

# SECTION 280E

TRIPPING THROUGH FEDERAL TAX LAW



# THE ORIGINS OF 280E

- 1981: Edmondson v. C.I.R.
  - Tax Court permitted business deductions for Edmondson's "ordinary business expenses" under the Internal Revenue Code
  - Allowed \$105,300 in deductions
  - "We are persuaded that the petitioner made substantial use of his apartment in his drug business."
- 1982: Court enacts the Tax Equity and Responsibility Act (TEFRA)





# OVERVIEW OF THE CONTROLLED SUBSTANCES ACT (CSA)

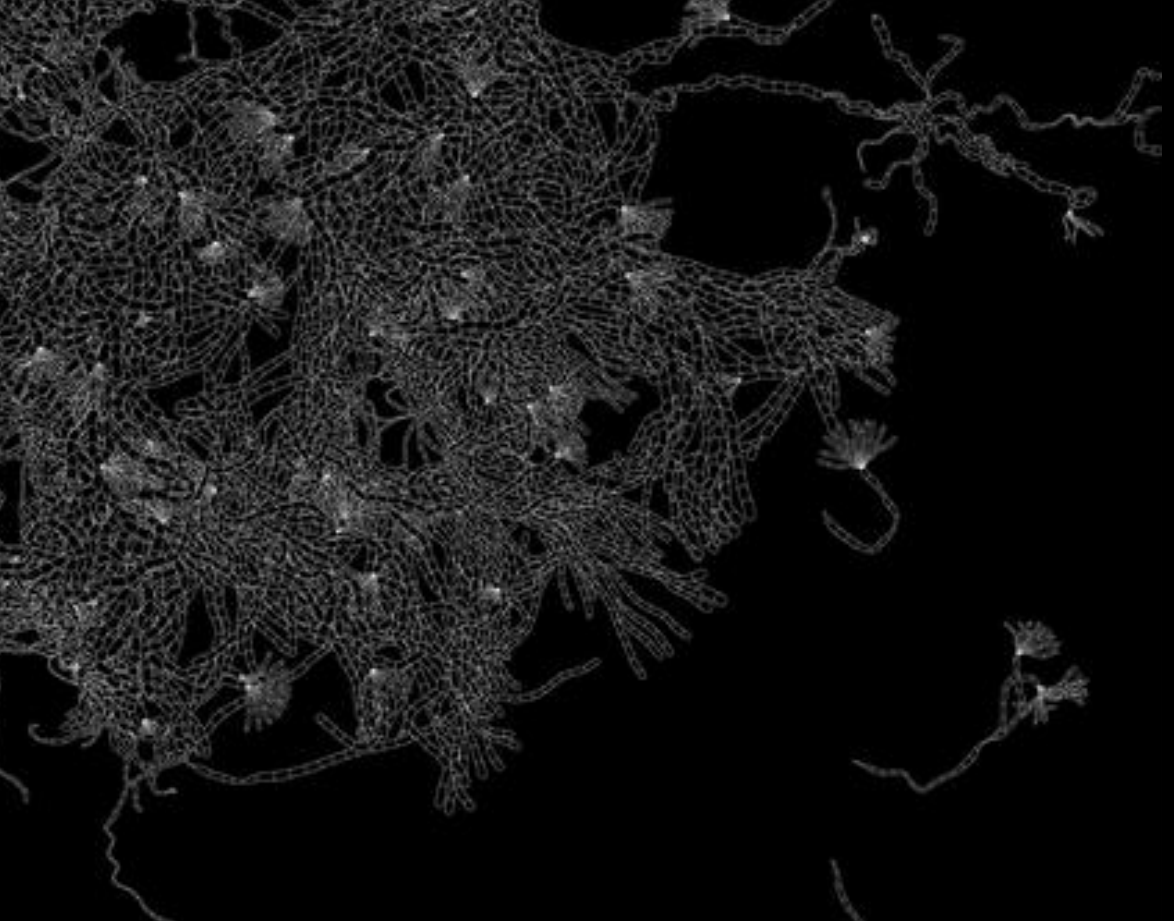
- Enacted in 1971 under the Nixon administration
- Divides substances into 5 “Schedules”
- Factors that influence Schedule
  - (1) the potential for abuse,
  - (2) accepted medical use, and
  - (3) safety and potential for addiction
- Scheduling is not based on scientific consensus



