Appeal No. 19-73078

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

PATIENTS MUTUAL ASSISTANCE COLLECTIVE CORPORATION
D.B.A
HARBORSIDE HEALTH CENTER,

Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

On Appeal from the United States Tax Court

BRIEF OF AMICUS CURIAE NATIONAL CANNABIS INDUSTRY ASSOCIATION SUPPORTING APPELLANT IN FAVOR OF REVERSAL

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CORPORATE DISCLOSURE STATEMENT

Amicus Curiae National Cannabis Industry Association ("NCIA") is a non-profit trade association with the mission of advancing the legal and responsible cannabis industry. NCIA operates under § 501(c)(6) of the Internal Revenue Code. It has no parent corporation and, as it has no stock, no publicly held company owns 10% or more of its stock.

Date: June 2, 2020

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STATEMENT OF AMICUS CURIAE

Amicus Curiae National Cannabis Industry Association (NCIA) is a nonprofit and nonpartisan cannabis trade association founded in 2010. NCIA has nearly 2,000 member businesses. It works to protect the growth of a responsible and legitimate cannabis industry nationwide and for a favorable social, economic, and legal environment for the cannabis industry. Counsel for NCIA authored this brief in whole. No party or counsel for any party, or any other person other than amicus curiae and its counsel, contributed money to fund the preparation and submission of this brief. Counsel for all parties have consented to the filing of this amicus brief. *See* Fed. R. App. P. 29(a)(2) & Circuit Advisory Committee Note to Rule 29-3 (obtaining consent relieves the Court of the need to consider a motion).

INTRODUCTION AND SUMMARY OF ARGUMENT

The sale of medical and recreational marijuana is legal in California. It operates in a highly regulated market that the State carefully administers. This market—like other lawful markets—produces substantial economic benefits through tax revenue for the State, as well as job creation and myriad other positives. It also provides critical benefits to the people of California: it is no longer subject to

credible dispute that for patients suffering from certain ailments, medical marijuana provides health benefits, too. The State and the medical community concur as to these therapeutic effects.

In deference to the sound policy choice by California and other states to allow legalized marijuana, Congress forbids the Department of Justice from undertaking any federal criminal enforcement action against operators in the legal medical marijuana market. Yet, when it comes time to issue tax bills, the Commissioner of the Internal Revenue Service treats the businesses in this lawful industry no differently than common criminals.

Legal marijuana businesses are treated as criminal enterprises by the IRS through the imposition 26 U.S.C. § 280E. Section 280E is a decades-old provision of the tax code, passed during the height of the Reagan administration's "war on drugs," intended to punish criminal drug operators by stripping their ability to claim deductions on their tax returns. So, while ordinary businesses can deduct expenses such as rent, wages, taxes, and license payments, under § 280E lawful state marijuana dispensaries are taxed by the IRS on revenue *before* accounting for those expenses. This provision has the effect of subjecting State-sanctioned

marijuana businesses—like Appellant Harborside Health Center ("Harborside")—to unprecedentedly high effective tax rates of up to 75%.

The tax burden lawful marijuana operators suffer through the IRS' imposition of §280E is so severe, that many commentators identify punitive taxation under § 280E as the single biggest threat to the industry. If legal marijuana is taxed out of existence, one inevitable consequence is an expansion of the illegal market. And the illegal marijuana market, which operates unregulated, does not produce the same public benefits as does the lawful market. Its purveyors are unconcerned with safety, selling tainted goods that injure or sometimes even kill those who use them. Moreover, the illegal market does not generate the economic gains that the lawfully operated market does.

Given the harsh effects of § 280E, it then comes as no surprise that as applied to lawful marijuana businesses in California and elsewhere, the statute offends Constitutional restraints intended to prevent the U.S. Government from abusing its taxing powers. Section 280E violates the Sixteenth Amendment because by treating expenses like rent and wages as a form of income, it reaches beyond the Sixteenth Amendment's prohibition on taxing "income" that does not represent gain. Section 280E

violates the Eighth Amendment's Excessive Fines Clause as well. It has both hallmarks of an excessive fine: It is intended to be (and is) punitive, and the punishment it imposes is "grossly disproportional to the gravity of" the underlying offense. When it comes to legal marijuana sales, there is no "offense" at all, so §280E is, in effect, *per se* disproportionally harsh.

For all these reasons, NCIA urges this Court to vacate the decision below and hold that § 280E violates the Sixteenth and Eighth Amendments. This Court should do so now to halt § 280E's stifling effects and its accompanying incentivizing of the illegal marijuana market.

ARGUMENT

I. Legalized Medical Marijuana Yields Substantial Public Health and Economic Benefits

Since the passage of the California Compassionate Use Act ("CCUA") of 1996, California has permitted the lawful sale of medical marijuana. *See* Cal. Health & Safety Code § 11362.5(b)(1)(A) (West 2007). The CCUA exempts State-regulated dispensaries like those operated by Harborside from California criminal laws that otherwise penalize possession or cultivation of marijuana. *Id.* § 11362.5(d). California expanded the scope of lawful marijuana sales in 2016, when voters passed a further ballot measure, Proposition 64, permitting

recreational users access to marijuana through state-licensed facilities. *See* Cal. Health & Safety Code § 11362.1.

