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## Pot Dispensary's Tax Code Fight Faces Skeptics At 9th Circ.

By **Diana Novak Jones**

Law360 (February 9, 2021, 10:08 PM EST) -- A California pot dispensary made its case before the Ninth Circuit on Tuesday that a clause in the tax code that bars marijuana businesses from taking nearly all deductions is unconstitutional, but at least two of the judges seemed skeptical of its position.

In the cannabis industry's latest attempt to take down the section of the tax code that prevents state-legal marijuana companies from deducting most business expenses, counsel for Harborside Inc. asked a three-judge panel to find the clause, known as 280E, an unconstitutional violation of the 16th Amendment. The 16th Amendment only gives Congress the power to tax income, and by denying all deductions, 280E is forcing cannabis businesses to pay taxes on far more than that, the company argued.

But during oral arguments, the panel seemed to object to that assertion — and whether it was properly put before them.

James Mann, counsel for Harborside, had just begun his arguments when Circuit Judge Daniel Bress said that it didn't seem like the 16th Amendment argument was raised before the appeal.

Mann said that the 16th Amendment was mentioned in the U.S. Tax Court's opinion in the case and in the trial counsel's brief, adding that's all that is necessary for arguments involving the amendment to be made on appeal.

"I'm not sure I agree," Judge Bress said. "The way it's touched upon in the tax court decision seems to be quite a bit different than the way you're arguing it here."

Harborside, a well-known entity in California's cannabis world, is the latest company to take on 280E, which was designed to target drug traffickers but now has many state-legal cannabis businesses **paying tax rates approaching 70%**.

The clause, added to the tax code during the war on drugs, only allows marijuana dispensaries, growers and processors to deduct their costs of goods sold, or the costs they pay for the goods they sell. It's the only type of blanket ban on deductions that exists in the code.

And the Internal Revenue Service has taken a strong stance on enforcing the clause, auditing marijuana businesses regularly and hitting them with hefty bills for back taxes if they take deductions that the agency deems improper.

Many of those companies have taken the IRS — and 280E itself — to court, but judges have repeatedly upheld the clause and said it can be enforced against state-legal pot businesses.

What can be included in costs of goods sold has also been subject to litigation. The IRS says it can only include the wholesale costs of products, while the marijuana industry has tried to include costs associated with inventory, like labor and storage.

Harborside has been fighting its own IRS debts for years. It received notices of deficiency from the IRS for tax years 2007 to 2012 that claimed the company owed about \$30 million in back taxes and penalties.

Harborside took the IRS to trial in 2016, attacking 280E's constitutionality for the first time. But the judge sided with the agency, finding that Congress has broad authority to grant or deny deductions.

The trial judge also agreed with the IRS that Harborside could only deduct the wholesale prices of its products as costs of goods sold. But he threw out the IRS' penalties, sending Harborside a bill in October 2019 for **just over \$11 million** in unpaid taxes.

Harborside appealed to the Ninth Circuit in May, **leveling up the company's fight** against 280E.

In arguments Tuesday, Mann told the court that the 16th Amendment only levies taxes on income, which is understood as gain. With all deductions banned by 280E, cannabis companies are being taxed on more than income, he contended.

But Circuit Judge Andrew Hurwitz said that he saw the allowance for the cost of goods sold as a deduction.

"They allow some deduction, cost of goods sold, not others," Judge Hurwitz said. "Why isn't that just a tax on something less than gross receipts, rather than on income? Are we fighting about the definition of income?"

Counsel for the IRS, Nathaniel Pollock of the U.S. Department of Justice's Tax Division, argued that the 16th Amendment is not the source of Congress' ability to tax.

"Even supposing it taxed more than income, it would be a constitutional tax under Article 1 [of the U.S. Constitution]," Pollock said. "The fundamental tenet of the constitutional argument is a complete misunderstanding of the history of the 16th Amendment."

Mann also claimed that the definition of costs of goods sold that both the court and the IRS are using is improper, and Harborside should be allowed to include more of its expenses related to the goods rather than just the goods themselves.

But Pollock said that argument hadn't been properly made in the case record leading up to the appeal.

Mann used his rebuttal time to ask the court to take a closer look at how the definition of costs of goods sold is applied to the cannabis industry.

"If you look at the amicus briefs in this case, it's not fair to the industry not to provide a true assessment of the tax accounting standards that apply to cannabis sellers," he said.

Circuit Judges Daniel Bress and Andrew Hurwitz and U.S. District Judge Clifton Corker sat on the panel for the Ninth Circuit.

Harborside is represented by James Mann of the Law Office of James B. Mann.

The IRS is represented by Nathaniel Pollock and Gilbert Stephen Rothenberg of the DOJ's Tax Division.

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

--Editing by Steven Edelstone.