# OVERVIEW OF CSA SCHEDULES

- Schedule I:
  - Marijuana, Psilocybin, LSD, Heroin
- Schedule II:
  - Cocaine, Amphetamine drugs (Adderall), Fentanyl, Morphine, Opium, Oxycodone
- Schedule III:
  - Ketamine, Anabolic Steroids, Marinol (a THC derived drug),
- Schedule IV:
  - Benzodiazepines, Ambien
- Schedule V:
  - Cough suppressants, CBD Oil,





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.

26 U.S.C.A. § 280E, I.R.C. §280E§

280E. Expenditures in connection with the illegal sale of drugs



# THREE KEY ELEMENTS TRIGGER 280E

- (1) A Business
- (2) Trafficking
- (3) A Schedule I or II substance under the CSA





# WHAT ARE ORDINARY BUSINESS EXPENSES?

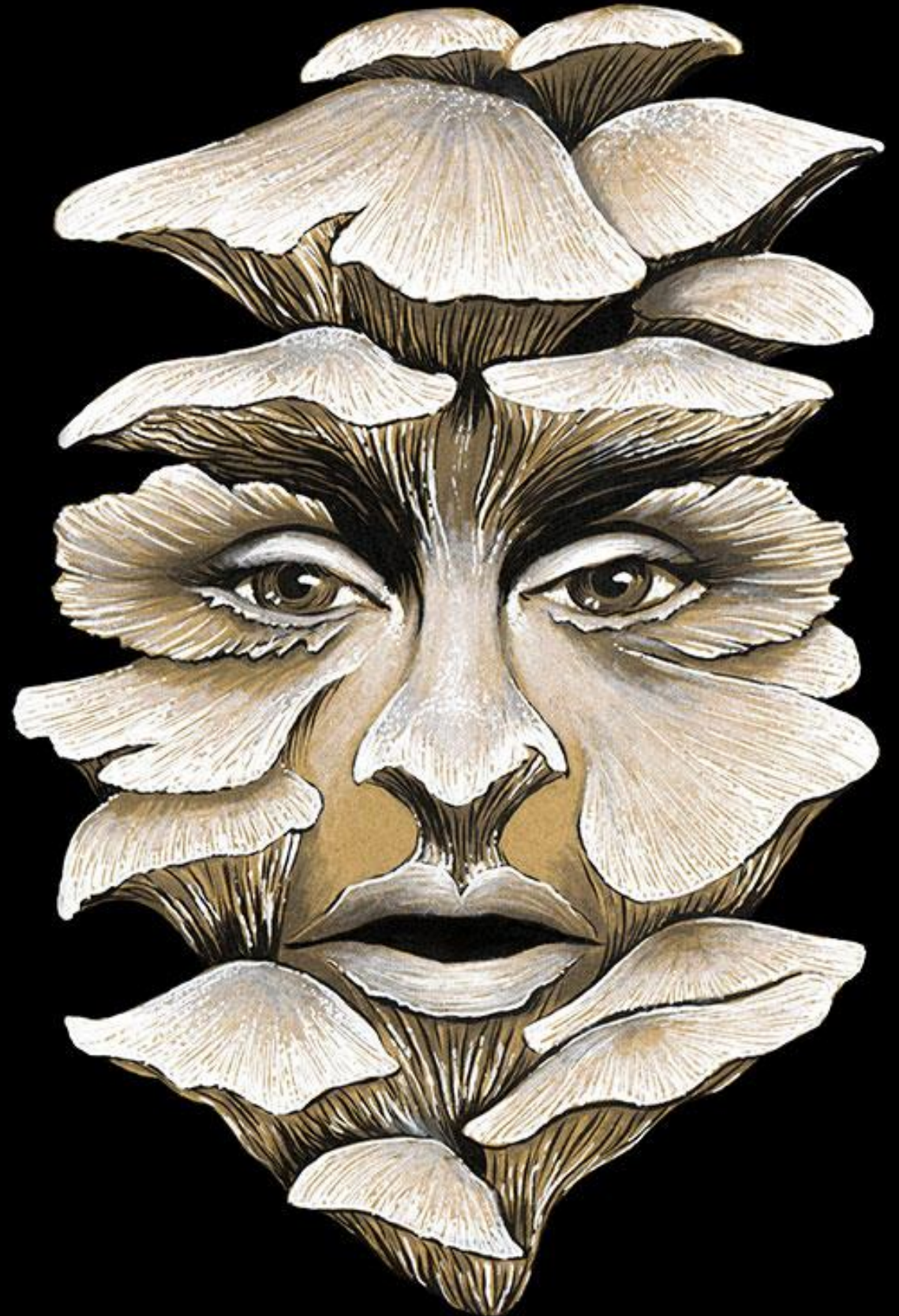
- Employee salaries;
- Utility costs such as electricity, internet and telephone services,
- Health insurance premiums,
- Marketing and advertising costs,
- Repairs and maintenance,
- Rental less for facilities,
- Routine repair and maintenance, payments to contractors,
- General and administrative costs (bookkeeping, legal expenses, technology costs)





