

Cannabis Business Blog

The IRS and the Controlled Substance Act

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Two recent District Court cases, *High Desert Relief, Inc. v. United States of America* and *Alpenglow Botanicals, LLC et. al. v. United States of America* have raised a novel issue in the IRS's audits of cannabis businesses. Both of these suits were petitions to quash IRS summonses. A taxpayer who is under a civil audit from the IRS can petition a District Court to "quash", or cancel, a summons issued to a third party for information relating to the IRS's audit of that taxpayer. This type of suit is notoriously difficult for taxpayers.

The theory raised by *High Desert Relief* and *Alpenglow Botanicals* is that because Section 280E of the Internal Revenue Code allows the IRS to disallow deductions for expenses relating to the trafficking of goods prohibited by the federal Controlled Substances Act, the IRS is, in essence, conducting criminal investigations. The IRS is, generally, prohibited from using civil summons to gather information for criminal prosecutions under the Fourth Amendment. The District Courts in New Mexico and Colorado ruled in these cases that the IRS is permitted to use civil summons to investigate violations of the Controlled Substances Act for the purpose of conducting a civil audit.

Thus far, neither ruling has been appealed. The IRS will certainly consider these cases victories, though, in their audit program of cannabis businesses, underscoring the importance of careful tax planning around Code Section 280E for both recreational and medicinal cannabis businesses.

Warning Regarding Federal Law: The possession, distribution, and manufacturing of marijuana is illegal under federal law, regardless of state law which may, in some jurisdictions, decriminalize such activity under certain circumstances. Penalties for violating federal drug laws are very serious. For example, a conviction on a charge of conspiracy to sell drugs carries a mandatory minimum prison term of five years for a first offense and, depending on the quantity of marijuana involved, the fine for such a conviction could be as high as \$10 million. In addition, the federal government may seize, and seek the civil forfeiture of, the real or personal property used to facilitate the sale of marijuana as well as the money or other proceeds from the sale. Although the U.S. Department of Justice (DOJ) recently rescinded its guidance regarding prioritization of criminal prosecutions of individuals and entities operating in compliance with effective state regulatory systems, DOJ left in place long standing guidance to federal prosecutors regarding how to exercise this discretion. Individuals and companies are cautioned to consult with experienced attorneys regarding their exposure to potential criminal prosecution before establishing business operations in reliance upon the passage of state laws which may decriminalize such activity. Federal authority to prosecute violations of federal law as crimes or through seizures and forfeiture actions is not diminished by state law. Indeed, due to the federal government's jurisdiction over interstate commerce, when businesses provide services to marijuana producers, processors or distributors located in multiple states, they potentially face a higher level of scrutiny from federal authorities than do their customers with local operations.

Tags: cannabis businesses, civil audit, Controlled Substances Act, deductible expenses, Fourth Amendment, IRS, Section 280E of the Internal Revenue Code, Tax Planning