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International Tax Watch

Who's Afraid of Code Sec. 280E?

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Introduction

Marijuana—technically, any product that contains more than 0.3% tetrahydrocannabinol ("THC") (a "THC Product")—is now legal in one form or another in most U.S. states, and states that have legalized THC Products have been collecting substantial tax revenues. For example, in 2020, California exceeded $1 billion in THC Product-related tax revenues, and Illinois collected over $200 million in THC Product-related tax.[1] Yet, because THC Products remain illegal at the U.S. federal level, THC Product businesses operate under a severe handicap, regardless of the extent to which they comply with state law. Specifically, Code Sec. 280E denies deductions for expenditures a company makes "in carrying on any trade or business" that "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." In other words, Code Sec. 280E taxes THC Product companies that violate U.S. federal or state criminal law on gross, as opposed to net, income. The application of Code Sec. 280E can be devastating, as it can leave these companies with a tax bill that exceeds their operating cash flow.

Judge Gustafson illustrated the predicament of a company that is subject to Code Sec. 280E in a partial dissent from the Tax Court's opinion in *Northern California Small Business Assistants Inc.*[2] Judge Gustafson hypothesized a widget seller that purchases 100 widgets at a cost of $6 per widget, yielding COGS of $600. The widget seller leases a retail space for $200 and pays wages of $200 to employees, yielding additional expenses of $400, so that the widget seller's total out-of-pocket expenditures for COGS ($600) and additional expenses ($400) equal $1,000. Judge Gustafson observed that if the widget seller sells the 100 widgets at a price of $9 each, it has gross receipts of $900, which, after being reduced by its total costs of $1,000 (the sum of COGS and total expenses), yield a loss of $100. In Judge Gustafson's words, "No one would propose that this seller had any gain."

Yet, if the widget seller were to sell THC Products costing the same amount, the seller would still have a loss of $100, but Code Sec. 280E would disallow any deduction for rent and wage expenses totaling $400. Thus, the seller would

recognize gross receipts of $900, less COGS of $600, and would be forced to pay tax on "a supposed taxable 'income' of $300—despite having incurred not gain but loss." Judge Gustafson concluded that Code Sec. 280E "would fabricate gain where there was none and would impose a tax based on artificial income."

Therefore, determining whether or not Code Sec. 280E applies is a critical exercise for companies that commercialize THC Products. In this column, using a hypothetical (yet common) scenario, we analyze the U.S. international tax implications of Code Sec. 280E. As we discuss in detail below, we conclude that Code Sec. 280E should not disallow deductions for expenses U.S. persons incur in connection with (i) maintaining THC Product intellectual property ("IP") in, and licensing that IP from, the United States, (ii) engaging in THC Product research and development ("R&D") in the United States, and (iii) assisting with and overseeing from the United States non-U.S. operations that manufacture, market, distribute, dispense, and sell THC Products outside the United States, where it is legal to do so. We further conclude that Code Sec. 280E should not disallow deductions against tested or subpart F income for expenses CFCs incur in connection with manufacturing, marketing, distributing, dispensing, and selling THC Products outside the United States, where it is legal to do so.

Multinational Operations Involving THC Products: A Hypothetical Structure

The growth of the THC Product industry on the state level, together with the fact that the United States is home to a wealth of talent in the food and beverage, cosmetic, and pharmaceutical sectors, means that non-U.S. THC Product companies are just as likely, if not more likely, to find high-value employees in the United States as they are to find them abroad. In light of these facts, a non-U.S. THC Product company might develop/acquire and hold in the United States portfolios of THC Product IP to deploy in the U.S. recreational market in the future, or to license to non-U.S. persons until U.S. legalization occurs. A non-U.S. THC Product company might also employ individuals in the United States, either directly or through a U.S. subsidiary, who use their expertise to (i) conduct R&D with respect to THC Products in the United States and oversee and direct contract R&D with respect to THC Products outside the United States, and (ii) assist with and oversee from the United States non-U.S. operations that manufacture, market, distribute, dispense, and sell THC Products outside the United States.

For purposes of this column, we assume a hypothetical non-U.S. THC Product company ("ForeignCo") with a U.S. subsidiary ("USSub") and a non-U.S. subsidiary ("ForeignSub"). The commercialization of THC Products is fully legal in the ForeignCo and ForeignSub jurisdictions and in the states in which USSub and its employees are located and operate.

