passed 2012, in effect 2014), Washington (passed 2012, in effect 2014), Oregon (passed 2014, in effect 2015), Alaska (passed 2014, in effect 2016), the District of Columbia (passed 2014, non-sales features in effect 2015, sales features on hold due to congressional opposition). **Medical marijuana:** California (1996), Alaska (1998), Oregon (1998), Washington (1998), Maine (1999), Colorado (2000), Hawaii (2000), Nevada (2000), Montana (2004), Rhode Island (2006), New Mexico (2007), Vermont (2007), Michigan (2008), Arizona (2010), New Jersey (2010), Delaware (2011), the District of Columbia (2011), Connecticut (2012), New Hampshire (2013), Massachusetts (2013), Maryland (2014), Minnesota (2014), New York (2014), Guam (2014), Georgia (2015), Texas (2015). **Decriminalization:** Oregon (1973), Alaska (1975), Colorado (1975), California (1976), Maine (1976), Minnesota (1976), Ohio (1976), New York (1977), North Carolina (1977), Mississippi (1978), Nebraska (1979), Nevada (2002), Massachusetts (2009), Maryland (2014), Delaware (2015), Missouri (2017).

2 See Gallup, "Illegal Drugs," <http://www.gallup.com/poll/1657/illegal-drugs.aspx>.

3 Constitutional challenges to the federal government's power to prohibit sale or possession of illegal drugs have not succeeded. See *United States v. Oakland Marijuana Buyers Cooperative*, 532 U.S. 483 (2001) (rejecting medical necessity defense against federal marijuana laws); *Gonzales v. Raich*, 545 U.S. 1 (2005) (upholding federal prohibition of non-sold intrastate marijuana as within the Constitution's interstate commerce clause; 6-3 decision). See also *United States v. Doremus*, 249 U.S. 86 (1919) (upholding the Harrison Narcotics Act's banning of heroin sales as validly incidental to the taxing power; 5-4 decision); *Linder v. United States*, 268 U.S. 5 (1925) (questioning the constitutional scope of the Harrison Narcotic Act but not invalidating it); *Casey v. United States* (1928) (upholding the use of the Harrison Narcotic Act to criminalize possession of drugs notwithstanding any evidence relating to tax stamps or payment of revenue; 5-4 decision); *Nigro v. United States* (1928) (upholding the Harrison Narcotic Act's narrowing of legal distribution of narcotics designed to prohibit the products as a valid exercise of the taxing power; 6-3 decision); *Leary v. United States*, 395 U.S. 6 (1969) (striking down the Marihuana Tax Act of 1937 as necessarily violating the Fifth Amendment right against self-incrimination; Congress responded by enacting direct regulation of dangerous drugs through the Comprehensive Drug Abuse Prevention and Control Act of 1970, which includes the Controlled Substances Act of 1970).

4 See Office of the Deputy Attorney General, "Guidance Regarding Marijuana Enforcement," Aug. 29, 2013; Office of the Deputy Attorney General, "Guidance Regarding Marijuana Related Financial Crimes," Feb. 14, 2014.

5 Consolidated and Further Continuing Appropriations Act, 2015, P.L. 113-235, section 538, 128 Stat. 2217 (Dec. 16, 2014); extended in full by Continuing Appropriations Act, 2016, P.L. 114-53, 129 Stat. 505 (Sept. 30, 2015).

6 See, e.g., Jacob Sullum, *The Federal Ban on Medical Marijuana Was Not Lifted*, REASON MAGAZINE (Jan. 4, 2016), <http://reason.com/archives/2016/01/04/the-federal-ban-on-medical-marijuana-was>; Jacob Sullum, *Colorado Settlement Suggests RICO Nuisance Suits Will Hinder Legal Pot Industry*, REASON MAGAZINE (Dec. 31, 2015), <https://reason.com/blog/2015/12/31/settlement-suggests-rico-nuisance-suits>; Jacob Sullum, *Marijuana Ads are 'Nonmailable,' but That Doesn't Mean You Can't Mail Them*, REASON MAGAZINE (Dec. 18, 2015), <https://reason.com/blog/2015/12/18/marijuana-ads-are-nonmailable-but-that-d>; Jacob Sullum, *Cannabis Cash Conundrum, Continued*, REASON MAGAZINE (Sept. 22, 2014), <http://reason.com/archives/2014/09/22/cannabis-cash-conundrum-continued>.

