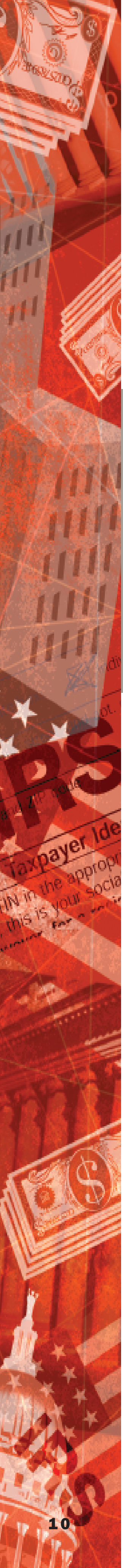

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Deductibility of Medical Marijuana Treatment

While several states and Washington, D.C., have legalized medical marijuana for use in certain situations, the federal government still considers it an illegal substance. This disparity can have a tax impact on both the patients who use it and the medical providers who distribute it.

As of June 2011, 16 states and the District of Columbia allowed for certain uses of medical marijuana. Despite being legal for such purposes in these locations, the use of marijuana remains at odds with federal authorities. A U.S. Justice Department memorandum written in June 2011 and reported in *The Washington Post* (Victor Zapana, "Progress Seen on Medical Marijuana," July 31, 2011, p. C1) suggests that prosecutors can target state-licensed dispensaries regardless of state law because such activities violate federal law. Amid the current uncertainties, this article explores the impact on federal taxes related to the deductibility of the costs of marijuana purchased for use for medical purposes by a patient or medical services provider.

Patients

Qualified medical expenditures for individuals are authorized by Internal Revenue Code (IRC) §213(a) and are deductible on Schedule A as itemized deductions subject to a 7.5% floor of adjusted gross income. Whether an expense qualifies as a medical expense deduction usually depends on whether the drug was obtained through a medical prescription from a physician. IRC §213(d)(3) defines the term " prescribed drug" to mean "a drug or biological which requires a prescription of a physician for its use by an individual." In order for the costs to meet the definition of "medical care" provided in Reg. §1.213-1(e)(2), medicines and drugs must be procured legally and generally accepted as falling within the category of medicine and drugs.

In regard to the deductibility of an amount paid to obtain a controlled substance for medical purposes in violation of federal law, such as the Controlled Substance Act (CSA), Revenue Ruling 97-9 (1997-1 C.B. 77, February 13, 1997) concludes, "Notwithstanding state law, a controlled substance (such as marijuana) obtained in violation of the CSA is not 'legally procured' within the meaning of §1.213-1(e)(2). Further an amount expended to obtain a controlled substance (such as marijuana) in violation of the CSA is an amount expended for an illegal treatment within the meaning of §1.213-1(e)(1)(ii). Accordingly [the taxpayer] may not deduct under §213 the amount paid to purchase marijuana."

This ruling makes it clear to taxpayers that the costs to buy marijuana in violation of the CSA wouldn't meet the tests for deductibility even in the presence of state law permitting its use by prescription. Therefore, current federal tax authorities don't support the deductibility of the costs of marijuana purchased by patients for medical use.

Medical Providers

When determining the deductibility of the costs of medical marijuana, medical providers must consider the tax authorities related to business expense deductions. For an expense to qualify as a business deduction under IRC §162, an otherwise ordinary and necessary business expense must not result in an illegal transaction. According to IRC §162(c)(2), "No deduction shall be allowed…if the payment constitutes an illegal bribe, illegal kickback, or other illegal payment under any law of the United States, or under any law of a State…" Furthermore, IRC §280E specifically prohibits a deduction in connection with the trade or business of selling illegal drugs:

"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."

Here again, illegal drugs are defined as controlled substances within the meaning of the CSA for which either federal or state law prohibits the activity. Therefore, current federal tax authorities don't support the deduction of the costs of medical marijuana incurred by medical providers.

Yet an analysis of the Tax Court's decision in *Californians Helping to Alleviate Medical Problems, Inc. v. Comm., 128 TC 173 2007* may provide some opportunity for planning that preserves recovery of capital for the costs of marijuana and the deductibility of business expenses occurred in other activities at the medical provider. In *Californians*, the Tax Court upheld the disallowance of the deduction of marijuana-related expenses but allowed the portion of expenses relating to caregiving activities.

The taxpayer in this case was organized as a nonprofit public benefit corporation and charged its members a fee for reimbursement of its costs, including the marijuana. It operated a community center at approximately breakeven costs, but it didn't have federal tax-exempt status. The taxpayer showed through credible testimony and overall records that the caregiving activities were a substantially different and separate business from the medical marijuana treatment services. The organization's primary purpose was to provide caregiving services to its members, who were suffering from debilitating diseases; a secondary purpose was to provide and counsel them on the use of medical marijuana. In its decision, the Tax Court held that "§280E does not preclude petitioner from deducting expenses attributable to a trade or business other than that of illegal trafficking in controlled substances simply because petitioner also is involved in the trafficking in a controlled substance." The Court ordered an allocation of the organization's costs between the caregiving services that didn't involve marijuana, which would be deductible, and those expenses that did involve marijuana, which would be nondeductible. The Court recommended allocation based on usage, including number of personnel and square footage used in the activities.

Tax Considerations

Federal tax authorities don't support a patient's deducting the costs of treatment with marijuana as a medical expense, nor do they support the deduction of related business expenses for the medical provider. But there is some practical information to be drawn from *Californians* for the organizations that provide marijuana for medical purposes. Because the Tax Court allowed an allocation of costs within the operation of the medical service organization, providers should keep careful records that both substantiate their costs and purpose and allocate those costs between services that involve treatment with medical marijuana and those that don't.

In addition, it's also important to keep records and documentation concerning inventory and related cost of goods sold. The IRS originally disallowed the California group's offset for both deductions and cost of goods sold under IRC §280E, but it later conceded its determination except for the deductions. There's a legislative and judicial history of treating cost of goods sold as an offset in determining gross income rather than as an ordinary and necessary business expense deduction under IRC §162. Senate reports (S. Rept. 97-494 (Vol. 1) at 309 (1982)) discussing the scope of IRC §280E indicate that Congress wanted to avoid certain Constitutional challenges that could arise if it were to prohibit a taxpayer from recovering cost of goods sold:

"All deductions and credits for amounts paid or incurred in the illegal trafficking in drugs listed in the Controlled Substances Act are disallowed. To preclude possible challenges on Constitutional grounds, the adjustment to gross receipts with respect to effective costs of goods sold is not affected by this provision of the bill."

This legislative history is restated in the Court's opinion in *Californians.*

The federal government doesn't afford §501(c) status to medical marijuana dispensaries under public policy doctrine (Steve L. Gill, Damon M. Fleming, G.E. Whittenburg, "Medical Marijuana Tax Issues: Federal-State Law Conflict," *Practical Tax Strategies*, August 2010). The organization in *Californians* didn't have federal tax-exempt status, but it may have been engaged in some activities that qualified. An article in *Tax Management Estates, Gifts and Trusts Journal* suggests that, for federal purposes, qualifying organizations (1) establish an IRC §501(c)(3) charity to administer the traditional, charitable activities and a separate, noncharity to administer medical marijuana business services; (2) keep membership fees separated; and (3) pay taxes on the medical marijuana fees without any offsetting deductions ("Costs of Medical Marijuana Are Not Deductible Expenses," July 12, 2007). Based on the language in the Senate reports, organizations may also want to consider tracking the inventory costs of the marijuana product itself and reporting it as a cost of goods sold rather than as an ordinary business deduction. **SF**

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