California's trailblazing approach to legalization has led to widespread adoption of similar laws. Thirty-nine states and the District of Columbia permit patients to use marijuana for medicinal purposes; many jurisdictions have also legalized recreational use as well. *See, e.g.*, Alaska Stat. Ann. §§ 17.37.010–17.37.080 (2014); A.R.S. §§ 36-2801–36-2819 (2014) (Arizona); Fla. Stat. § 381.986 (2016) (Florida); Haw.R.S. §§ 329-121–329-128 (2012) (Hawaii); La. Rev. Stat. § 40:1046 (2015) (Louisiana); Mont. Code Ann. §§ 50-46-301–50-46-345 (2018) (Montana); Wash. Rev. Code §§ 69.51A.005–69.51A.900 (2013) (Washington).

The public overwhelmingly supports marijuana laws like those in California. Recent polling reveals that 93% of Americans favor legalizing medical marijuana for public use, and 63% support legalization for nonmedical use. Quinnipiac Univ. Poll, *U.S. Voters Believe Comey More than Trump, Quinnipiac University National Poll Finds; Support for Marijuana Hits New High* 2 (Apr. 26, 2018), *available at* https://poll.qu.edu/images/polling/us/us04262018_ufcq23.pdf.

Public support for such measures is warranted, as lawful, regulated regimes like California's provide considerable societal benefits.

Legalized medical marijuana has a measurably positive effect on public health. The CCUA was premised on a finding that medical marijuana provides relief to patients suffering from "cancer, anorexia, AIDS, chronic pain, spasticity, glaucoma, arthritis, [and] migraine[s]." Cal. Health & Safety Code § 11362.5(a)(b)(1)(A). Californians were right. As this Court observed in 2002, "[a] surprising number of health care professionals and organizations have concluded that the use of marijuana may be appropriate for a small class of patients who do not respond well to, or do not tolerate, available prescription drugs." *Conant v. Walters*, 309 F.3d 629, 640–41 (9th Cir. 2002). Dozens of medical studies confirm the therapeutic benefits of medical marijuana, especially as a treatment for chronic pain.[1]

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[1] *See, e.g.*, Kevin P. Hill, *Medical Marijuana for Treatment of Chronic Pain and Other Medical and Psychiatric Problems: A Clinical Review*, 313 JAMA, 2474–83 (2015); Kevin H. Boehnke et al., *Medical Cannabis Use Is Associated with Decreased Opiate Medication Use in a Retrospective Cross-Sectional Survey of Patients with Chronic Pain*, 17 J Pain 1–6 (2016), *available at* https://www.omofmedicine.org/wp-content/uploads/2018/05/um-om-pain-study.pdf; Gemayel Lee et al., *Medical Cannabis for Neuropathic Pain*, 22 Current Pain & Headache Rep. 8 (2018) ("Nearly 20 years of clinical data supports the short-term

In continuing recognition of the important medicinal benefits marijuana offers, California recently classified licensed cannabis sales facilities as an "essential business" exempt from statewide restrictions implemented by the Governor in response to the COVID-19 pandemic. *See* Bureau of Cannabis Control, "Notice Regarding COVID-19 And Commercial Cannabis Business" (Mar 21, 2020) ("Because *cannabis is an essential medicine for many residents*, licensees may continue to operate at this time . . . .") (emphasis added), *available at* https://cannabis.ca.gov/2020/03/21/notice-regarding-covid-19-and-commercial-cannabis-businesses/.

Legalized marijuana generates substantial economic benefits as well. State-level taxation of marijuana has resulted in a massive influx

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use of cannabis for the treatment of neuropathic pain."); Office of the Surgeon Gen., U.S. Dep't of Health & Human Servs., Facing Addiction in America: The Surgeon General's Report on Alcohol, Drugs, and Health 1–21 (2016) ("There is a growing body of research suggesting the potential therapeutic value of marijuana's constituent cannabinoid chemicals in numerous health conditions including pain, nausea, epilepsy, obesity, wasting disease, addiction, autoimmune disorders, and other conditions."); Marcus A. Bachhuber et al., *Medical Cannabis Laws and Opioid Analgesic Overdose Mortality in the United States, 1999-2010*, 174 JAMA Internal Med. 1668 (2014) (reporting a substantially lower rate of opioid-related deaths in states that have legalized medical marijuana).

of revenue for California. In 2018, California brought in over $345 million in revenue from the cannabis industry, through excise, sales, and cultivation taxes. BDS Analytics, *California: Lessons from the World's Largest Cannabis Market*, at 24 (Aug. 2019) (hereinafter "BDS Analytics"). And these numbers continue to grow. "In December 2019, it was reported that since January 2018, California's cannabis sales had generated 411.3 million in excise tax, $98.9 million in cultivation tax, and $335.1 million in sales tax." Ethan Xavier et al., *Impact of Marijuana (Cannabis) on Health, Safety and Economy*, 5 IDOSR Journal of Experimental Sciences 45–46 (2020); *see also* George Theofanis, *The Golden State's 'High' Expectations: Will California Realize the Fiscal Benefits of Cannabis Legalization?*, 49 U. Pac. L. Rev 155, 179–80 (2017) (summarizing studies projecting as much as $1 billion annually in increased tax revenues, and tens of thousands of jobs created).

