San Jose Wellness v. Commissioner of Internal Revenue, 156 T. C. No. 4 (U. S. Tax Ct. 2021)

The U. S. Tax Court ruled that a medical cannabis dispensary's deductions for depreciation and charitable contributions are disallowed under I. R. C. § 280E, which prohibits deductions for businesses trafficking in controlled substances. This decision reinforces the broad application of § 280E, impacting how such businesses calculate taxable income and affirming the IRS's stance on related penalties.

Parties

San Jose Wellness (Petitioner) filed petitions against the Commissioner of Internal Revenue (Respondent) in the U. S. Tax Court, contesting determinations made in notices of deficiency for tax years 2010, 2011, 2012, 2014, and 2015.

Facts

San Jose Wellness (SJW) operated a medical cannabis dispensary in San Jose, California, under state law. The dispensary sold cannabis to individuals with valid doctor's recommendations and also offered noncannabis items and services like acupuncture and chiropractic care. SJW used the accrual method of accounting and claimed deductions for depreciation and charitable contributions on its federal income tax returns for the taxable years 2010, 2011, 2012, 2014, and 2015. The Commissioner disallowed these deductions under I. R. C. § 280E and assessed accuracy-related penalties for 2014 and 2015, later conceding the penalty for 2014.

Procedural History

The Commissioner issued notices of deficiency for the years in question, disallowing SJW's deductions and asserting penalties. SJW petitioned the U. S. Tax Court for review. The cases were consolidated for trial, and the court reviewed the issues under a de novo standard, focusing on the applicability of § 280E to the claimed deductions.

Issue(s)

Whether I. R. C. § 280E disallows SJW's deductions for depreciation under I. R. C. § 167 and charitable contributions under I. R. C. § 170, given that SJW's business involved trafficking in controlled substances?

Rule(s) of Law

I. R. C. § 280E disallows any deduction or credit for amounts paid or incurred during the taxable year in carrying on a trade or business that consists of trafficking in controlled substances within the meaning of the Controlled Substances Act.

Holding

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The U. S. Tax Court held that SJW's deductions for depreciation and charitable contributions were properly disallowed under I. R. C. § 280E. The court also upheld the accuracy-related penalty for the taxable year 2015, finding that SJW did not act with reasonable cause and in good faith.

Reasoning

The court's reasoning was structured around the statutory conditions of § 280E: (1) deductions must be for amounts paid or incurred during the taxable year; (2) these amounts must be related to carrying on a trade or business; and (3) the trade or business must consist of trafficking in controlled substances. The court interpreted depreciation as an amount incurred during the taxable year, based on Supreme Court precedent in Commissioner v. Idaho Power Co. , 418 U. S. 1 (1974), and its own decision in N. Cal. Small Bus. Assistants Inc. v. Commissioner, 153 T. C. 65 (2019). The charitable contributions were seen as made in carrying on SJW's business, following the broad interpretation of § 280E in previous cases like Patients Mutual Assistance Collective Corp. v. Commissioner, 151 T. C. 176 (2018). The court rejected SJW's arguments that its business did not exclusively consist of trafficking and that depreciation and charitable contributions were not covered by § 280E. For the penalty, the court found that SJW did not establish reasonable cause or good faith, given the clear legal landscape regarding § 280E at the time of filing.

Disposition

The court's decision affirmed the Commissioner's disallowance of SJW's deductions for depreciation and charitable contributions for all years in question and upheld the accuracy-related penalty for the taxable year 2015.

Significance/Impact

This case reaffirms the expansive reach of I. R. C. § 280E, clarifying that it applies not only to typical business expenses but also to depreciation and charitable contributions. It underscores the challenges faced by businesses operating in the medical cannabis industry under federal tax law, emphasizing the importance of understanding and complying with § 280E. The decision also highlights the stringent standards for avoiding accuracy-related penalties, requiring taxpayers to demonstrate reasonable cause and good faith in light of existing legal authority.

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