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RESEARCH MEMORANDUM

To:

From: Nora.Legal

Date:

Re: Marijuana federal tax deductions and banking funds

QUESTIONS PRESENTED

1. **What are the restrictions regarding federal tax deductions for a marijuana dispensary legal under state law?**

2. **Are there any restrictions on banking funds for a marijuana dispensary?**

SHORT ANSWERS

1. The federal courts have interpreted Section 280E to preclude deducting any ordinary and necessary expenses incurred in trafficking medical marijuana. However, the tax payer may deduct other business expenses that are not related to trafficking if these are separate and continuous businesses and the expenses for each are well documented.

2. Generally, both federal criminal law and banking regulations restrict financial institutions from providing banking services to marijuana dispensaries. Despite assurances from DOJ and FinCEN, a number of other federal regulators can substantially affect financial institutions that provide banking services to marijuana-related businesses, making such practices risky, difficult, and effectively impractical.

RESEARCH FINDINGS

I. What are the restrictions that are there regarding federal tax deductions for a marijuana dispensary legal under state law?

The Internal Revenue Code ("the Code") "allows a business to deduct from its gross income 'all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on [the] trade or business." Olive v. C.I.R., 792 F.3d 1146, 1148 (9th Cir. 2015) (quoting 26 U.S.C. § 61(a)). However, the Code recognizes exceptions to § 162(a). "One such exception applies when the 'amount paid or incurred during the taxable year' is for the purpose of 'carrying on any trade or business . . . consist[ing] of trafficking in controlled substances." Id. at 1148 (quoting 26 U.S.C. § 280E).[1] "In the context of section 280E, marijuana is a schedule I controlled substance." Californians Helping to Alleviate Med. Problems, Inc. v. C.I.R., 128 T.C. 173, 181 (2007). Thus, even when the use and sale of medical marijuana is legal under State law, federal law prohibits its use and sale. Beck v. C.I.R., 110 T.C.M. (CCH) 141, *5 (T.C. 2015); *See also* Olive at 1149. Accordingly, medical marijuana dispensaries, though legal under state law, "traffic" in a controlled substance within the meaning of § 280E. Beck at *5; Californians Helping at 182.

A. Business Expenses Not Deductible Under 26 U.S.C. § 280E.

The Courts have consistently held that, under § 280E, when a tax payer incurs expenses operating a "Vapor Room" or "Alternative Herbal Health Services dispensaries," these cannot be deducted for federal tax purposes. Olive at1149; Beck at *5. However, when the tax payer is

[1] "Section 280E even disallows a deduction for expenses that are not illegal per se" like salaries, rent, telephone. https://www.irs.gov/pub/irs-wd/201504011.pdf

engaged in two trades or businesses, where one is caregiving services and the other is the supply of medical marijuana, the United States Tax Court has held that deductions are not precluded by § 280E for the trades or businesses did not involve "trafficking" in a controlled substance. Californians Helping at 180-182 (2007). "[W]hether an activity is a trade or business separate from another trade or business is a question of fact that depends on (among other things) the degree of economic interrelationship between the two undertakings." Id. at 183. Moreover, a taxpayer's characterization of two or more undertakings as separate activities is accepted by the Commissioner "unless the characterization is artificial or unreasonable." Id. "A taxpayer, to be engaged in a trade or business for purposes of section 162, must be involved in the activity with continuity and regularity and the taxpayer's primary purpose for engaging in the activity must be for income or profit. Olive at 41. Additionally, "[d]eductions are a matter of legislative grace, and taxpayers must maintain sufficient records to substantiate the amounts of their income and entitlement to any deductions or credits claimed." Beck at *5 (citing Rule 142(a)(1)).

In Californians Helping to Alleviate Med. Problems, Inc. v. C.I.R., 128 T.C. 173 (2007), the petitioner claimed that § 280E does not preclude the petitioner from deducting the ordinary and necessary expenses attributable to its provision of counseling and other caregiving services because it provided caregiving services separate from the supply of medical marijuana to its members Id. at 174. The United States Tax Court agreed. Id. at 183. The court reasoned that:

> Section 280E and its legislative history express a congressional intent to disallow deductions attributable to a trade or business of trafficking in controlled substances. They do not express an intent to deny the deduction of all of a taxpayer's business expenses simply because the taxpayer was involved in trafficking in a controlled substance. We hold that section 280E does not preclude petitioner from deducting expenses attributable to a trade or business other than that of illegal trafficking in controlled substances simply because petitioner also is involved in the trafficking in a controlled substance.