II. Unregulated and Unlawful Marijuana Sales Create Public Health Risks and Impose Economic Costs

Of course, neither the public health nor economic benefits of legalized marijuana accrue in the unregulated illegal market.

Unlawful marijuana products are associated with affirmatively harmful effects on public health. Recent government analyses revealed

that, as of February 18, 2020, illicit marijuana products tied to impurities in vaping products injured nearly 3,000 Americans and resulted in sixty-eight deaths. *See* Centers for Disease Control and Prevention, *Outbreak of Lung Injury Associated with the Use of E-Cigarette, or Vaping, Products* (Feb. 25, 2020). These impurities were not present in cartridges sold by legitimate marijuana dispensaries. Erika Edwards, *Vaping Illness 'Breakthrough' Points to Vitamin E Oil as a Cause, CDC Says*, NBCNews.com, NBCUniversal News Group (Nov. 8, 2019).

The Governor of California noted that these injuries and deaths were caused by "illegally-obtained and produced cannabis products." *See* Cal. Exec. Order No. N-18-19 (Sept. 16, 2019). The Centers for Disease Control found that the impurities were roughly nine times more likely to come from "informal sources such as a dealer, off the street or from a friend" than from their legal equivalents. Press Briefing Transcript, Centers for Disease Control and Prevention (Nov. 8, 2019), https://www.cdc.gov/media/releases/2019/t1108-telebriefing-vaping.html.

Moreover, illegal marijuana is often trafficked through complex networks of international criminal organizations. *See* Matthew A.

Christiansen, *A Great Schism: Social Norms and Marijuana Prohibition*, 4 Harv. L. & Pol'y Rev. 229, 237 (2010). Those drug cartels often compete over territory and market share, resulting in violence and crime in the United States and in neighboring countries. *Id.*

Legalized marijuana, by contrast, does not cause these harms because it is tightly regulated and carefully administered. The California Bureau of Cannabis Control regulates medicinal and nonmedicinal marijuana at every stage, including cultivation, distribution, transportation, storage, processing, and sale of cannabis for adult use. *See* Cal. Bus. & Prof. Code §§ 26000–26231.2. Under these regulations, state laboratories test samples for potency, moisture content, residual pesticides, foreign materials, and harmful microbes. *See* Cal. Code Regs. tit. 16, § 5715 (testing procedures). The state has also promulgated regulations governing packaging, quantity limits, and hours that retailers may operate. *See, e.g.*, Cal. Code Regs. tit. 16, § 5409 (quantity and potency limits); Cal. Bus. & Prof. Code § 26070.1 (packaging requirement); Cal. Code Regs. tit. 16, § 5403 (hours limitations).

The unregulated illegal marijuana market also fails to produce the economic benefits that legal sales generate. Put simply, illegal marijuana

sales do not generate a thin dime of tax revenue. And the government misses out on a lot of dimes when sales are channeled to the illegal market. Recent estimates are that illicit sales of marijuana in California in 2019 reached $8.7 billion. BDS Analytics at 6. So, when tax policies are so severe that they penalize the lawful market, it is the illicit market that stands to gain, and the State that stands to lose. *Id.* at 10 ("Tax rates may or may not affect consumer behavior in general, but they certainly do when they are set at high levels on a product widely available through an established illicit pipeline.").

California's recreational market provides an example of this phenomenon. Total volume of legal marijuana sales actually declined in California in 2018, the first year in which recreational sales were permitted. Geoff Lawrence & Spence Purnell, *Marijuana Taxation & Black Market Crowd-Out* 9 (Jan. 2020), https://reason.org/wp-content/uploads/marijuana-taxation-black-market-crowd-out.pdf. [T]otal legal sales amounted to around $3 billion in 2017 when only medical marijuana was permitted, but fell to $2.5 billion in 2018." *Id.* As a result, the State generated significantly less tax revenue than anticipated in 2018, and the Governor reduced his revenue forecasts for FY2019 and

FY2020. *Id.* This disappointing first-year performance was attributed, in part, to sky-high federal income taxes caused by § 280E's application. *Id.* at 12 (result of § 280E "is that marijuana businesses are taxed federally on amounts far in excess of their net income.").

III. The IRS Uses § 280E of the Tax Code To Punish Lawful Marijuana Businesses

The federal government has, in substantial part, deferred to state-level decisions to decriminalize marijuana. While marijuana remains a controlled substance under federal law, for states where medical marijuana is legal Congress has commanded the Department of Justice not to enforce federal criminal statutes that may sweep in legal medical use. *See United States v. McIntosh*, 833 F.3d 1163 (9th Cir. 2016). Between 2014 and 2019, Congress passed a series of appropriations riders that prevent DOJ from using any funds to prevent states "from implementing their own State laws that authorize the use, distribution, possession, or cultivation of medical marijuana." Consolidated and Further Continuing Appropriations Act, 2015, Pub. L. No. 113-235, § 538, 128 Stat. 2130, 2217 (2014); *see also* Consolidated Appropriations Act, 2018, § 538 132 Stat. 348, 444 (2018) (extending § 538 through September

30, 2018). The current version of the rider is effective through September 30, 2020.

