San Jose Wellness v. Commissioner, 156 T. C. 4 (U. S. Tax Court 2021)

In a significant ruling, the U. S. Tax Court upheld the IRS's denial of deductions for depreciation and charitable contributions claimed by San Jose Wellness, a medical cannabis dispensary, under I. R. C. § 280E. The court found that these deductions were disallowed because they were incurred in a business that trafficked in controlled substances, reinforcing the broad application of § 280E to all deductions related to such businesses. This decision impacts how cannabis businesses can report their taxable income, emphasizing the strict limitations imposed by federal tax law on deductions for expenses related to the sale of marijuana.

Parties

San Jose Wellness (Petitioner), a California corporation operating a medical cannabis dispensary, challenged the determinations of the Commissioner of Internal Revenue (Respondent) regarding the disallowance of deductions and the imposition of penalties for the taxable years 2010, 2011, 2012, 2014, and 2015. The case was heard in the U. S. Tax Court, with the Commissioner represented by Nicholas J. Singer and Julie Ann Fields, and San Jose Wellness represented by Henry G. Wykowski, Katherine L. Allen, and James Brooks Mann.

Facts

San Jose Wellness operated a medical cannabis dispensary in San Jose, California, selling cannabis to individuals with a valid doctor's recommendation. The business also sold non-cannabis items and provided holistic services such as acupuncture and chiropractic care. For the years in question, San Jose Wellness used the accrual method of accounting and reported gross receipts ranging from $4,997,684 to $6,729,831. The company claimed deductions for depreciation and charitable contributions on its federal income tax returns, which were disallowed by the Commissioner under I. R. C. § 280E, which prohibits deductions for expenses incurred in a business trafficking in controlled substances.

Procedural History

The Commissioner issued notices of deficiency to San Jose Wellness for the taxable years 2010, 2011, 2012, 2014, and 2015, disallowing deductions for depreciation and charitable contributions and determining deficiencies in federal income tax. San Jose Wellness timely filed petitions with the U. S. Tax Court seeking redetermination of the deficiencies and penalties. The cases were consolidated for trial. The Commissioner initially determined accuracy-related penalties under I. R. C. § 6662 for the years 2014 and 2015 but later conceded the penalty for 2014. The standard of review applied by the Tax Court was de novo.

Issue(s)

Whether the deductions for depreciation under I. R. C. § 167(a) and charitable

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contributions under I. R. C. § 170(a) claimed by San Jose Wellness are disallowed under I. R. C. § 280E, which prohibits deductions for any amount paid or incurred during the taxable year in carrying on a trade or business that consists of trafficking in controlled substances?

Rule(s) of Law

I. R. C. § 280E states: “No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted. ” The Tax Court had previously interpreted this statute to apply broadly to all deductions, including those under §§ 167 and 170, as established in cases such as N. Cal. Small Bus. Assistants Inc. v. Commissioner, 153 T. C. 65 (2019).

Holding

The Tax Court held that San Jose Wellness’s deductions for depreciation and charitable contributions were properly disallowed under I. R. C. § 280E because these amounts were incurred in carrying on a trade or business that consisted of trafficking in controlled substances. The court also sustained the accuracy-related penalty for the taxable year 2015, finding that San Jose Wellness did not act with reasonable cause and in good faith with respect to the underpayment of tax.

Reasoning

The Tax Court’s reasoning was based on a thorough analysis of the statutory text and prior caselaw. The court found that depreciation, as an amount “incurred” during the taxable year under the accrual method of accounting, fell within the scope of § 280E. This interpretation was supported by Supreme Court precedent in Commissioner v. Idaho Power Co. , 418 U. S. 1 (1974), which characterized depreciation as a cost incurred in the taxable year. Similarly, the court rejected San Jose Wellness’s argument that its charitable contributions were not made “in carrying on” its trade or business, finding that the contributions were part of the company’s business activities. The court also considered the policy implications of § 280E but determined that the statute’s clear language and prior interpretations left no room for exceptions. Regarding the penalty, the court found that San Jose Wellness failed to demonstrate reasonable cause or good faith in its tax reporting, given the established caselaw and guidance on § 280E at the time of filing its 2015 return.

Disposition

The Tax Court affirmed the Commissioner’s disallowance of the deductions for depreciation and charitable contributions for all years at issue and sustained the accuracy-related penalty for the taxable year 2015.

Significance/Impact

This decision reinforces the broad application of I. R. C. § 280E, affecting how businesses involved in the sale of controlled substances, such as cannabis, can claim deductions on their federal income tax returns. It clarifies that even deductions for depreciation and charitable contributions are subject to § 280E’s prohibition, impacting the tax planning and reporting of these businesses. The ruling also underscores the importance of understanding and complying with federal tax law, even in states where cannabis is legal for medical or recreational use. Subsequent cases and guidance have continued to follow this interpretation, solidifying the limitations on deductions for cannabis businesses.

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