USSub holds IP rights associated with THC Products and licenses these rights to ForeignCo in exchange for royalties. USSub also has employees in the United States who perform THC Product-related R&D in the United States. In addition, USSub engages ForeignSub to perform R&D on USSub's behalf and pays ForeignSub a service fee in consideration for its activities.

The USSub employees assist with and oversee THC Product manufacturing, marketing, distribution, dispensation, and sales of THC Products in the ForeignCo jurisdiction. ForeignCo pays USCo a service fee for these activities.

ForeignCo, ForeignSub, and USCo do not import, manufacture, distribute, dispense, or sell THC Products in the United States, and do not possess THC Products with the intent to import, distribute, dispense, or sell these products in the United States.

Diagram 1 below depicts the relevant structure.

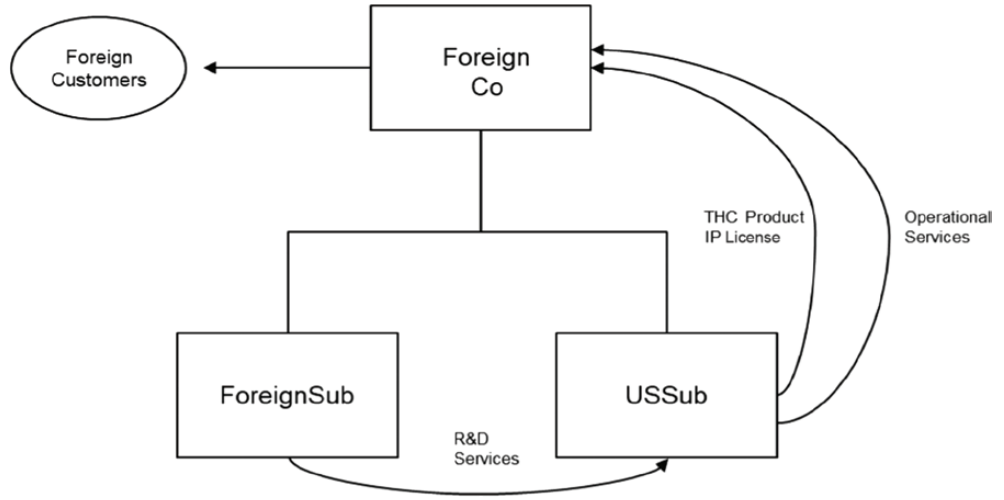
As a result of the repeal of Code Sec. 958(b)(4), ForeignSub should be a CFC. If a U.S. person indirectly owns 10% of the ForeignSub vote or value, ForeignSub's tested and subpart F income could be relevant to this U.S. shareholder.

The royalties and service fees that USSub derives from ForeignCo could qualify for FDII, at least under current law. The service fees that USSub pays to ForeignSub could run afoul of the BEAT, but it is highly unlikely that USSub has crossed the BEAT's gross receipts threshold.

Practically speaking, in this structure, assuming that the group is still in the growth phase, what likely matters most from a U.S. tax perspective is that the group pays U.S. tax, if any, on net, and not gross, income. For the reasons we discuss below, Code Sec. 280E should not prevent USSub from deducting expenses associated with (i) maintaining THC Product IP in, and licensing THC Product IP from, the United States, (ii) engaging in THC Product R&D in the United States, and (iii) assisting with and overseeing from the United States ForeignSub R&D and a ForeignCo operation that manufactures, markets, distributes, dispenses, and sells THC Products.

As the operation of Code Sec. 280E turns on the Controlled Substances Act ("CSA") specifically and U.S.

DIAGRAM 1.



federal criminal law generally, we begin with the application of the CSA and U.S. federal criminal law to the ForeignCo group's activities.

The CSA/U.S. Federal Criminal Law

The CSA regulates substances listed in five schedules based upon a substance's medical use, potential for abuse, safety, or dependence liability. Marijuana is a Schedule I controlled substance. THC Products contain more than 0.3% THC and should therefore constitute marijuana for purposes of Schedule I.[3]