Despite these plain, recent, and ongoing federal acknowledgments of the non-criminal status of state-level medical marijuana sales, the IRS has seized on a thirty-eight-year-old provision in the tax code enacted to curb criminal conduct—§ 280E—to treat lawful marijuana dispensaries like Harborside as though they were illegal businesses. 26 U.S.C. § 280E.

Congress passed § 280E in 1982 in the wake of a widely criticized tax court decision that policy-makers believed allowed drug dealers to improperly claim business deductions. *See Edmonson v. Comm'r of Internal Rev.*, 42 T.C.M. (CCH) 1533 (1981). Section 280E provides that:

> 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.

26 U.S.C. § 280E.

So, while ordinary businesses can deduct business expenses such as rent, wages, taxes, and license payments, under § 280E lawful state marijuana dispensaries like Harborside are taxed by the IRS on revenue

before accounting for those expenses. For example, Harborside reported total income of $4,034,529 in 2008 (gross receipts of $12,443,674 minus $8,409,505 in costs of goods sold). Harborside deducted $3,964,097 from its total income for expenses like salaries and wages ($2,135,078), compensation of officers ($519,764), rents ($283,301), and taxes / licenses ($46,663), ultimately reporting a taxable income of $70,492. ER 294. Because Harborside could not have operated without paying its employees and officers, rent, and taxes, its $4,034,529 in total income does not represent what Harborside gained in 2008. Nevertheless, the IRS seeks to tax Harborside on the pre-deduction number (developed post-audit).

The punitive tax treatment sets Harborside apart from other lawful businesses, which are entitled to deduct costs like wages, rents, and taxes before reporting taxable income. Section 162 of the Tax Code permits all businesses to deduct "trade or business expenses," which includes: "a reasonable allowance for salaries or other compensation for personal services actually rendered," traveling expenses, and "rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the

taxpayer has not taken or is not taking title or in which he has no equity." 26 U.S.C. § 162(a). So, Congress considers salaries, travel expenses, and rentals necessary for carrying on a business, but denies those deductions to legal marijuana dispensaries like Harborside under § 280E.

The federal government thus operates an untenable and inconsistent policy under which federal criminal prosecutorial authorities *do not punish* lawful medical marijuana sales, but federal tax authorities *do punish them* as though it were criminal. Benjamin Moses Leff, *Tax Planning for Marijuana Dealers*, 99 Iowa L. Rev. 523, 526 (2014). This scheme results in taxation of marijuana businesses in California and around the country at an effective rate of between 40 and 75%. Tom Huddleston, Jr., *The Marijuana Industry's Battle Against the IRS*, Fortune (Apr. 15, 2015), http://fortune.com/2015/04/15/marijuana-industry-tax-problem/; Steve Hargreaves, *Marijuana Dealers Get Slammed by Taxes*, CNN Money (Feb. 25, 2013), http://money.cnn.com/2013/02/25/smallbusiness/marijuana-tax/ (estimating up to 75% tax rate).

This is more than double the average effective tax rate imposed on lawful business. Bill Greenberg & Rebecca Greenberg, *26 USC Section*

280E: Will the Dragon Now Be Slayed?, 25 J.L. & Pol'y 549, 550 (2017) (government taxes cannabis and cannabis-based businesses "at a rate of 70 percent or more, compared to an average business's tax rate of 30 percent"); *see also* Julie Pack, *Powerless to Penalize: Why Congress Lacks the Power to Penalize Marijuana Businesses Through § 280E of the Internal Revenue Code*, 59 Ariz. L. Rev. 1081, 1085 (2017) ("Because of § 280E's application, state-authorized marijuana businesses on paper pay a tax rate between 30 and 40%, but in reality pay closer to a 70, 80, or even 90% rate by some estimates."). As one commentator noted: "Section 280E of the Internal Revenue Code makes the running of a marijuana business nearly impossible." Sam Kamin, *The Limits of Marijuana Legalization in the States*, 99 Iowa L. Rev. Bull. 39, 43 (2014).

Meanwhile participants in the illegal market, so long as they evade criminal prosecution, operate free from any tax burden whatsoever. Jeremy P. Gove, *Colorado and Washington Got Too High: The Argument for Lower Recreational Marijuana Excise Taxes*, 19 Rich. J.L. & Pub. Int. 67, 89 (2016) (noting the "discrepancy between taxed legal marijuana and the untaxed illegally obtained marijuana").

IV. Punitive Taxation of the Marijuana Industry Encourages an Expansion of the Illegal Market

Given the backbreaking tax burden that § 280E imposes, legal marijuana business operators are justifiably concerned that the IRS' insistence on 280E's application to lawful state-level marijuana sales will eventually tax the industry into oblivion. Leff, 99 Iowa L. Rev. at 526 ("Now that [§ 280E] applies to state-sanctioned marijuana sellers as well as illegal drug dealers, it creates a federal tax situation that some believe may drive legitimate marijuana sellers out of business."). Thus, the lawful cannabis industry has long considered excessive federal taxation, specifically § 280E, to be the largest obstacle to survival of the lawful marijuana market. Marijuana Business Daily, "Marijuana Business Conference Wrapup: 36 Tips, Lessons & Takeaways for the Cannabis Industry," (Nov. 15, 2012) ("The federal tax situation is the *biggest threat to [legal marijuana] businesses and could push the entire industry underground*.") (emphasis added).

