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9th Circ. Tosses Pot Co.'s Constitutional Attack On Tax Clause

By **Diana Novak Jones**

Law360 (April 22, 2021, 6:30 PM EDT) -- The Ninth Circuit shot down the cannabis industry's latest challenge to a tax code clause that bars pot businesses from taking deductions on Thursday after the court said it wouldn't consider an argument that the clause is unconstitutional.

California cannabis company Harborside took on the clause, 280E, as it fought back against a nearly \$30 million bill for back taxes from the IRS. The case drew attention for years as it wound its way through the U.S. Tax Court and up to the Ninth Circuit, attacking 280E as an unfair and unconstitutional burden on businesses in the rapidly expanding legal marijuana industry.

In its ruling upholding the Tax Court's decision on Thursday, the three-judge appellate panel acknowledged the significance of the case but said it wouldn't even address Harborside's argument that 280E violates the 16th Amendment. That argument wasn't presented before the Tax Court, it said.

The panel's opinion primarily addressed Harborside's secondary aim, which was to allow more of its expenditures for maintaining its inventory under the definition of cost of goods sold, the only expenses marijuana businesses are allowed to deduct. But again, the panel said it couldn't address Harborside's main argument about inventory costs because it hadn't been heard in the Tax Court.

And what was left wasn't enough to push the panel to overturn the Tax Court's holding on Harborside's costs of goods sold, it said.

"Although Harborside is subject to serious tax consequences because of the nature of its business, see I.R.C. § 280E, the primary argument it has preserved for our review fails based on generally applicable provisions of federal tax law," U.S. Circuit Judge Daniel Bress wrote in the opinion. "Marijuana dispensaries, like all taxpayers, must abide by the intricacies of the Internal Revenue Code and the Treasury regulations."

The ruling follows a long line of IRS court wins on the issue of 280E, which the agency has aggressively enforced against state-legal marijuana businesses. Added to the tax code during the war on drugs, the clause specifically bans businesses whose trade "consists of trafficking in controlled substances" from deducting business expenses other than the costs they incur for the goods they sell.

Harborside's Tax Court case, which stemmed from the bill for back taxes it incurred for tax years 2007 through 2012, ended with a ruling that upheld 280E. But the company did escape some of its penalties, knocking the bill down to \$11 million, according to court records.

It appealed to the Ninth Circuit, arguing the 16th Amendment only allows for taxes on income, and by denying all deductions, 280E is taxing marijuana businesses on far more than just their income.

The IRS countered that the 16th Amendment is not the source of Congress' ability to levy taxes.

During oral arguments in February, Harborside's attorney James Mann had only just started talking about the 16th Amendment when Judge Bress questioned whether that argument **was ever presented** to the Tax Court.

It was then Mann said he knew he had an uphill battle, he told Law360 after the ruling Thursday.

"It is clearly a loss. There's no disguising that," Mann said. "My overall assessment is that the court exercised its rightful discretion to punt."

Representatives for the IRS did not immediately respond to a request for comment Thursday.

It's not clear where the case — or the issue — could go from here. Mann said he couldn't speak for Harborside on its plans going forward, and a representative for the company didn't return a call seeking comment.

But Mann said many issues surrounding 280E remain open, including whether a popular strategy of dividing companies into separate entities and keeping the plant-touching part of the business confined to one of them would allow a business to take more deductions.

Court rulings aren't the industry's only hope, however.

The clause applies only to substances listed on the U.S. Drug Enforcement Administration's Schedule I and II, so legislation that would deschedule or reschedule marijuana could impact 280E's applicability to the industry.

The Marijuana 1-to-3 Act, **introduced in January**, is designed to neutralize 280E by moving cannabis from a Schedule I to a Schedule III substance under the Controlled Substances Act.

Marijuana decriminalization legislation teased by Senate Majority Leader Chuck Schumer, D-N.Y., could also impact 280E, although he has yet to release many details about the bill — other than to say it is forthcoming.

U.S. Circuit Judges Andrew D. Hurwitz and Daniel A. Bress and U.S. District Judge Clifton L. Corker, sitting by designation, sat on the panel for the Ninth Circuit.

Harborside is represented by James B. Mann.

The IRS is represented by Deputy Assistant Attorney General T. Joshua Wu, Principal Deputy Assistant Attorney General Richard E. Zuckerman, Nathaniel S. Pollock, Francesca Ugolini and Michael J. Haungs of the U.S. Department of Justice's Tax Division.

The case is Patients Mutual Assistance Co v. CIR, case number 19-73078, in the U.S. Court of Appeals for the Ninth Circuit.

--Additional reporting by Sam Reisman. Editing by Janice Carter Brown.