# PRACTICAL IMPLICATIONS FOR PSILOCYBIN BUSINESSES

- Similar to cannabis, legal psilocybin businesses will pay around 3x more to operate their businesses than other businesses
- Businesses may deduct Cost of Goods Sold (COGS), but all other deductions are disallowed





# RELEVANT CASE LAW: CHAMP

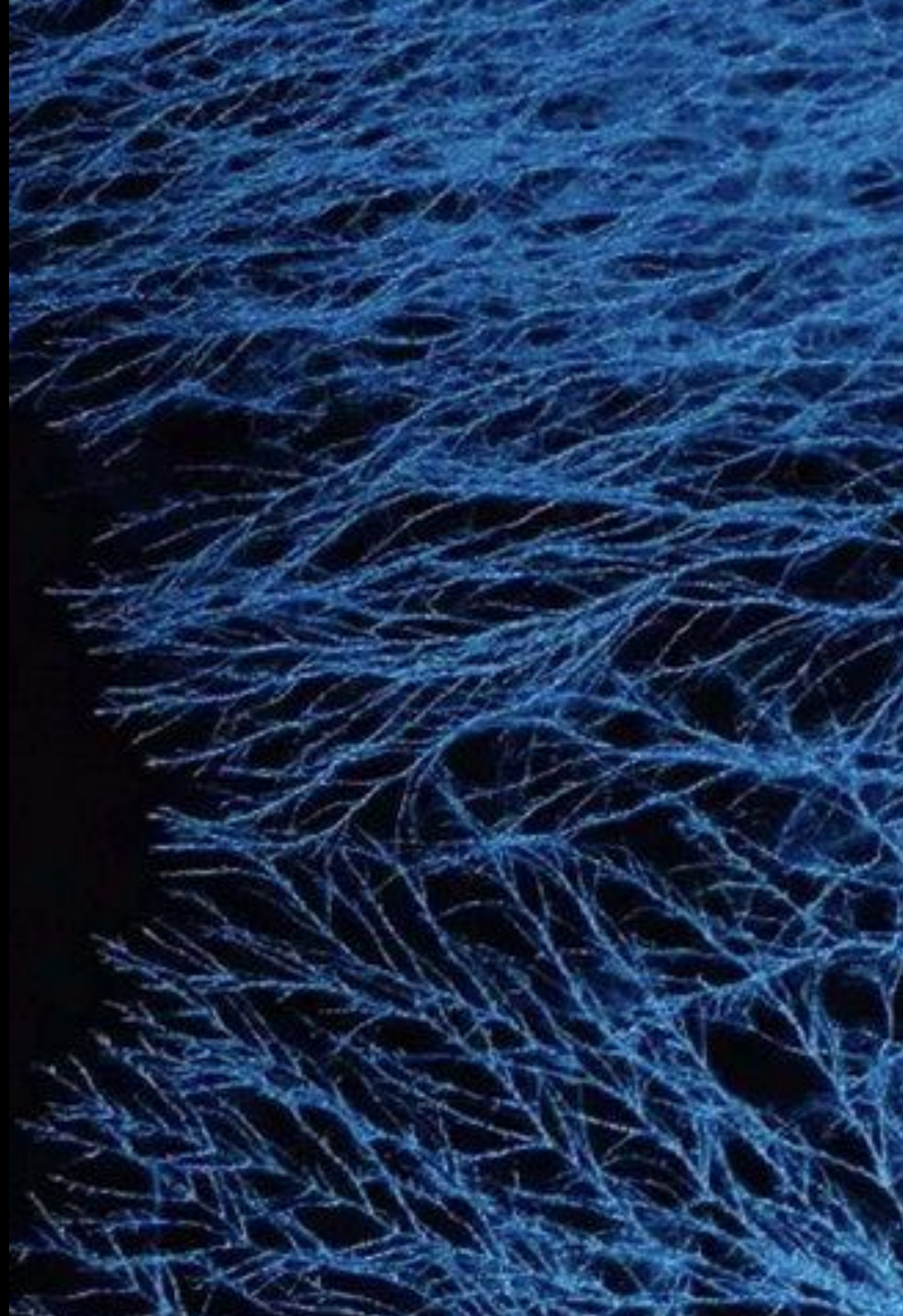
- Californians Helping to Alleviate Medical Problems, Inc., v. C.I.R. (CHAMP)
  - In 2007, the 9th Circuit held that the separate business activities constituted separate businesses
- Court noted that over 70% of employees were engaged in therapeutic services rather than cannabis