Tax law is the second major federal obstacle to state efforts to construct a legal marijuana industry. 26 U.S.C. § 280E singles out legal marijuana retailers for a significantly higher income tax burden relative to other types of legal businesses. All businesses, including illegal businesses, are required to pay income tax on the difference between their revenue and their expenses.⁷ Section 280E was enacted in 1982 to deny the deduction of business expenses to those selling drugs on Schedules I and II of the Controlled Substances Act. While intended to punish drug dealer kingpins from deducting expenses like guns and smuggling yachts, the IRS applies it to state-authorized marijuana retailers, punishing taxpayers trying to comply with the law and creating a competitive advantage for the very drug dealer kingpins that Section 280E was enacted to punish.

Section 280E may or may not have been good policy in 1982, but the changing landscape of marijuana now results in a tax code artificially tilted against legal businesses battling the black market. Modernizing section 280E would restore fundamental fairness by assessing income tax on income for all businesses legal under state law.

Section 280E Denies Business Deductions to Those Selling Drugs Illegal under Federal Law

26 U.S.C. § 280E, enacted in 1982, reads as follows:

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.

The law was passed after a Minnesota drug dealer caught with 100 pounds of marijuana and 1.1 million amphetamine tablets was assessed taxes by the IRS, and he filed with deductions for 29,000 miles of automobile mileage, telephone calls, a \$50 scale, packaging materials, and his home office.⁸ While the legislative record demonstrates the target of the provision were drug dealers trafficking in dangerous drugs, the IRS applies

⁷ Senator John Sharp Williams of Mississippi, who managed the floor debate in favor of the 1913 federal income tax law, opposed amendments to limit business deductions only for "lawful" and "legitimate" businesses: "The object of this bill is to tax a man's net income; that is to say, what he has at the end of the year after deducting from his receipts his expenditures or losses. It is not to reform men's moral characters; that is not the object of the bill at all." See also *United States v. Sullivan*, 274 U.S. 259 (1927) ("We see no reason [...] why the fact that a business is unlawful should exempt it from paying the taxes that, if lawful, it would have to pay."); *Commissioner v. Tellier*, 383 U.S. 687 (1966) ("We start with the proposition that the federal income tax is a tax on net income, not a sanction against wrongdoing.[...] Income from a criminal enterprise is taxed at a rate no higher and no lower than income from more conventional sources.")

⁸ See *Edmondson v. Commissioner*, T.C. 1981-623.

Section 280E to marijuana retailers in states that have legalized marijuana, contending that they are trafficking in a Schedule I controlled substance.⁹ These retailers are thus denied business deductions that all other businesses, including all non-drug-related illegal businesses, may take.¹⁰

Among the costs that marijuana retailers cannot deduct are employee salaries, utility costs, health insurance premiums, marketing and advertising costs, repairs and maintenance, rental fees, and contractor payments.¹¹ The IRS has permitted retailers to deduct their cost of goods sold, because of a historical view that cost of goods sold are a component of gross income and not a deduction by themselves, although the IRS has had difficulty conforming this to its general rules on taxation of inventory.¹² In early 2015, the IRS issued a memo on this point suggesting it would challenge deductions for administrative costs, state excise taxes, storage, purchasing, and depreciation.¹³

Section 280E Imposes Disproportionately Higher Taxes on State-Legal Marijuana Businesses Compared to All Other Businesses

The enormous negative effect on legal marijuana businesses cannot be understated. The following three examples are real examples provided by the National Cannabis Industry Association from their members. Table 1 is a Colorado medical cannabis business that paid a 55 percent effective tax rate in 2013 due to section 280E, a tax bill nearly twice as high as a similarly-situated non-marijuana business.

9 See *Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner*, 128 T.C. 173 (2007); *Olive v. Commissioner*, 139 T.C. 19 (2012), *affirmed* 792 F.3d 1146 (9th Cir. 2015). In *Olive*, the IRS attempted to deny even the Cost of Goods Sold deduction due to insufficient paperwork, but the Tax Court allowed the taxpayer to deduct an industry-average of 75 percent. See also Kimberly A. Houser, Jeffrey Gramlich, and Debra Sanders, *How Current Tax Law Policy Affects the Marijuana Industry*, 79 STATE TAX NOTES 583 (Feb. 22, 2016).

10 Congress has denied business deductions in one other major area: for bribes and kickbacks as against public policy, for all businesses. See 26 U.S.C. § 162(c).

11 See National Cannabis Industry Association, "Internal Revenue Code Section 280E: Creating an Impossible Situation for Legitimate Businesses," <https://thecannabisindustry.org/uploads/2015-280E-White-Paper.pdf>.

12 See Internal Revenue Service Office of Chief Counsel, "Taxpayers Trafficking in a Schedule I or Schedule II Controlled Substance – Capitalization of Inventoriable Costs," Dec. 10, 2014, <https://www.irs.gov/pub/irs-wd/201504011.pdf> (applying the 1982 version, rather than the current version, of inventory rules to state marijuana retailers to prevent violating section 280E).