Id. at 182.

The caregiving services were separate from the supply of medical marijuana because the "[p]etitioner was regularly and extensively involved in the provision of caregiving services, and those services are substantially different from petitioner's provision of medical marijuana." Id. at 183.

It is relevant to note that the courts have been reluctant to apply the above proposition when the petitioner has not provided "evidence that he had any business activity unrelated to the sale or distribution of marijuana" and when the "petitioner has not established which, if any, expenses were for any alleged services offered and which expenses related to the sale of marijuana." Beck v. C.I.R., 110 T.C.M. (CCH) 141, *5 (T.C. 2015). In Olive v. C.I.R., 139 T.C. 19 (2012)., the court rejected the petitioner's claim that § 280E did not preclude him from deducting expenses incurred in operating "Vapor Rooms." Id. at 42. The court reasoned that "[t]he Vapor Room would not have had any revenues at all (and could not have operated) if none of the patrons had purchased marijuana from petitioner." Id. Moreover, the court concluded that "[t]he Vapor Room did not spawn a second business simply by occasionally providing the patrons with snacks, a massage, or a movie, or allowing the patrons to play games in the room and to talk there to each other." Id.

Similarly, courts have rejected claims of a separate business when the petitioner claimed that it also derived separate income from the sale of books, T-shirts, and other items. Canna Care, Inc. v. C.I.R., 110 T.C.M. (CCH) 408, *4 (T.C. 2015). The Canna Care court reasoned that no evidence was presented to determine "what percentage of petitioner's income was from the sale of medical marijuana and what percentage was from the sale of other items." Id. The court

relied on the parties' stipulation in concluding that the petitioner was engaged in one business -- selling medical marijuana. Id.

B. Deductions Available as Costs of Goods Sold ("COGS").

Based on the foregoing, it appears that when the tax payer is engaged in the business of "trafficking" marijuana alone, where its other business operations are not separate, sustained, and continuous, or where it fails to keep sufficient records of controlled substance sales compare to other business it may be precluded from claiming tax deductions under section 280E. However, when the tax payer has other legal business, apart from the marijuana-related business, it may claim may claim federal deductions if it can show that the separate business is an independent and continuing business.

II. Are there any restrictions on banking funds for a marijuana dispensary?

In spite of the United States following a dual banking system, where banks may either choose a federal charter or state charter, banks have been reluctant in providing funds to marijuana dispensary because of federal criminal law and the pervasiveness of federal banking regulation. Julie Andersen Hill, Banks, Marijuana, and Federalism, 65 Case W. Res. L. Rev. 597, 605–06, 631 (2015). According to press reports, financial institutions that provide banking services to marijuana industry are few and far between. Id. at 634 n. 192. Banks are wary because "marijuana is illegal under the federal law" and "federal law enforcement agencies have significant power to punish institutions that do not comply with federal law." Id. at.605. Relevant laws include the Federal Controlled Substances Act, the Federal Anti-Money Laundering Statutes, Federal Deposit and Share Insurance, Federal Reserve Regulation of Member Banks, and Federal Bank Holding Company Regulation. Id. at 605-631.

A. Relevant federal laws restricting marijuana banking:

(i) The Federal Controlled Substances Act not only prohibits manufacturing, distributing, or dispensing marijuana, but also aiding and abetting any of the above. 21 U.S.C. §§ 801-904 (2012). Thus, when a financial institution renders a small inventory loan, checking account, or credit card payment processing services, it potentially conspires to distribute marijuana, and it may be acting as an accessory if it accepts deposits consisting of revenue from the sale of marijuana. Banks, Marijuana, and Federalism, 65 Case W. Res. L. Rev. 597 at 608.

