DUDE, WHERE'S MY DEDUCTION?

Zackary Pullin*

Congress enacted § 280E as part of the Tax Equity and Fiscal Responsibility Act of 1982. Section 280E prohibits the deduction of any expenses paid or incurred in carrying on any trade or business if such trade or business consists of trafficking in controlled substances within the meaning of schedule I or II of the Controlled Substances Act of 1970 (CSA) and that trade or business is prohibited by federal law or by the law of a state in which the trade or business is conducted.

Although § 162(c)(2) was in existence prior to 1982, this provision only disallows deductions for illegal business expenses. In other words, a deduction for a business expense is disallowed under § 162(c)(2) if the making of the payment itself is illegal, regardless of whether the underlying business that gave rise to such payment is illegal. Thus, legal expenses of an illegal business continue to be deductible. In Edmondson v. Comm’r, the Tax Court held that ordinary and necessary business expenses, the payment of which were legal, incurred by a taxpayer in the business of selling amphetamines, cocaine, and marijuana were deductible under § 162 of the Code.

In an apparent reaction to Edmondson, Congress enacted § 280E. The legislative history of § 280E makes clear that Congress intended the provision to further the public policy of prohibiting illegal drug dealing:

There is a sharply defined public policy against drug dealing. To allow drug dealers the benefit of business expense deductions at the same time that the U.S. and its citizens are losing billions of dollars per year to such persons is not compelled by the fact that such deductions are allowed to other legal enterprises. Such deductions should be disallowed on public policy grounds.

Marijuana is included in Schedule I of the CSA and federal law prohibits the manufacture and distribution of marijuana. Therefore, by reason of § 280E, persons engaged in the business of growing and/or distributing marijuana cannot deduct ordinary and necessary business expenses. According to legislative history, the denial of such deductions is intended to promote a public policy of deterring the manufacture and distribution of marijuana.

In 1996, California became the first state to legalize the use, possession, and cultivation of marijuana for patients who possess a written or oral recommendation from their physician. Today, twenty-eight states and the District of Columbia have legalized the use of marijuana and permit the conduct of a business cultivating and marketing marijuana.

* Counsel, Sidley Austin LLP.
1 Accardo v. Comm’r, 942 F.2d 444 (7th Cir. 1991).
Further, the District of Columbia and eight of those states allow the use of recreational marijuana without the need for a physician’s recommendation.

Popular support for the legalization of marijuana has steadily grown since § 280E was originally enacted in 1982. According to a Gallup poll conducted in 1969, 12% of Americans thought marijuana use should be legal. From the late 1970s through the mid-1990s, approximately 25% of Americans thought marijuana use should be legal. The percentage of respondents who favored making use of the drug legal exceeded 30% by 2000 and 40% by 2009. While support for marijuana legalization has vacillated a bit over the past six years, it has averaged 48% from 2010 through 2012 and has averaged above 56% ever since. Today, 58% of respondents say marijuana use should be legal in the United States. 4

Although the use, possession and cultivation of marijuana continues to be illegal under federal law, U.S. Department of Justice (DOJ) Deputy Attorney General James M. Cole issued a memorandum (the “Cole Memo”) on August 29, 2013 providing guidance to federal prosecutors regarding enforcement of federal marijuana law in states where marijuana has been decriminalized. 5 The Cole Memo guidance applies to all of the DOJ’s federal enforcement activity, including civil enforcement and criminal investigations and prosecution, concerning marijuana in all states. The Cole Memo lists eight areas that are a priority focus for the federal government’s enforcement of marijuana policy, including preventing the distribution of marijuana to minors and preventing the use of marijuana while operating a vehicle. In states where marijuana is decriminalized and where laws are passed to protect the federal government’s areas of priority focus, the Cole Memo provides that the DOJ should allow state law enforcement and regulatory bodies to be the primary means of addressing marijuana-related activities. 6 Therefore, pursuant to the Cole Memo, a state that has legalized marijuana and has adequate regulations addressing marijuana growth, distribution, and use should expect that the federal government will not interfere with marijuana-related businesses operating within its borders.

On February 14, 2014, the Department of the Treasury’s Financial Crimes Enforcement Network (FinCEN) issued guidance clarifying expectations for financial institutions seeking to provide services to marijuana-related businesses. 7 The FinCEN guidance clarifies how financial institutions can provide services to marijuana-related businesses consistent with their obligations under federal law. The FinCEN guidance repeats the priority focus areas of the Cole Memo and requires banks to conduct additional diligence on any marijuana-related customers to assess whether one of the priority focus areas of the Cole Memo is implicated. Although the FinCEN guidance does not give banks immunity for servicing customers in the marijuana industry, the memo is intended to give banks confidence that they will not be punished if they provide services to legitimate

6 Id.  
marijuana businesses in states where such businesses are legal, despite the fact that such businesses remain illicit under federal law. In 1982, Congress enacted § 280E on public policy grounds to deter those engaged in the manufacture and distribution of illegal drugs. At the time of its enactment, marijuana was illegal in every state and the majority of the public disapproved of marijuana legalization. However, public policy with respect to the manufacture and distribution of marijuana has evolved. Today, twenty-eight states and the District of Columbia have legalized the use of marijuana and permit businesses to cultivate and market marijuana. Further, a majority of the public now consistently favors the legalization of marijuana. Through memorandums and other guidance, the federal government has openly recognized this shift in public perception and acquiesced to the manufacture and distribution of marijuana where such business activity is legal under state law.

The public policy purpose behind § 280E of deterring the manufacture and distribution of illegal drugs no longer seems valid or sustainable with respect to the manufacture and distribution of marijuana in states where such business activity is legal. Therefore, in consideration of the evolution in public policy concerning marijuana use and cultivation, § 280E should be amended to provide an exception to the general disallowance of deductions for persons engaged in the business of manufacturing or distributing marijuana in a manner that is consistent with applicable state law.


9 While an exception should be made under § 280E as described above, the author believes the more practical solution is to remove marijuana from Schedule I and II of the CSA through the CSA’s rulemaking process.