13 See *id.* A later 2015 memo concluded that excise tax payments should be treated as a reduction in amount realized on subsequent sale of property. See Internal Revenue Service Office of Chief Counsel, "Section 164, Section 280E, and the State of Washington Marijuana Excise Tax," June 9, 2015, <https://www.irs.gov/pub/irs-wd/201531016.pdf>.

Table 1.
Colorado Medical Marijuana Business Tax Bill vs. Similarly Situated Non-Marijuana Business

Category	Marijuana-Related Business	Similarly Situated Non-Marijuana Business
Gross Sales	\$776,772	\$776,772
Cost of Goods Sold	\$435,819	\$435,819
Gross Income/Profit	\$340,953	\$340,953
Cost of Salaries & Wages	\$85,004	\$85,004
Cost of Repairs & Maintenance	\$6,638	\$6,638
Cost of Rent	\$8,325	\$8,325
Cost of Advertising	\$33,915	\$33,915
Cost of Supplies	\$13,195	\$13,195
Other Operating Expense Costs	\$6,729	\$6,729
Total Operating Expenses	\$153,806	\$153,806
Deductible Expenses	\$0	\$153,806
Income Before Taxes	\$340,953	\$187,147
Tax Due	\$102,900	\$56,480
Effective Tax Rate	55%	30%

Table 2 is a newly-started medical marijuana business in Arizona, incurring many up-front costs as many start-up businesses do while building its revenue. While a non-marijuana business would pay no income tax on their first year loss, the marijuana business with the same income and expenses is handed a \$189,781 tax bill.

Table 2.
Arizona Medical Marijuana Business Tax Bill vs. Similarly Situated Non-Marijuana Business

Category	Marijuana-Related Business	Similarly Situated Non-Marijuana Business
Gross Sales	\$876,420	\$876,420
Cost of Goods Sold	\$319,386	\$319,386
Gross Income/Profit	\$557,034	\$557,034
Cost of Salaries & Wages	\$417,204	\$417,204
Cost of Repairs & Maintenance	\$4,522	\$4,522
Cost of Rent	\$102,343	\$102,343
Cost of Advertising	\$32,253	\$32,253
Cost of Supplies	\$3,441	\$3,441
Other Operating Expense Costs	\$308,100	\$308,100
Total Operating Expenses	\$867,863	\$867,863
Deductible Expenses	\$0	\$867,863
Income Before Taxes	\$557,034	(\$310,829)
Tax Due	\$189,781	\$0
Effective Tax Rate	(Over 100% - income tax imposed on loss)	0%

There is strong anecdotal evidence of Section 280E causing such hugely disproportionate tax bills for these businesses authorized by state law but treated as criminal by the IRS. “You have a lot of organizations that end up failing and closing after two or three years because of the tax burden imposed by 280E,” Denver accountant Jordan Cornelius told the *Washington Post* in 2014.¹⁴ *Fortune* magazine reported marijuana businesses paying effective tax rates from 40 to 70 percent, “compared to the typical corporate tax rate of around 35%.”¹⁵ The *New York Times* found Seattle dispensary owner John Davis paid \$46,340 in taxes on profits of \$53,369—a tax rate of 86 percent—and a Colorado dispensary that struggled to pay its \$866,000 tax bill on gross receipts of \$1.7 million.¹⁶ Oregon medical dispensary owner Jeremy Plumb told reporters that the IRS gets most of his revenue, and *Williamette Week* cited industry analysts saying that many marijuana businesses are temporarily using venture capital until the federal tax law is changed.¹⁷

Options for Modernizing Section 280E

Congress has options for addressing the problems caused by the current version of section 280E.

- *Deschedule or Legalize Marijuana.* Congress could change the federal treatment of marijuana to remove it from the Controlled Substances Schedule, which would effectively decriminalize it, or to take further affirmative steps to legalize marijuana by enacting a regulatory and tax regime similar to that undertaken by Colorado, Washington, Alaska, Oregon, and the District of Columbia. The removal of marijuana from the scope of the Controlled Substances Act would automatically remove marijuana businesses from the scope of Section 280E.
- *Reschedule Marijuana.* Marijuana is currently on Schedule I under the Controlled Substances Act, meaning it has a high potential for abuse and no medically accepted use. In 1972, the National Organization for the Reform of Marijuana Laws (NORML) petitioned the Drug Enforcement Agency (DEA) to reschedule marijuana to Schedule V, citing the Shafer Commission report and other government reports finding marijuana has a relatively low social cost. The DEA denied the petition in 1988. In 2002, the group Americans for Safe Access petitioned the DEA to reschedule marijuana, citing supportive evidence from the American Medical Association and other medical sources. The DEA denied the petition in 2011. Advocates are consequently reluctant to try a third rescheduling petition. However, if marijuana were rescheduled, the section 280E problem may be eliminated as it applies only to substances on Schedules I and II of the Controlled Substances Act.

