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TAX LITIGATION ISSUES

Expert Analysis

Incriminating Expenses: Cannabis Legalization and the Fifth Amendment

By
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In recent years, more than half the states and the District of Columbia have adopted legislation either decriminalizing or legalizing cannabis, giving rise to numerous for-profit businesses. Congress, however, has not seen fit to join this movement toward liberalized controlled substance laws, which means that while growing and distributing cannabis is lawful in certain states, individuals engaged in such conduct remain subject to prosecution under federal laws.

Proponents frequently argue that legalization will, among other things, transform the cannabis industry into a legitimate, regulated business sector, thereby generating significant state tax revenues. However, under both the Obama Administration (which declined to enforce federal criminal laws banning the distribution of marijuana outside certain priority areas) and the Trump Administration (which has resumed general enforcement of those laws), the Internal Revenue Service has consistently applied a provision of the Internal Revenue Code that precludes the deductibility of expenses associated with operating an illegal drug trade. This conflict between state laws legalizing the cannabis industry and federal tax law precluding participants in that industry from deducting business expenses disadvantages cannabis businesses from a federal tax perspective, and has given rise to a series of cases exploring the Fifth Amendment implications of the disallowance of business deductions for state-sanctioned businesses.

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Evidentiary Burdens

In response to the Tax Court's decision in *Edmondson v. Commissioner*, 42 T.C.M. (CCH) 1553 (1981), which allowed a taxpayer to deduct expenses incurred in an illegal drug trade, Congress enacted §280E of the Internal Revenue Code, which disallows deductions for expenses incurred "in carrying on any trade or business if such trade or business… consists of trafficking in controlled substances."

In *Feinberg v. Commissioner*, 916 F.3d 1330 (10th Cir. 2019), shareholders of Total Health Concepts, LLC (THC), an S-Corporation licensed by the state of Colorado to operate two medical marijuana dispensaries, challenged deficiencies imposed after the IRS disallowed THC's business expenses under §280E. After the Tax Court rejected the taxpayers' in limine motion for a ruling that the IRS bore the burden of proving

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that §280E applies, THC's shareholders refused to answer the IRS's discovery requests, invoking their Fifth Amendment privilege against self-incrimination. The Tax Court rejected this assertion of the Fifth Amendment and, after the taxpayers unsuccessfully sought a writ of mandamus, ultimately avoided the issue by finding that the taxpayers had failed to substantiate the claimed expenses.

On appeal to the U.S. Court of Appeals for the Tenth Circuit, the parties agreed that the Tax Court's rationale was insufficient, but the court nonetheless affirmed on the separate basis that, in light of their assertion of the Fifth Amendment, the taxpayers had failed to demonstrate that §280E did not preclude their deduction of business expenses. In so holding, the court rejected the taxpayers' argument that the Tax Court's decision "placing the burden of proof on them to disprove their business is engaged in the trafficking of a controlled substance violates their Fifth Amendment right against self-incrimination." In reaching this conclusion, the Tenth Circuit distinguished a series of Supreme Court cases striking down regulations requiring individuals to disclose information related to their illegal activity, and quoted its earlier decision in *Alpenglow Botanicals v. United States*, 894 F.3d 1187, 1197 (2018), for the proposition that "deductions 'are matters of legislative grace…and Congress has unquestioned power to condition, limit, or deny deductions from gross income in arriving at the net which is to be taxed."

Thus, the court found that taxpayers faced with §280E disallowances could be required to choose between proving that they are not engaged in trafficking or simply foregoing the deduction. Relying on the Supreme Court's decision in *United States v. Rylander*, 460 U.S. 752 (1983), which held that a possible failure of proof on an issue where the defendant has the burden is not compulsion that requires the burden to be shifted to the government, the Tenth Circuit concluded that losing a deduction afforded through "legislative grace" is not sufficiently punitive to trigger Fifth Amendment privileges.

The Collective Entity Doctrine

One week after its decision in *Feinberg*, the Tenth Circuit decided *High Desert Relief, Inc. v. United States*, 917 F.3d 1170 (2019), which also addressed application of the Fifth Amendment where the IRS disallowed deductions under §280E. In *High Desert Relief*, the entity at issue (HDR) sought to quash summonses for business records contending, in part, that they had been "issued for an improper purpose—specifically, that the IRS in seeking to determine the applicability of [§280E], was mounting a de facto criminal investigation pursuant to the Controlled Substances Act."