(ii) Under the Federal Money Laundering Control Act, the financial institutions are required to avoid assisting customers who manufacture, distribute, or dispense marijuana. Id. at 610. Further, they are expected to discover illegal activity and report it to federal officials to prevent the wrongdoers from accessing the banking system. Id. Additionally, under the Bank Secrecy Act ("or BSA") and USA PATRIOT Act, financial institutions must maintain programs designed to detect and prevent money laundering. Id. at 611. "The Bank Secrecy Act requires the financial institutions to report illegal and suspicious activities to the federal Financial Crimes Enforcement Network ("FinCEN")." Id. at 613. The "institutions must file currency transactions reports for any transaction that involves more than $10,000 in cash." Id. They must also provide suspicious activity reports for transactions involving 'at least $5,000 in funds or other assets' if the banks, knows, suspects, or has reason to suspect (1) involves funds derived from illegal activity or is an attempt to disguise funds derived from illegal activity; (2) is designed to evade regulations promulgated under the BSA; or (3) lacks a business or apparent lawful purpose. Id.

(iii) Federal Deposit and Share Insurance is another tool by which financial institutions are controlled. Id. at 617. In order to retain federal insurance, financial institutions must comply

with FDIC or NCUA restrictions. Id. at 617-618. If Bank Secrecy Act violations are found, financial institutions faced significant civil penalties or revocation of deposit insurance, which effectively forces them out of business. Id. at 618-619.

(iv) Federal Reserve Regulations of member banks – Here, if the state banks choose to become members of the Federal Reserve System, they subject themselves to federal regulation by using federal deposit or share insurance. Id. at 625. The Federal Reserve regularly examines state member banks and their compliance with the Bank Secrecy Act and the bank's risk management practices to ensure that the bank does not provide deposit or loan services to illegal enterprises under federal law, including marijuana related business. Id. at 626.

(v) Federal Bank Holding Company Regulation – The federal government regulates all bank holding companies and banks, irrespective of their size.

(vi) Federal Payment Systems Administration – The Monetary Control Act of 1980 requires the Federal Reserve to offer payment system services to all depository institutions, including nonmember banks and credit unions. Id. at 627-28. By establishing regulations and policies governing access to its payment system, the Federal Reserve has the ability to impact practices at all financial institutions using these systems. Id.

The above federal laws limit state control over the financial institutions. Id. at 630. However, in light of recent state initiatives to legalize medical marijuana, the Department of Justice (DOJ)[2] and Financial Crimes Enforcement Network[3] (FinCEN, a division of the U.S. Treasury) have issued guidance detailing their current enforcement priorities and expectations

[2] U.S. Department of Justice, *Guidance Regarding Marijuana Related Financial Crimes* (Feb. 14, 2014), available at https://www.justice.gov/sites/default/files/usao-wdwa/legacy/2014/02/14/DAG%20Memo%20-%20Guidance%20Regarding%20Marijuana%20Related%20Financial%20Crimes%202%2014%2014%20(2).pdf

[3] Available at https://www.fincen.gov/sites/default/files/shared/FIN-2014-G001.pdf

for financial institutions seeking to provide services to marijuana-related business.

B. Federal Guidance

1. Department of Justice Guidance

DOJ has indicated that it will not target legal marijuana businesses as long as they meet following regulatory requirements:

- Preventing the distribution of marijuana to minors;
- Preventing revenue from the sale of marijuana from going to criminal enterprises, gangs, and cartels;
- Preventing the diversion of marijuana from states where it is legal under state law in some form to other states;
- Preventing state-authorized marijuana activity from being used as a cover or pretext for the trafficking of other illegal drugs or other illegal activity;
- Preventing violence and the use of firearms in the cultivation and distribution of marijuana;
- Preventing drugged driving and the exacerbation of other adverse public health consequences associated with marijuana use;
- Preventing the growing of marijuana on public lands and the attendant public safety and environmental dangers posed by marijuana production on public lands; and
- Preventing marijuana possession or use on federal property.

U.S. Department of Justice, Guidance Regarding Marijuana Related Financial Crimes, p.1 (Feb. 14, 2014).