The CSA's implementing criminal statute, 21 USC §841, makes it a crime "to manufacture,[4] distribute,[5] dispense,[6] or possess with intent to manufacture, distribute, or dispense, a controlled substance." In addition, 21 USC §846 criminalizes any attempt or conspiracy to commit an offense defined under the CSA. In our hypothetical structure, ForeignCo, ForeignSub, and USSub should not be engaged in any activity in the United States that would violate 21 USC §841 or 846. Nevertheless, particularly because USSub is licensing IP to ForeignCo that ForeignCo uses to commercialize THC Products, a controlled substance, in the ForeignCo jurisdiction, and USSub is also assisting ForeignCo with commercializing THC Products in that jurisdiction, the structure raises the question of whether activities *outside of the United States* may be subject to the CSA. If that were the case, USSub (along with ForeignCo and ForeignSub) could be in violation of the CSA because 18 USC §2 makes it a crime to aid or abet the commission of any federal crime, including crimes under the CSA.[7]

In this respect, there is a strong presumption against the extraterritorial application of U.S. criminal laws. As the Supreme Court has held, "[a]bsent clearly expressed congressional intent to the contrary, [U.S.] federal laws [are] construed to have only domestic application."[8] Courts have applied the presumption against extraterritoriality to the CSA and have held that those provisions of the CSA that do not explicitly apply to conduct outside the United States do not apply extraterritorially in the absence of a jurisdictional nexus.[9]

Neither 21 USC §841 nor 21 USC §846 contains any statement about extraterritorial application. By contrast, two provisions of the CSA do contain explicit extraterritoriality provisions. Specifically, 21 USC §959, which relates to the foreign manufacture of drugs for U.S. importation, states: "This section is intended to reach acts of manufacture or distribution committed outside the territorial jurisdiction of the United States."[10] Similarly, 21 USC §960a, which criminalizes "narco-terrorism," or the support of terrorist groups with the proceeds of illegal drug trafficking, contains a statement that, subject to other conditions, it shall apply to acts committed "in whole or in part outside of the United States."[11] Conspiracies to commit these specific offenses also apply extraterritorially.[12] In short, when Congress intended provisions of the CSA to apply extraterritorially, it expressed this intent clearly, as it did in 21 USC §§959 and 960a. The absence of any such statements in other provisions of the CSA demonstrates that Congress did not intend these other provisions to have extraterritorial application.

Simply put, in our hypothetical structure, ForeignCo, ForeignSub, and USCo are not engaging in activities that

relate to the importation of THC Products into the United States or in narco-terrorism. Therefore, to the extent the activities of ForeignCo, ForeignSub, and USCo involve manufacturing, distributing, dispensing, or selling, or possessing with the intent to manufacture, distribute, dispense, or sell, *outside the United States*, the CSA should not apply to criminalize these activities.

Even under a broad construction of the term, engaging in THC Product R&D and licensing THC Product IP should not constitute trafficking because performing R&D and licensing IP does not involve buying, selling, or distributing. The analysis should be similar with respect to manufacturing THC Products since manufacturing is also not equivalent to buying, selling, or distributing.

While the legality of conduct outside the United States is generally irrelevant to the CSA itself, the application of other criminal statutes can turn on the treatment of the relevant conduct under foreign law. For example, the activities of USSub could in theory rise to the level of a conspiracy to distribute narcotics. However, 21 USC §846 only criminalizes conspiracies to commit an "offense defined in this subchapter." Because the distribution of THC Products in foreign countries where distribution is legal is not an offense under Title 21, or any other U.S. statute, conspiring to distribute THC Products in those foreign countries while in the United States should not violate 21 USC §846.[13]

Equally important, financial transactions, in the United States or elsewhere, involving proceeds from lawful, non-U.S. transactions involving THC Products, should not violate U.S. money laundering laws. The relevant criminal statute, 18 USC §1956, defines "specified unlawful activity" (the proceeds of which constitute criminal proceeds for purposes of a money laundering prosecution) as "an offense *against a foreign nation* involving— … (i) the manufacture, importation, sale, or distribution of a controlled substance (as such term is defined for the purposes of the Controlled Substances Act)…."[14] Therefore, if a THC Product business is legal in the relevant foreign country, the business should not represent an "offense against a foreign nation" and the proceeds from that business should not constitute criminal proceeds for purposes of U.S. money laundering laws.

For this reason, it is critical for the commercialization of THC Products outside the United States to be legal under the applicable foreign law. In our hypothetical, the fact that commercializing THC Products is legal in the ForeignCo jurisdiction means that USSub and its employees should not be engaged in an unlawful conspiracy to distribute narcotics. It also means that the royalties and service fees that USSub receives from ForeignCo should not violate U.S. money laundering laws.

