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Marijuana Business: Are Depreciation and Charitable Contributions Deductible?

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A recent court case, San Jose Wellness (2021) 156 T.C. No. 4, has emerged in the marijuana industry highlighting the proper allocation of costs and the deductibility or disallowance based upon the specific facts. To address the question posed in the title of this article, we will bring you the arguments and findings made in this recent case as well as in other cases.

Current Tax Framework

A brief discussion of the tax law provisions pertaining to the income taxation of the cannabis industry is important to understand the current court case.

Internal Revenue Code (IRC) Sec. 280E states that no deduction is allowed for any amount paid or incurred during the tax year in carrying on any trade or business that consists of trafficking in controlled substances, if that trafficking is prohibited by federal law within the meaning of Schedule I and II of the Controlled Substances Act (CSA) or by the law of the state in which the trade or business is conducted.

Trafficking, as defined under the CSA, includes the growing, distributing and selling of marijuana or cannabis. Courts have held that the sale of marijuana constitutes trafficking regardless of legality at the state level.

Entities operating in the cannabis industry are denied a deduction for "ordinary and necessary" business expenses allowable under IRC Sec. 162 to most businesses (illegal and legal). State and local tax deductions allowable under IRC Sec. 164 are also denied to entities operating with the cannabis industry.

A taxpayer engaged in the business of trafficking controlled substances, however, is allowed to determine cost of goods sold (COGS) using the inventory-costs regulations under IRC Sec. 471(c). This Code section cannot be used to treat a disallowed deduction (e.g., salary, depreciation, or rent expense) as a cost of inventory to circumvent IRC Sec. 280E.

If a marijuana company does decide to use Sec. 471(c), then the entity should be careful what costs it decides to recast under their COGS, focusing on the real costs related to producing the product. The IRS has consistently held that retail rent, retail labor and advertising are not deductible under IRC Sec. 280.

San Jose Wellness Case

San Jose Wellness, a corporation, operated a medical marijuana dispensary pursuant to California law. It had distinct business activities consisting of (1) sale of cannabis to individuals who held a valid doctor's recommendation to use cannabis; (2) sale of non-cannabis items including T-shirts, pipes, and batteries; and (3) "holistic" services including acupuncture and chiropractic.

San Jose Wellness held their business activities consisted of not just the sale of cannabis items and, therefore, their trade or business does not consist exclusively the trafficking in controlled substances. Consequently, IRC Sec. 280E would not apply in their case.

The Court disagreed with the taxpayer's interpretation of what activities their business consisted of for purposes of IRC Sec. 280E.

The Court cited Patients Mutual Assistance Collective Corp d/b/a Harborside Health Center (Harborside) (2018) 151 T.C. 176 and stated it saw no reason to depart from this case.

Harborside, a California medical cannabis dispensary, had deducted IRC Sec. 162 expenses. The Tax Court ruled against Harborside stating that it did not have separate trades or business. It was engaged in only one business, which was the trafficking in a controlled substance.

The second issue of this current court case deals with deductibility of depreciation expense. San Jose Wellness took the position that depreciation is outside the scope of IRC Sec. 280E because the depreciation is not "paid or incurred during the tax year."

The Court disagreed and cited Commissioner vs Idaho Power (S Ct 1974) 35 AFTR 2d 74-5244. It stated that depreciation is a certain presently-incurred cost and thus was an amount paid or incurred during the tax year. The Court's position was that depreciation – inasmuch as it represents utilizing capital – is as much an expenditure as the utilization of labor or other items of direct cost.

San Jose Wellness also took the position that its charitable contributions were not paid in "carrying on" a trade or business as required by IRC Sec. 280E.

It is well-established that corporations are permitted to make substantial contributions which have the outward form of gifts where the activity being promoted by the so-called gifts tends to reasonably promote the goodwill of the business of the contributing corporation.

In the Court's view, San Jose Wellness contributed the amounts at issue "in carrying on" its trade or business. San Jose Wellness' argument that charitable contributions, by definition, are not business expenditures was dismissed by the Court and disallowed.

This case highlights the reality that there is no one universal approach that fits all situations. Each entity may operate with unique operations (e.g., producer, processor, wholesaler or a retail establishment) within the industry and should be examined on a case-by-case basis.

Current Developments

The Biden administration's Acting Solicitor General is urging the U.S. Supreme Court to uphold a ruling approving the IRS' bid for information about a Colorado cannabis business, Standing Akimbo, saying the federal law is clear that pot is illegal.

The Acting Solicitor General's position is that Colorado, under the Supremacy Clause, may not authorize any individual or business to violate federal law. Marijuana remains illegal under the federal Controlled Substances Act regardless of what Colorado law allows. Therefore, the IRS was properly investigating whether Standing Akimbo violated IRC Sec. 280E.

We will keep you updated on these current developments.

Contact Us

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