# RELEVANT CASE LAW:HARBORSIDE

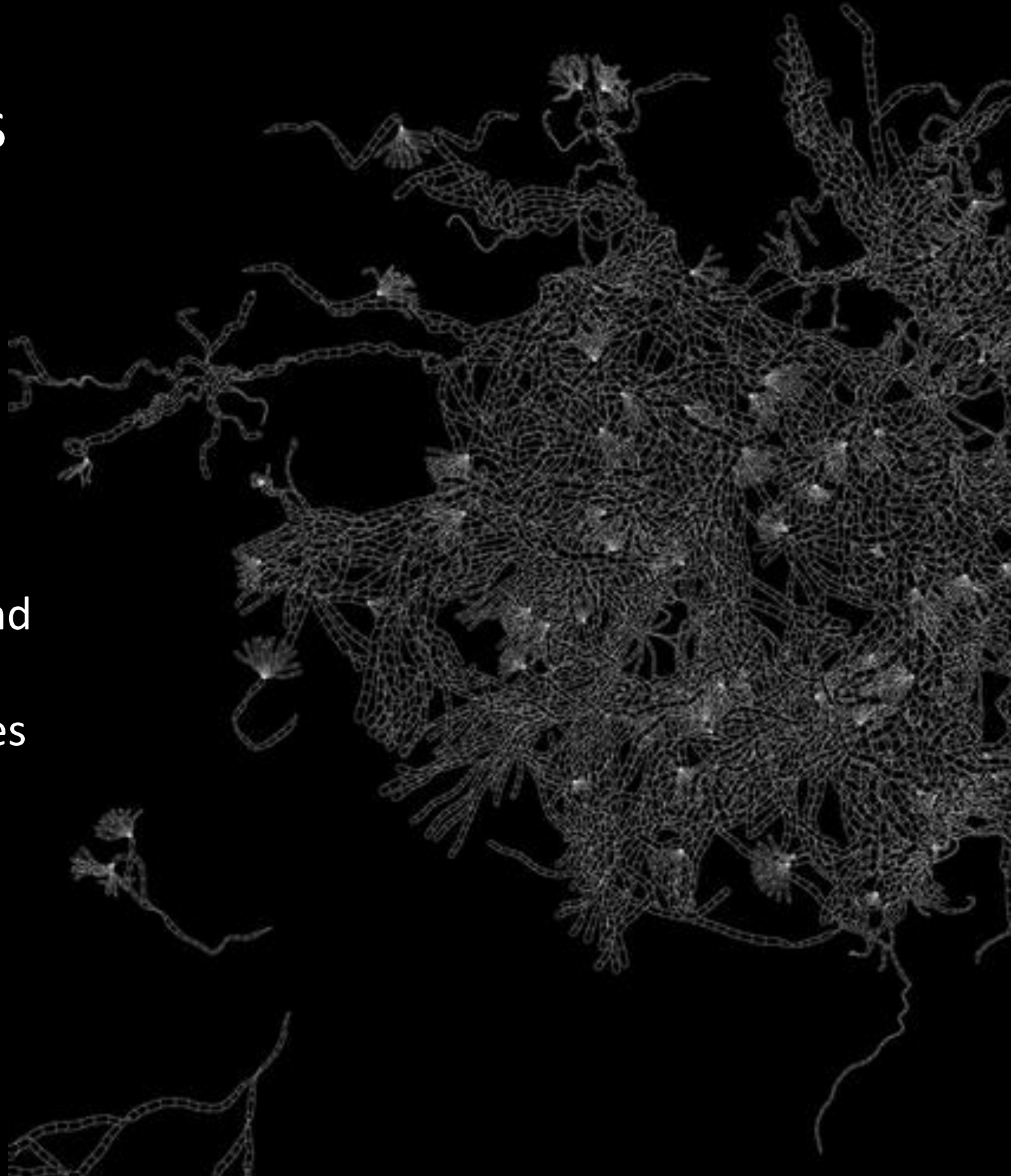
- Harborside is one of the largest and oldest cannabis companies in the U.S.
- All deductions disallowed; required to pay \$29 million in back taxes
- 9th Circuit held that any activity ancillary to cannabis sales falls under 280E
- Did not overrule CHAMP, but rather added a layer of complexity for businesses





# KEY FACTORS IN COURT ANALYSIS'S

- Percentage of revenue attributable to controlled substance
- Degree of organizational and economic separation between business structures
- Business purposes
- Similarity of undertakings



# WHAT DOES THIS MEAN FOR PSILOCYBIN BUSINESSES IN WASHINGTON?

- Legal psilocybin businesses will likely be subject to 280E's restrictions unless they can prove:
  - A strong degree of separation between business functions;
  - Financial separation;
  - Self-sufficiency of each respective business;
  - That records are distinct and separate;
  - That the right for each business to exist separately is granted by federal law.
- Section 446(d)





# REFERENCES

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- Patients Mut. Assistance Collective Corp. v. Comm'r, 151 T.C. 176, 179 (2018).
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- I.R.C. § 162(a) (2018) .
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- S. REP. NO. 97-494, at 309 (1982).
- Controlled Substances Act, 21 U.S.C. §§ 801-828 (2012).
- Carrie E. Keller, Comment, The Implications of I.R.C. 280E in Denying Ordinary and Necessary Business Expense Deductions to Drug Traffickers, 47 ST. LOUIS U. L.J. 157, 158-59 (2003) (citing Comm'r v. Tellier, 383 U.S. 687, 691 (1966)).
- Charles A. Borek, The Public Policy Doctrine and Tax Logic: The Need for Consistency in Denying Deductions Arising from Illegal Activities, 22 U. BALT. L. REV. 54 (1992).
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