In summary, the ForeignCo structure described above should not violate U.S. federal criminal law. The structure also should not violate U.S. state criminal law based on the assumption that commercializing THC Products is fully legal in the state(s) where USSub has employees and operates.

Code Sec. 280E

As we noted in the introduction to this column, Code Sec. 280E prohibits taxpayers from taking U.S. federal income tax deductions (or tax credits) for expenditures they make "in carrying on any trade or business" that "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." Congress enacted Code Sec. 280E in 1982 in direct response to *Edmondson*,[15] in which the Tax Court allowed a taxpayer to take certain deductions in connection with his business in the illegal drug trade. Congress did not believe that enterprises engaged in the illegal drug trade should be entitled to business-expense deductions on public policy grounds, for the same reason that Congress denied deductions for, *e.g.*, illegal bribes.[16]

In our hypothetical, each member of the ForeignCo group is engaging in activities that involve THC Products, a Schedule I controlled substance. Code Sec. 280E should nevertheless not apply to any member of the group because none of the members is engaging in unlawful activity—a conclusion that is consistent with the policy behind Code Sec. 280E.

Neither Code Sec. 280E nor the CSA defines "trafficking." In the seminal case of *Californians Helping to Alleviate*

Med. Problems, Inc. ("C.H.A.M.P"), the Tax Court held that "trafficking" under Code Sec. 280E means to "engage in commercial activity: [to] buy and sell regularly."[17] The Tax Court and the other federal courts have applied *C.H.A.M.P.* repeatedly in subsequent cases, and we are unaware of any decision rejecting it.[18]

At the same time, some federal courts, such as the Court of Appeals for the Seventh Circuit in *Gamero v. Barr*,[19] have construed "trafficking" more broadly to mean all manner of distribution in other contexts, such as immigration removal proceedings. Importantly, in *Gamero*, the Seventh Circuit stated: "As used in federal and state controlled-substances statutes, 'trafficking' is a broad term casting a wide net and covering all manner of unlawful distribution of—and possession with intent to distribute—controlled substances."[20] We are unaware of any authority to support the proposition that "trafficking" could apply to wholly lawful commercial activity. Even if "trafficking" could conceivably encompass lawful activities, Code Sec. 280E expressly limits its scope to trafficking "*which is prohibited by Federal law or the law of any State*[.]" Therefore, while the scope of the activities that fall under "trafficking" may be broader than the definition in *C.H.A.M.P.*, in the context of Code Sec. 280E in particular, that scope should be limited by the fact that these activities must also be unlawful.

Even under a broad construction of the term, engaging in THC Product R&D and licensing THC Product IP should not constitute trafficking because performing R&D and licensing IP does not involve buying, selling, or distributing. The analysis should be similar with respect to manufacturing THC Products since manufacturing is also not equivalent to buying, selling, or distributing. Assisting with and overseeing an operation that markets, distributes, dispenses, and sells THC Products does involve activities that correspond to selling and distributing. These activities should not constitute "trafficking" to the extent they relate to an operation in a jurisdiction where marketing, distributing, dispensing, and selling THC Products are lawful. Even if they were to constitute "trafficking," as discussed above, they should not be prohibited by U.S. federal law (or, in our hypothetical, the laws of the relevant states).

Accordingly, Code Sec. 280E should not apply to deny USSub deductions for expenses associated with the IP it licenses or the services it performs. Furthermore, if ForeignSub has a U.S. shareholder, ForeignSub should compute its tested income without regard to Code Sec. 280E for the same reason—*i.e.*, because performing R&D with respect to THC Products should not constitute unlawful trafficking. Even if ForeignSub ultimately engages in commercial activities like ForeignCo, Code Sec. 280E should not deny ForeignSub deductions for the same reason it should not deny USSub deductions for assisting with marketing, distributing, and selling THC Products outside the United States: ForeignSub is not violating U.S. federal law by marketing, distributing, dispensing, and selling THC Products where it is legal to do so.

The purpose of this column is not to suggest that Code Sec. 280E is a paper tiger. Numerous Tax Court cases demonstrate that THC Product enterprises run the real risk of financial ruin if Code Sec. 280E applies.

Importantly, if, instead of operating in the United States through USSub, ForeignCo were to employ the U.S. personnel directly, the CSA and Code Sec. 280E conclusions should be the same because the U.S. activities should remain lawful. Depending on the availability of a tax treaty, ForeignCo would likely have a U.S. trade or business, be subject to U.S. income tax at graduated rates on income that is effectively connected with the conduct of a U.S. trade or business ("ECI"), and also be subject to the branch profits tax.[21] Yet ForeignCo should still compute its ECI, if any, based on net income, just like USSub and ForeignSub.