2. FinCEN guidance

FinCEN enforces the Banking Secrecy Act, which requires financial institutions to monitor their customer accounts for suspicious activity related to money laundering and other financial crimes, and to file suspicious activity reports ("SARs") for account holders they suspect are engaged in illegal activity. FinCEN, BSA Expectations Regarding Marijuana-Related Businesses, p.3 (Feb. 14, 2014). Regardless of any state law legalizing marijuana, a financial institution is required to file a SAR "if it knows, suspects, or has reason to suspect that a transaction conducted or attempted by, at, or through the financial institution: (i) involves funds

derived from illegal activity or is an attempt to disguise funds derived from illegal activity; (ii) is designed to evade regulations promulgated under the BSA, or (iii) lacks a business or apparent lawful purpose." Id.

Similar to DOJ, FinCEN has also released a letter identifying its Banking Secrecy Act expectations for financial institutions seeking to provide services to marijuana-related businesses. Id. The goal is to "enhance the availability of financial services for, and the financial transparency of, marijuana-related businesses." Id. at p.1 The letter notes, "the decision to open, close, or refuse any particular account or relationship should be made by each financial institution based on a number of factors specific to that institution" including "its particular business objectives, an evaluation of the risks associated with offering a particular product or service, and its capacity to manage those risks effectively." Id. at p. 2. It noted that "thorough customer due diligence is a critical aspect of making this assessment." Id. FinCEN's provides the following guidance in assessing the risk to provide services to marijuana-related business:

> (1) verifying with the appropriate state authorities whether the business is duly licensed and registered;
> (2) reviewing the license application (and related documentation) submitted by the business for obtaining a state license to operate its marijuana-related business;
> (3) requesting from state licensing and enforcement authorities available information about the business and related parties;
> (4) developing an understanding of the normal and expected activity for the business, including the types of products to be sold and the type of customers to be served (e.g., medical versus recreational customers);
> (5) ongoing monitoring of publicly available sources for adverse information about the business and related parties;
> (6) ongoing monitoring for suspicious activity, including for any of the red flags described in FinCEN guidance; and
> (7) refreshing information obtained as part of customer due diligence on a periodic basis and commensurate with the risk.

Id.

Additionally, FinCEN details when the financial institutions are required to file a SAR for "Marijuana Limited," "Marijuana Priority," and "Marijuana Termination" suspicious activity reports: Id. at p.3-5.

C. State-Chartered Financial Cooperatives.

In 2014, Colorado passed legislation allowing licensed marijuana businesses to form financial services co-ops. Julie Andersen Hill, Banks, Marijuana, and Federalism, 65 Case W. Res. L. Rev. 597, 638-639 (2015). However, these co-ops had to comply with federal requirements, including the Banking Secrecy Act. Id. Moreover, the co-ops are dependent on federal banking regulations even if they do not need to secure federal deposit insurance or will not be owned by a federally regulated holding company. This is because each co-op needs the written approval of the Federal Reserve System Board of Governors for access to the Federal Reserve System relating to proposed depository activities. Id. (citing COLO. REV. STAT. § 11-33-104(4)(a)). The co-ops face other challenges because they are nonmember depository institutions and a co-ops, rather than a bank or credit union. Banks, Marijuana, and Federalism, at p. 640.

Based on the foregoing, it appears that because of federal drug and anti-money laundering laws, and the power the federal regulators wield to punish both federal and state charted financial institutions, there are burdensome and costly barriers for financial institutions to provide services, despite assurances from DOJ and FinCEN. There is also the fact that States have no authority to prevent federal authorities from enforcing federal law.

CONCLUSIONS

Under 26 U.S.C. § 280E, a business cannot deduct expenses for any activities related to

trafficking in a controlled substance. However, if the tax payer can prove that he or she is conducting another business that is separate, continuing, and unrelated to marijuana business, § 280E may not apply to those separate expenses.

Federal criminal law and banking regulations restrict financial institutions from providing banking services to businesses engaged in "illegal" activity, including trafficking in controlled substances. Though federal regulatory bodies like DOJ and FinCEN have issued policy letters and guidance documents, financial institutions are still wary. Further, apart from these regulatory bodies, there are other federal regulatory bodies like FDIC, NCUA, or Federal Reserve that might determine that the institution was not effectively managing its risk and take enforcement actions against it. Additionally, the state has no power to prevent the federal authorities from enforcing the federal law.