14 Terence McCoy, *How the IRS and Congress cripple the marijuana industry with an obscure, decades-old law*, WASHINGTON POST, Nov. 5, 2014, [HTTPS://WWW.WASHINGTONPOST.COM/NEWS/MORNING-MIX/WP/2014/11/05/HOW-THE-IRS-AND-CONGRESS-CRIPPLE-THE-MARIJUANA-INDUSTRY-WITH-AN-OBSURE-DECADES-OLD-LAW/](https://www.washingtonpost.com/news/morning-mix/wp/2014/11/05/how-the-irs-and-congress-cripple-the-marijuana-industry-with-an-obscure-decades-old-law/).

15 Tom Huddleston, Jr., *The marijuana industry's battle against the IRS*, FORTUNE, APR. 15, 2015, [HTTP://FORTUNE.COM/2015/04/15/MARIJUANA-INDUSTRY-TAX-PROBLEM/](http://fortune.com/2015/04/15/marijuana-industry-tax-problem/).

16 See Jack Healy, *Legal Marijuana Faces Another Federal Hurdle: Taxes*, NEW YORK TIMES, MAY 9, 2015, [HTTP://WWW.NYTIMES.COM/2015/05/10/US/POLITICS/LEGAL-MARIJUANA-FACES-ANOTHER-FEDERAL-HURDLE-TAXES.HTML](http://www.nytimes.com/2015/05/10/us/politics/legal-marijuana-faces-another-federal-hurdle-taxes.html).

17 See Aaron Mesh, “Marijuana Businesses Are Raking In Money—and the IRS Will Take Most of It,” *Williamette Week*, Oct. 7, 2015, <http://www.wweek.com/2015/10/07/marijuana-businesses-are-raking-in-money-and-the-irs-will-take-most-of-it/>.

- *Repeal Section 280E.* Repealing the entire provision would naturally eliminate its unforeseen effects, although it would restore business tax deductions for those engaged in the illegal sale of drugs other than marijuana.
- *Expand Section 280E with Specific Exceptions.* Section 280E's use of the term "trafficking" has been given broad meaning by the IRS and the courts, and one option would be to include specific exemptions, such as for intrastate activity, non-selling activity, or activity in states that have legalized marijuana sales. While it would address the issue, it may not anticipate all future potential situations.
- *Change One Word in Section 280E.* Section 280E applies to sellers trafficking in controlled substances "which is prohibited by federal law or the law of any state" (emphasis added). By changing the "or" to an "and," section 280E would only apply to those situations where the trafficking activity violates both federal and state law. Section 280E would thus no longer apply to the sale of retail marijuana in states that have legalized it, while not affecting the status quo in other states.

Modernizing 280E Would Restore Tax Neutrality and Level the Playing Field

Tax neutrality is the concept that the tax code should not be used to pick winners and losers, and instead should, to the best it can, simply raise revenue to pay for needed spending. Non-neutral tax policy, using the tax code to punish certain activities by denying generally available tax treatment, can advance other policy goals, such as halting activities that are abhorrent to public policy. Unless narrowly focused, though, such punitive provisions like section 280E can lead to problematic results if not kept up to date with changing circumstances.

Section 280E was enacted to depart from neutral tax policy, by denying drug dealers the same tax benefits enjoyed by all others engaged in business activity. The authors of section 280E, however, wrote the provision so broadly that it encompasses activity permitted under state law and supported by a majority of the population, and now even where Congress has prohibited the executive branch from halting it. No one denies that section 280E was not written with state-legal marijuana in mind. To those who oppose legal marijuana, that fight should be carried out in the criminal code, in the state legislatures, and at the ballot box. It should not be carried out by retaining an antiquated tax provision that the IRS struggles to apply, that hurts honest taxpayers trying to comply with the law, that benefits black market drug dealers by imposing considerable burdens on their legal competitors, and that prevents the full development of legal marijuana businesses authorized by state law.



Conclusion

In explaining that they had no choice but to uphold the application of section 280E to medical marijuana dispensaries, three federal judges wrote in 2015 that “[i]f Congress now thinks that the policy embodied in § 280E is unwise as applied to medical marijuana sold in conformance with state law, it can change the statute.”¹⁸ Taxpayers are being assessed tax on income that they never see. That should change.

¹⁸ *Olive v. Commissioner*, 792 F.3d 1146 (9th Cir. 2015).