Thus, HDR argued that §280E requires a determination of criminality; that the IRS lacks the authority to determine if a taxpayer's conduct violates the federal narcotics laws; and that to the extent Congress authorized the IRS to investigate narcotics violations, such an authorization would be legal only if the IRS were prohibited from sharing information with law enforcement or if the taxpayer were given immunity.

After rejecting the first two of these arguments, the court in *High Desert Relief* refused to consider the third, finding in part that the argument failed under the collective-entity doctrine, which holds that "an individual cannot rely upon the [Fifth Amendment] privilege to avoid producing the records of a collective entity which are in his possession, even if these records might incriminate him personally," see *Bellis v. United States*, 417 U.S. 85, 88 (1974). Thus, the court noted that HDR "is not a natural-person taxpayer and, consequently, has no Fifth Amendment privilege that it can properly invoke."

Of course, the collective-entity doctrine has broad application beyond the deductibility of business expenses under §280E. For example, in *United States v. Fridman*, 337 F. Supp. 3d 259 (S.D.N.Y. 2018), Judge Victor Marrero in the Southern District of New York concluded that trusts "held out to the world as being separate and apart from their beneficiaries," are collective entities with no Fifth Amendment privileges.

Marrero further concluded that not only did the trust lack any "act of production" privilege under the Fifth Amendment, but that a custodian of records can be compelled to provide oral testimony identifying or authenticating documents on behalf of the trust. Also last year, U.S. Court of Appeals for the Ninth Circuit followed a series of decisions

from other circuits applying the collective entity doctrine to small, closely-held entities, including single member LLCs, notwithstanding the risk that a jury would inevitably realize who produced the records. *See In re Twelve Grand Jury Subpoenas*, 908 F.3d 525 (9th Cir. 2018).

A 'Dead Letter' Exemption To §280E?

High Desert Relief was initiated before the Trump Justice Department resumed enforcement of the federal laws regarding marijuana, and the taxpayer in that case highlighted the inconsistency between the IRS's rejection of deductions under §280E and the Obama Administration's then-existing policy of declining to enforce the federal laws criminalizing the distribution of cannabis in arguing that §280E should not be enforced because the Justice Department's policy rendered it a "dead letter." Under the dead letter doctrine, while the IRS has disallowed business expenses where they "frustrate sharply defined national or state policies proscribing particular types of conduct," see *Commissioner v. Tellier*, 383 U.S. 687, 694 (1966), public policy disallowances should not be based on laws or policies that have become dead letters "in the sense that state authorities charged with their enforcement take no action on violations called to their attention," see *Boucher v. Comm'r*, 77 T.C. 214, 220 (1981); see also *Bondy v. Comm'r*, 62 T.C.M. (CCH) 1126 (1991); *Custis v. Comm'r*, 43 T.C.M. (CCH) 1511 (1982).

In rejecting HDR's dead letter argument, the Tenth Circuit principally relied on then-Attorney General Jeff Sessions' rescission of the Obama-era policy, but further cast doubt on the viability of a dead letter exception given what it perceived to be limited support in the case law (notwithstanding the Tax Court decisions, HDR appeared to have relied exclusively on a 1964 district court, *Sterling Distributors v. Patterson*, 236 F. Supp. 479 (N.D. Ala. 1964), addressing the provision of free beer as part of a promotional campaign).

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Although unavailing, the dead letter argument also creates a potential Fifth Amendment complication. In theory, if the criminal law in question were truly a dead letter and no longer a valid reason to fear prosecution, the taxpayer may well lack a reasonable fear of prosecution, thereby negating any basis to assert the privilege against self-incrimination. See, e.g., *United States v. Luck*, 852 F.3d 615, 629 (6th Cir. 2017). Although the Tenth Circuit did not address this point in any of its dispensary cases, a court could conclude that a defendant's use of the dead letter argument undermines his or her right to assert the privilege.

Conclusion

Legislation has been introduced precluding application of §280E to businesses engaged in the sale of marijuana that is lawful under state law. While such legislation, if passed, would moot the specific dispute that prompted the Tenth Circuit's decisions in *Feinberg* and *High Desert Relief*, those decisions will nevertheless remain important reminders of the limitations of the Fifth Amendment privilege in litigation over disputed deductions.

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