This tax burden has consequences that extend beyond the constricting effects on the legal market. Commentators fear that if lawful marijuana businesses are forced to operate under this punitive tax scheme, many may make the economically rational decision to abandon

it. If that happens, the result will be an increase in the size of the illegal marijuana market. Daniel Rowe, *Harmonizing Federal Tax Law and the State Legalization of Marijuana*, 51 Loy. LA L. Rev. 291, 315 (2018) ("[T]he inability of legal marijuana businesses to stay in business because of the onerous tax burden could undermine public policy preferences for safe, regulated marijuana and affordable access to medicine."); Kamin, 99 Iowa L. Rev. Bull. at 43 ("[M]arijuana practitioners are disadvantaged not just vis-à-vis other legitimate businesspersons but also vis-à-vis those involved in other, more serious, criminal conduct."); Lawrence, et al., *Marijuana Taxation & Black Market Crowd-Out*, at 11 ("Given the lower cost and greater availability of unlicensed marijuana in California, many consumers have simply chosen to stick with this alternative.").

And the data suggests that these fears of an increasing illegal market are well-founded. In California in 2019, illicit spending on marijuana was $8.7 billion—roughly two-and-a-half times the $3.1 billion spent on lawful sales. BDS Analytics at 6.

V. Section 280E Violates the Sixteenth Amendment Because It Taxes More Than Income

The federal strategy for taxing legal medical marijuana dispensaries means that these businesses are taxed on amounts far in

excess of their net income. Harborside is a good example: The IRS denied it any deductions for the relevant taxable years—including those for necessary business expenses like rent, salaries, and benefits—which means it paid income taxes on income it never realized. This strategy is based on an overreaching and expansive interpretation of § 280E, which was never intended to reach lawful businesses like Harborside. This highly aggressive tax scheme, unmoored from consideration of the businesses' actual income, violates Congress' carefully delimited powers to tax only "income" under the Sixteenth Amendment.

The Sixteenth Amendment allows Congress to tax income, or gain. But by using § 280E to deny *all* deductions, without considering which deductions are "necessary as a matter of actual fact" to the taxpayer's business, *Davis v. United States*, 87 F.2d 323, 324 (2d Cir. 1937), Congress taxes more than gain. That is unconstitutional.

A. "Income" in the Sixteenth Amendment means "gain."

The Sixteenth Amendment says: "The Congress shall have the power to lay and collect taxes on income, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. Const. Amend. XVI. It creates an

exception to the rule that Congress may not levy direct taxes (like income taxes) without apportionment among the states. U.S. Const. Art. I, § 2.[2] But that exception is narrow: It permits Congress to levy a direct tax only on *income*. So, what is income?

Income is gain, or something that contributes to wealth. Early interpretations of the Sixteenth Amendment confirm this. In *Eisner v. Macomber*, 252 U.S. 189 (1920), for example, the Court defined income in the Sixteenth Amendment as "the *gain* derived from capital, from labor, or from both combined." *Id.* at 207 (quoting *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179, 185 (1918)) (emphasis added); *Bowers v. Kerbaugh-Empire, Co.*, 271 U.S. 170, 174 (1926) (collecting cases applying rule that income equals gain).

[2] Apportionment means that each state must pay an amount of direct taxes relative to its proportion of the U.S. population. So, if states A and B have a similar population, they must pay a similar amount in aggregate income taxes to the federal government. This works if the per capita income in both states is the same. But say the per capita income in state A is much higher than in state B—the individuals in state B must pay a higher proportion of their income to taxes than those in state A. Erik M. Jensen, *The Taxing Power, the Sixteenth Amendment, and the Meaning of "Incomes"*, 33 Ariz. St. L.J. 1057, 1067 (2001). This type of taxation is as politically untenable as it sounds.

Precisely defining income was important to the *Eisner* Court (and is important now) because the Sixteenth Amendment "did not extend the taxing power to new subjects, but merely removed the necessity which otherwise might exist for an apportionment among the states of taxes laid on income." *Eisner*, 252 U.S. at 206. Therefore, reasoned the Court, "it becomes essential to distinguish between what is and what is not 'income,'" as only an unapportioned direct tax on income is constitutional. *Id. see also id.* at 219 (holding that unapportioned tax on stock dividend was unconstitutional under the Sixteenth Amendment).

In the same vein, binding case law holds that Congress can't constitutionally tax a loss. *See Bowers*, 271 U.S. at 175. The taxpayer in *Bowers* borrowed money from a German bank in German marks (converted to U.S. dollars) for various stateside construction projects. *Id.* at 172. Its projects weren't successful, and it suffered losses in the relevant taxable years. But, when it finally paid back its loans, "the difference between the value of the marks borrowed at the time the loans were made and the amount paid to the Custodian was" more than half a million dollars. *Id.* at 173. The Commissioner taxed this amount as income. The Supreme Court invalidated this tax under the Sixteenth

Amendment. Because the taxpayer ultimately suffered a loss, the Commissioner could not tax the increased value of the loans as income. *Id.* at 175.