Conclusion

The purpose of this column is not to suggest that Code Sec. 280E is a paper tiger. Numerous Tax Court cases demonstrate that THC Product enterprises run the real risk of financial ruin if Code Sec. 280E applies. Nevertheless, Code Sec. 280E should not discourage non-U.S. enterprises that manufacture, market, distribute, dispense, and sell THC Products lawfully outside the United States from establishing robust supportive operations in the United States or using the United States as an IP hub. A company that does not violate U.S. federal and state criminal law should have nothing to fear from Code Sec. 280E.

ENDNOTES

[1] *See, e.g.*, *www.cdtfa.ca.gov/dataportal/charts.htm?url=CannabisTaxRevenues*; *www.newsweek.com/illinois-record-1-billion-marijuana-sales-years-end-surpassing-liquor-1588354*.

[2] *Northern California Small Business Assistants Inc.*, 153 TC 65, 83–84 (2019).

[3] The 2018 Farm Bill amended the CSA to remove hemp-derived products from the definition of marijuana under Schedule I. *See* the Agriculture Improvement Act of 2018 ("The 2018 Farm Bill"), P.L. 115-334, §12619. "Hemp" is defined to include any part of the cannabis plant with a THC concentration of no more than 0.3% on a dry weight basis. *Id.*, at Act Sec. 297A.

[4] The term "manufacture" means "the production, preparation, propagation, compounding, or processing of a drug or other substance, either directly or indirectly or by extraction from substances of natural origin, or independently by means of chemical synthesis or by a combination of extraction and chemical synthesis, and includes any packaging or repackaging of such substance or labeling or relabeling of its container; except that such term does not include the preparation, compounding, packaging, or labeling of a drug or other substance in conformity with applicable State or local law by a practitioner as an incident to his administration or dispensing of such drug or substance in the course of his professional practice." 21 USC §802(15).

[5] The term "distribute" means "to deliver (other than by administering or dispensing) a controlled substance or a listed chemical." 21 USC §802(11). *See also* 21 USC §841(a)(1).

[6] The term "dispense" means "to deliver a controlled substance to an ultimate user or research subject by, or pursuant to the lawful order of, a practitioner, including the prescribing and administering of a controlled substance and the packaging, labeling or compounding necessary to prepare the substance for such delivery." 21 USC §802(10).

[7] 18 USC §2.

[8] *RJR Nabisco, Inc. v. European Cmty.*, 136 SCt 2090, 2100 (2016) (finding that the presumption of extraterritoriality was rebutted only with respect to certain applications of the Racketeer Influenced and Corrupt Organizations Act ("RICO")).

[9] *See, e.g., Muench*, CA-2, 694 F2d 28, 33 (1982) ("... the intent to distribute within the United States supplies a jurisdictional nexus that might otherwise be lacking. The intent to cause effects within the United States also makes it reasonable to apply to persons outside United States territory a statute which is not expressly extraterritorial in scope.").

[10] 21 USC §959(d).

[11] 21 USC §960a(b)(4). 21 USC §960a has three separate parts: (1) it "identifies a set of drug-related activities that would be punished under a separate statute if they were committed within the jurisdiction of the United States"; (2) the statute prohibits engaging in those drug-related activities "knowing or intending to provide, directly or indirectly, anything of pecuniary value to any person or organization that has engaged or engages in terrorist activity"; (3) it contains five jurisdictional provisions, only one that need be proven. *In re Sealed Case*, DC-DC, 936 F3d 582, 585–586 (2019).

[12] *Cohen*, CA-2, 427 F3d 164, 168–169 (2005) (collecting cases to rebut an attempt to limit the extraterritorial application of either 21 USC §846 or §963).

[13] *Lopez-Vanegas*, CA-11, 493 F3d 1305, 1313 (2007) (where "the object of the conspiracy was to possess controlled substances outside the United States with the intent to distribute outside the United States, there is no violation of §841(a)(1) or §846."). For the sake of completeness, we note that provisions of the CSA *can* apply to conduct in part occurring outside the United States via 21 USC §846, but *only if* the specific acts have some specific territorial nexus to the United States. For example, conspiring to possess controlled substances within the United States, or intending to distribute controlled substances within the United States, while outside the United States, could each constitute a violation of 21 USC §846. *Id.*, at 1312 (noting that although 21 USC §841(a)(1) and §846 had been applied extraterritorially in other cases, "in each of those cases some other nexus to the United States allowed for extraterritorial application of §841(a)(1): defendants either possessed or conspired to possess controlled substances within the United States, or intended to distribute controlled substances within the United States.").

