As several states have permitted the use of marijuana for medical and recreational uses, one question that arises is what are the federal income tax consequences for businesses that sell marijuana?

There is no question that income from selling marijuana is taxable to the seller, regardless of whether such sale is legal or not under federal or state law. The Internal Revenue Code (IRC) uses a very broad definition of income, and income is taxable whether it comes from legal or illegal activities. Further, it can be taxed even if the proceeds are forfeited to the government.

While such income is taxable, the seller will be limited in its ability to deduct business expenses. Generally, a taxpayer can deduct all “ordinary and necessary” business expenses. However, IRC § 280E provides:

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 U.S. Tax Court has twice looked at this provision in the context of California medical marijuana dispensaries—CHAMP v. Commissioner in 2007 and Olive v. Commissioner in 2012. Both times, the court held that since marijuana is on Schedule I and the sale of it violates federal law, business expenses in connection with such sales are not deductible. In other words, the trigger is that the activities be prohibited by federal or state law—so long as the sale violates either one, the deduction for business expenses is denied.

There are three key points from these decisions. First, the court interpreted “trafficking” by looking to its dictionary definition, which is “to engage in commercial activity: buy and sell regularly.” Thus, the term is not limited to illegal drug smuggling activities, but also includes sales conducted by a “legitimate operation” authorized by state law, as well as supplying medical marijuana to a clinic’s members who pay for it and other services through a membership fee.

Second, § 280E does not apply to the cost of goods sold (COGS). Thus, marijuana sellers may subtract COGS (i.e., the cost of the marijuana) when determining their gross income. The statute only disallows the deduction of other types of expenses, such as labor, rent, and utilities.

Third, § 280E only applies to the drug part of a business. Thus, a clinic that provided a variety of services to terminally ill patients and supplied marijuana to some patients as part of that care could deduct the expenses related to the other care and services provided. However, when the provision of support and other services was merely incidental to the dispensing of marijuana, then the business was not able to deduct any expenses. The test for determining whether the marijuana part of a business can be separated from the other parts is whether they “share a close and inseparable organizational and economic relationship.”

While the holdings in these decisions seem clear, the Tax Court is currently hearing a case filed by another California medical marijuana dispensary challenging the applicability of § 280E, Canna Care Inc. v. Commissioner. In August 2014, the court issued an order setting the case for trial in March 2015. This case showcases the amounts of money that can be involved, as the IRS disallowed $2.6 million in deductions over a 3-year period, which resulted in the business owing $875,000 in additional taxes. Media reports indicate that the taxpayers argue that applying § 280E to state-authorized businesses is unfair and violates
the U.S. Constitution’s equal protection guarantees. If true, the taxpayers will have a very high hurdle to overcome in order to succeed. In general, classifications made for federal tax purposes are constitutionally permissible so long as “they bear a rational relation to a legitimate governmental purpose.” This is a low standard of review by the courts, and they typically show great deference to tax classifications made by legislatures. As the Supreme Court has noted, “[i]t has … been pointed out that in taxation, even more than in other fields, legislatures possess the greatest freedom in classification.” As such, equal protection challenges to tax legislation almost never succeed.

Meanwhile, legislation has been introduced in the 113th Congress that would amend § 280E to allow taxpayers like those in CHAMP, Olive, and Canna Care to deduct their expenses. Specifically, H.R. 2240 (Small Business Tax Equity Act of 2013) would amend § 280F so that the prohibition on deducting business expenses would not apply to businesses that sold marijuana so long as the sales were conducted in compliance with state law.

Finally, marijuana sellers must also comply with other federal tax laws, including the withholding and payment of payroll taxes. One issue that has garnered attention relates to the fact that some marijuana sellers operate in cash due to impediments with opening bank accounts. This causes problems under the federal tax code because it requires that employers pay payroll taxes electronically and subjects them to a monetary penalty if failing to do so. Thus, marijuana sellers who pay payroll taxes in cash are penalized up to 10% of the taxes paid. It was reported in July 2014 that a business in Colorado had filed suit in the Tax Court challenging the imposition of the penalty when it was unable to comply with the law because it could not open a bank account. The court has not yet released a decision.