So, "income" as used in the Sixteenth Amendment means "gain," and a tax on something beyond gain (such as a loss) is unconstitutional unless apportioned.

B. Gain is gross receipts minus COGS *and* necessary business expenses.

The Commissioner found, and the parties agree, that costs of goods sold (COGS) must be subtracted from gross receipts in order to ascertain "income." *See Alpenglow Botanicals, LLC v. United States*, 894 F.3d 1187, 1199 (11th Cir. 2018); *see also Max Sobel Wholesale Liquors v. Comm'r of Internal Rev.*, 630 F.2d 670, 671 (9th Cir. 1980). But *Alpenglow* and *Max Sobel* don't go far enough. To truly ascertain income, the Commissioner must account for expenses—in addition to COGS—without which the business could not operate. So, income is equal to gross receipts minus COGS *and* necessary business expenses.

The Second Circuit explained the importance of necessary business expenses in *Davis v. United States*, 87 F.2d 323 (2d Cir. 1937). It described our system of income taxation as providing a method for

computing income "whereby all receipts during the taxable period which are defined as gross income are gathered together and from that total are taken certain necessary items like" COGS; "ordinary and necessary expenses incurred in getting the so-called gross income; depreciation, depletion, and the like in order to reduce the amount computed as gross income to what is in fact income under the rule of *Eisner v. Macomber* . . . , and so lawfully taxable as such." *Id.* at 324.

It distinguished between deductions that are a matter of legislative "grace" and deductions that are necessary in order to determine what the taxpayer actually gained: "While such subtractions are called deductions . . . they are not to be confused with deductions of another sort like personal exemptions; deductions for taxes paid; losses sustained in unrelated transactions and other like privileges which Congress has seen fit to accord to income taxpayers under classifications it has established." *Id.* at 324–25. The first kind of deductions (i.e., "ordinary and necessary expenses incurred in getting the so-called gross income") are "inherently necessary as a matter of computation to arrive at income, the second may be allowed or not in the sound discretion of Congress . . . ." *Id.*

Deductions are said to be a matter of "legislative grace," but even if that's true, Congress is still bound by the Sixteenth Amendment's rule that the only unapportioned direct tax it may impose is a direct tax on income. U.S. Const. Amend. XVI; *Edwards v. Cuba R. Co.*, 268 U.S. 628, 631 (1925). In other words, Congress may not use its "legislative grace" to structure the tax code such that it taxes (without apportionment) something more than gain. More to the point, "section 280E does not prompt a question as to the constitutionality of 'disallowing a deduction.'" *N. Cal. Small Bus. Assistants Inc. v. Comm'r of Internal Rev.*, 153 T.C. 65, *14 (2019) (Gustafson, dissenting-in-part). When applied, § 280E allows "[*n*]*o* deduction[s]." 26 U.S.C. § 280E. "The result of section 280E is that the determination of the supposed 'income tax' liability of a taxpayer trafficking in illegal drugs bypasses altogether any inquiry as to his gain." *N. Cal. Small Bus. Assistants*, 153 T.C. 65 at *13 (Gustafson, dissenting-in-part). That's exactly what happened here.

C. The Commissioner violated the Sixteenth Amendment by using Section 280E to tax more than gain.

Relying on § 280E, the Commissioner taxed Harborside's gross receipts minus COGS without accounting for necessary business

expenses like salaries, rent, licenses, and other necessary costs of operating a business.[3]

In 2008, for example, the Commissioner found in its notice of deficiency that Harborside had a taxable income of $4,136,255. Harborside reported gross receipts for that year of $12,443,674, out of which it subtracted $8,409,505 in costs of goods sold, resulting in a top-of-the line total income of $4,034,529. ER 294. Harborside then deducted from its total income the necessary costs of doing business, including compensation of officers ($519,764), salaries and wages ($2,135,078), rents ($283,301), and taxes and licenses ($46,663). *Id.* It added to that deductions for charitable contributions, interest, advertising, and others to arrive at a taxable income before net operating loss deduction of $297,811. *Id.* After a net operating loss deduction, it reported taxable income as $70,492, on which it paid $12,623 in federal income taxes. *Id.* But the Commissioner considered all of Harborside's deductions—even those for necessary business expenses like rent—invalid under § 280E.

[3] The Commissioner also took an excessively narrow view of COGS, allowing Harborside to exempt only the *direct* costs of acquiring its inventory. This issue is addressed in Harborside's principal brief.

Therefore, it seeks to tax Harborside's pre-deduction income even though that doesn't reflect what Harborside actually gained in the taxable year.