[14] 18 USC §1956(c)(7)(B) (emphasis added).

[15] *Edmondson*, 42 TCM 1533, Dec. 38,379(M), TC Memo. 1981-623.

[16] *See* S. Rept. No. 97-494 (Vol. 1), at 309 (1982), 1982 U.S.C.C.A.N. 781, 1050. The Senate Finance Committee Report reasoned that: "On public policy grounds, the Code makes certain otherwise ordinary and necessary expenses incurred in a trade or business nondeductible in computing taxable income. These nondeductible expenses include fines, illegal bribes and kickbacks, and certain other illegal payments... There is a sharply defined public policy against drug dealing. To allow drug dealers the benefit of business expense deductions at the same time that the U.S. and its citizens are losing billions of dollars per year to such persons is not compelled by the fact that such deductions are allowed to other, legal, enterprises. Such deductions must be disallowed on public policy grounds." *Id*.

[17] *Californians Helping to Alleviate Med. Problems, Inc.*, 128 TC 173, 182, Dec. 56,935 (2007) (citing Webster's Third New International Dictionary 2423 (2002)). In *C.H.A.M.P.*, a medical marijuana cooperative that also provided caregiving services challenged the IRS's position that it was not entitled to *any* business expense deductions, arguing that it should at least be entitled to deduct those expenses related to its caregiving (*i.e.*, non-marijuana) services. *Id.*, at 182 (holding that "provision of caregiving services was a trade or business separate and apart from its provision of medical marijuana."). The Tax Court agreed with the cooperative, and held that Code Sec. 280E would not preclude it from deducting caregiving expenses simply because it was also involved in the sale of marijuana. *Id.*

[18] *See Canna Care, Inc.*, 110 TCM 408, Dec. 60,432(M), TC Memo 2015-206, 12, *aff'd*, CA-9, 694 FApp'x 570 (2017) (sale of non-marijuana items such as books and socks as part of a marijuana enterprise "was an activity incident to its business of distributing medical marijuana"; therefore Code Sec. 280E banned deductions for any of its business expenses); *Olive*, CA-9, 2015-2 USTC ¶50,377, 792 F3d 1146 (2015) (because the only income-generating activity that a dispensary engaged in was the sale of medical marijuana and all other services were offered at no cost to patrons, the business was precluded from deducting any of its business expenses); *Alternative Health Care Advocates*, 151 TC 225, 236–40 (2018) (construing *C.H.A.M.P.* and its progeny to find that a marijuana dispensary was not allowed deductions because its non-marijuana activities were "only ancillary—not occupying much time or space"); *Patients Mut. Assistance Collective Corp.*, 151 TC 176 (2018) (holding that Code Sec. 280E denies business-expense deductions to any trade or business that involves trafficking in controlled substances, even if that trade or business also engages in other activities). *See also Alpenglow Botanicals*, DC-CO, No. 16-cv-00258-RM-CBS, 2016 U.S. Dist. LEXIS 183041, 2016 WL 7856477, at *10–11 (Dec. 1, 2016) (construing the *C.H.A.M.P.* definition of "trafficking" as "to buy or sell regularly" to find that the IRS possesses the authority to investigate and determine whether a business "regularly bought or sold marijuana"), *aff'd*, CA-10, 894 F3d 1187; *accord High Desert Relief, Inc.*, DC-NM, No. 16-CV-469 MCA/SCY, 2017 U.S. Dist. LEXIS 50134, at *12–13 (Mar. 31, 2017).

[19] *Gamero v. Barr*, CA-7, 929 F3d 464 (2019).

[20] *Id.*, at 469.

[21] *See* Code Secs. 882, 884; *Pinchot*, CA-2, 40-2 USTC ¶9592, 113 F2d 718; *Lewenhaupt*, 20 TC 151, Dec. 19,606 (1953), *aff'd*, CA-9, 55-1 USTC ¶9339, 221 F2d 227; *de Amodio*, 34 TC 894, Dec. 24,315 (1960), *aff'd*, CA-3, 62-1 USTC ¶9283, 299 F2d 623.