But, as the Second Circuit reasoned in *Davis*, accounting for *some* deductions is necessary in order to determine "income" under the Sixteenth Amendment. 87 F.2d at 324; *see also Eisner*, 252 U.S. at 207 (income is "the *gain* derived from capital, from labor, or from both combined."). And that makes sense. Harborside could not have operated in 2008 without paying rent, paying its employees, and paying licenses. The money Harborside put to these necessary business expenses is therefore not income because it was not gained by Harborside during the taxable year; rather, it was spent on items necessary to keep the door open. *Bowers*, 271 U.S. at 175 (Commissioner may not tax money lost during the tax period). Layering on that the Commissioner's extremely narrow view of COGS—as encompassing only the direct cost of purchasing inventory—means that Harborside will pay federal income taxes on income it never actually earned. This violates the Sixteenth Amendment.

Harborside is not alone. The Commissioner uses § 280E to tax an entire legal industry—one that generates billions of dollars in tax

revenue, along with myriad other benefits—on income never realized. As used by the Commissioner, § 280E means a marijuana dispensary may not deduct the cost of employee compensation, utilities, legal, and accounting, even though the grocery store down the road regularly deducts these and other "ordinary and necessary" business expenses under § 162. "The result is that marijuana businesses are taxed federally on amounts far in excess of their net income." Lawrence et al., *Marijuana Taxation and Black Market Crowd-Out*, at 12. And to be clear, this is not a California-specific problem. Thirty-nine states have legalized medical marijuana, and many jurisdictions have legalized recreational use as well. Every legal marijuana business in each of these states toils under the oppressive cloak of § 280E. This punitive, widely applicable scheme is entirely out-of-step with how the Sixteenth Amendment framers viewed Congress's limited power to tax income. It cannot stand.

VI. Section 280E Violates the Eighth Amendment's Excessive Fines Clause

The (quite intentional) punitive effect of § 280E also gives rise to a separate constitutional violation: It offends the Eighth Amendment's Excessive Fines Clause, U.S. Const. Amend VIII, a provision enacted to

"guard[] against abuses of the government's punitive or law-enforcement authority." *Timbs v. Indiana*, 139 S.Ct. 682, 686–87 (2019).

As an initial matter, this Court has yet to decide whether the Excessive Fines Clause applies to corporations such as the Appellant Harborside. Although some Constitutional protections only apply to natural persons, many apply to corporations as well. *Hale v. Henkel*, 201 U.S. 43, 76 (1906), *overruled in part by Murphy v. Waterfront Comm'n of New York Harbor*, 378 U.S. 52 (1964); *see also*, *e.g.*, *Gulf, C. & S.F. Ry. Co. v. Ellis*, 165 U.S. 150, 154 (1897) ("It is well settled that corporations are persons within the provisions of the fourteenth amendment of the constitution of the United States."); *Citizens United v. Fed. Election Comm'n*, 558 U.S. 310, 342–43 (2010) (First Amendment).

Whether a particular Constitutional provision applies to corporations turns on "the nature, history, and purpose" of that provision. *First Nat. Bank of Bos. v. Bellotti*, 435 U.S. 765, 778 n.14 (1978). Here, the Excessive Fines Clause contains no textual limitation that would restrict its reach to natural persons. *See* U.S. Const. amend. VIII. Nor does the provision's purpose—"to prevent the government from abusing its power to punish," *Austin v. United States*, 509 U.S. 602, 607 (1993)—

imply any limitation to natural persons. *S. Union Co. v. United States*, 567 U.S. 343, 349 (2012). *See also Browning-Ferris Indus. of Vermont, Inc. v. Kelco Disposal, Inc.*, 492 U.S. 257, 285 (1989) (O'Connor, J., concurring in part and dissenting in part) ("The payment of monetary penalties . . . is something that a corporation can do as an entity . . ."). Because corporations cannot be imprisoned, fines are often the preferred method for imposing punishment. *Colorado Dep't of Labor & Emp't v. Dami Hosp., LLC*, 442 P.3d 94, 100 (Colo. 2019), *cert. denied sub nom. Colorado Dep't of Labor & Emp't, Div. of Workers' Comp. v. Dami Hosp., LLC*, No. 19-641, 2020 WL 129638 (U.S. Jan. 13, 2020) ("[T]he government regularly imposes a wide array of monetary penalties, both civil and criminal, on corporations for the purposes of punishing corporate misconduct and regulatory violations.").

Accordingly, several courts have applied the Eighth Amendment's protections against excessively punitive fines to fines imposed on corporations. *See*, *e.g.*, *Dami Hosp., LLC*, 442 P.3d at 100; *United States v. Seher*, 686 F. Supp. 2d 1323, 1327 (N.D. Ga. 2010), *aff'd sub nom. United States v. Chaplin's, Inc.*, 646 F.3d 846 (11th Cir. 2011) (same); *United States v. Advance Tool Co.*, 902 F. Supp. 1011, 1018 (W.D. Mo.

1995), *aff'd*, 86 F.3d 1159 (8th Cir. 1996) (same). The Eighth Amendment's text and purpose counsel this Court to do the same here.

Because Harborside's status as a corporation does not deprive it of the Excessive Fines Clause's protection, § 280E can only be upheld if it passes constitutional review.

To determine whether a law violates the Excessive Fines Clause, the court first considers whether the exaction at issue is a punishment or penalty; if so, it is considered a "fine" within the meaning of the Clause. *See Austin*, 509 U.S. at 609–10.

Next, if the fine is "excessive" it must be struck down. *United States v. Bajakajian*, 524 U.S. 321, 334 (1998). Excessiveness is determined by examining whether the fine is "grossly disproportional to the gravity of [the] offense." *Id.* at 334. In the Ninth Circuit, that inquiry is guided by consideration of: "(1) the nature and extent of the crime, (2) whether the violation was related to other illegal activities, (3) the other penalties that may be imposed for the violation, and (4) the extent of the harm caused." *United States v. $100,348.00 in United States Currency*, 354 F.3d 1110, 1122 (9th Cir. 2004).

Section 280E does not survive review under these standards.

First, § 280E is plainly meant as a punishment or penalty and therefore operates as a "fine" under the Excessive Fines Clause. Congress passed § 280E in response to the Tax Court's opinion in *Edmonson v. Commissioner*, which held that drug dealers—operating illegally under both state and federal law—could deduct business expenses in calculating federal income taxes. 42 T.C.M. (CCH) 1533. Congress intended § 280E to punish drug dealers like Edmonson, noting its passage was meant to enable a "sharply defined public policy against drug dealing." S. Rep. No. 97-494, at 309. Congress explained: "To allow drug dealers the benefit of business expenses 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." *Id.* Section 280E is therefore a penalty and so considered a "fine" within the meaning of the Excessive Fines Clause.

Nor does § 280E's classification within the tax code change its character as a penalty. The label affixed to government-mandated payments does not determine whether those payments are unconstitutional penalties. *Nat'l Fed'n of Indep. Bus. v. Sebelius*, 132 S. Ct. 2566, 2583 (2012). "Congress may not, for example, expand its power

under the Taxing Clause, or escape the Double Jeopardy Clause's constraint on criminal sanctions, by labeling a severe financial punishment a 'tax.'" *Id.*; *see also United States v. Constantine*, 296 U.S. 287, 294 (1935) ("If [an exaction is] in reality a penalty it cannot be converted into a tax by so naming it, * * * and we must ascribe to it the character disclosed by its purpose and operation, regardless of name."). Because § 280E is punitive in nature, calling it a "tax" does not shield it from the strictures of the Excessive Fines Clause. *Bailey v. Drexel Furniture Co.*, 259 U.S. 20, 38 (1922) ("[T]here comes a time in the extension of the penalizing features of the so-called tax when it loses its character as such and becomes a mere penalty, with the characteristics of regulation and punishment.").

Second, each factor of the disproportionality inquiry reveals that—at least as applied to marijuana businesses like Harborside operating lawfully under state law—the fine imposed by § 280E is "grossly disproportionat[e]" to the gravity of the underlying offense. As to "the nature and extent of the crime," Harborside's activities did not constitute a crime at all as a function of state law. *$100,348.00 in United States Currency*, 354 F.3d at 1121-2; Cal. Health & Safety Code

§ 11362.5(b)(1)(A). And Congress has ensured that the Department of Justice cannot treat Harborside's conduct as criminal either. Consolidated Appropriations Act, 2018, § 538 (2018). Nor was Harborside's conduct "related to other illegal activities." *$100,348.00 in United States Currency*, 354 F.3d at 1122. To the contrary, the § 280E penalty arose in the course of Harborside's lawful and voluntary attempts to pay the appropriate amount of federal tax owed. Next, Harborside is not exposed to any "other penalties" for engaging in the lawful sale of medical marijuana. *Id*.

Finally, the "extent of the harm caused" factor overwhelmingly favors lawful marijuana sellers like Harborside. *Id*. Harborside's conduct does not cause any harm at all—it instead creates a host of economic and public health *benefits*. *See supra* Section I. Indeed, this case illustrates the perversity of the tax scheme that § 280E allows, as it is the IRS' conduct that threatens to do harm with its ill-advised tax policy that unwittingly encourages the flourishing of an illegal marijuana marketplace. *See supra* Section IV.

By any rational measure, this application of § 280E is meant to punish entities like Harborside. And § 280E does so in a manner that is

completely disproportionate to the so-called "offense" of conducting a lawful business. This Court should therefore strike § 280E down under the Excessive Fines Clause.

CONCLUSION

NCIA respectfully request that this Court vacate the decision below and hold that § 280E violates the Sixteenth and Eighth Amendments as applied to Harborside and to other lawful marijuana businesses.

Dated: June 2, 2020

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CERTIFICATE OF COMPLIANCE

Pursuant to Federal Rules of Appellate Procedure 29(a)(4)(G) and 32(a)(7)(C), I certify that:

This brief complies with the type-volume limitation of Fed. R. App. P. 29(a)(5) because this brief contains 6,677 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(f).

This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because this brief has been prepared in a proportionately spaced typeface using Microsoft Word Century Schoolbook 14-point font.

Date: June 2, 2020

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CERTIFICATE OF SERVICE

I hereby certify that on June 2, 2020, I electronically filed the foregoing with the Clerk of the Court for the United States Court of Appeals for the Ninth Circuit by using the appellate CM/ECF system.

Participants in the case who are registered CM/ECF users will be served by the appellate CM/ECF system.

Date: June 2, 2020

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