TAX PROCEDURE: A MARIJUANA DISPENSARY CANNOT ENJOIN AN IRS INVESTIGATION CONCERNING TRAFFICKING IN A CONTROLLED SUBSTANCE

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Marijuana is legal for medical use in over half of the states, along with the District of Columbia. It is also legal for recreational use in eight states and the District of Columbia. At the federal level, however, marijuana is classified as a controlled substance under Schedule I of the Controlled Substances Act. This dichotomy creates a variety of tricky issues for marijuana growers and dispensaries.

One problem is that the Internal Revenue Code precludes deductions for business expenses for 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)." I.R.C. § 280E. The bar on claiming deductions for business expenses applies whenever the activity "is prohibited by Federal law *or* the law of any State in which such trade or business is conducted." *Id.* (emphasis added). Consequently, dispensaries that operate legally under state law cannot claim business expenses on their federal tax returns.

On May 2nd, the Tenth Circuit addressed the question whether a dispensary could seek an injunction barring the IRS from investigating whether it was trafficking in a controlled substance, ruling that the Anti-Injunction Act, I.R.C. § 7421(a) ("AIA"), and the provisions of the Declaratory Judgment Act, 28 U.S.C. § 2201, precluded the dispensary from seeking injunctive relief. *Green Solution Retail, Inc.*, No. 16-1281, 2017 U.S. App. LEXIS 7746 (10th Cir. May 2, 2017).

The taxpayer, Green Solution, was a marijuana dispensary operating several locations in Colorado. 2017 U.S. App. LEXIS 7746 at *2. While under audit, Green Solution filed suit in district court seeking to enjoin the IRS and related parties from investigating whether it was engaged in trafficking in a controlled substance. *Id.* at *3. Green Solution also sought a declaratory judgment determining that the IRS acts outside of its statutory authority if it makes findings that a taxpayer has engaged in trafficking activity prohibited under the Controlled Substances Act. *Id.*

Green Solution argued that it would suffer irreparable harm in the absence of relief as it would be deprived of income. It also asserted that it would be subject to a forfeiture of income and capital, as section 280E operated as a penalty. Finally, the taxpayer contended that its Fifth Amendment rights would be violated in the absence of relief because the IRS wanted it to turn over documents and respond to questions relating to whether it had engaged in trafficking. After the government moved to dismiss, the district court ruled that the taxpayer was barred from relief by the AIA and by the terms of the Declaratory Judgment Act. *Id.*

On appeal, the Tenth Circuit commenced its analysis by noting the peculiar position of marijuana under federal law; while technically illegal, in 2015 and 2016, Congress refused to appropriate funds to prosecute marijuana distribution crimes in states where it is legal under state law. *Id.* at *5 (citations omitted). The court also observed that "the IRS has pursued numerous marijuana dispensaries in Colorado and elsewhere to recoup unlawful business deductions." *Id.* (citations omitted).

Turning to the case before it, the Court of Appeals noted that the AIA barred "a suit for the purpose of restraining the assessment or collection of any tax." *Id.* at *6 (quoting I.R.C. § 7421(a)). The court also observed that the Declaratory Judgment Act was subject to a tax exception that is construed in a manner that is consistent with the AIA. *Id.* at *6-*7.

The taxpayer's first argument was that its effort to enjoin the IRS from investigating whether it was engaged in trafficking was "a step removed" from an action seeking to enjoin the assessment or collection of a tax. The taxpayer acknowledged that its position was inconsistent with the Tenth Circuit's opinion in *Lowrie v. United States,* 824 F.2d 827, 830 (10th Cir. 1987), which construed the AIA to extend to "activities leading up to, and culminating in assessment," but it asserted that the Supreme Court implicitly overruled *Lowrie* in *Direct Marketing Association v. Brohl*, 135 S. Ct. 1124 (2015). *Green Solution*, 2017 U.S. App. LEXIS 7746 at *7.

Before exploring the Tenth Circuit's analysis in *Green Solution*, some background on *Direct Marketing* is in order. In 2010, Colorado passed a law requiring retailers who did not collect sales tax to notify Colorado customers of their liability for use tax; the law also required the retailers to report data on sales to the customers and the Colorado Department of Revenue. 135 S. Ct. at 1128. A trade association of direct marketers brought suit to enjoin the enforcement of the reporting law; although they prevailed in the trial court, the Tenth Circuit reversed, holding that the trade association's claim was barred by the Tax Injunction Act, 28 U.S.C. § 1341. *Id.* at 1129. The Supreme Court reversed, concluding, among other things, that the reporting law did not involve any "assessment, levy or collection" within the meaning of the Tax Injunction Act. Id. at 1129-31. It also concluded that the Tenth Circuit had read the Tax Injunction Act too broadly when it concluded that an order barring enforcement of the reporting law would restrain tax assessments. *Id.* at 1132-33.

In *Green Solution*, the Tenth Circuit distinguished *Direct Marketing*, noting first that the AIA and the Tax Injunction Act were "different statues located in different titles of the United States Code." 2017 U.S. App. LEXIS 7746 at *16. And while acknowledging that the AIA served as the model for the Tax Injunction Act, the Court of Appeals emphasized that the two different statutes served different purposes and employed different language; the AIA bars any "suit for the purpose of restraining the assessment or collection of any tax," while the Tax Injunction Act provides that a district court may not "enjoin, suspend or restrain the assessment, levy or collection of any tax." *Id.* at *17 (quoting I.R.C. § 7421(a); 28 U.S.C. § 1341).

Next, the Tenth Circuit considered the implications of the Supreme Court's decision to read the term "restrain" narrowly to reach suits that would stop a tax assessment, levy, or collection, not merely inhibit one. In the court's view, the Supreme Court applied the narrower construction for two reasons, only one of which supported the taxpayer's position that *Direct Marketing* had overruled the Tenth Circuit's prior

precedent under the AIA. The Tenth Circuit recognized that the Supreme Court's decision to read the word "restrain" narrowly arguably supported the idea that matters leading up to a tax assessment did not fall within the ambit of the AIA because the act applied the term "restrain" to distinct phases of the process of taxation, specifically, assessment, levy, and collection, and the failure to read the term narrowly would essentially bar any suit with any adverse impact on a state's revenue. *Id.* at *17-*18.

But the court also observed that the Supreme Court had rejected a broad reading of the term "restrain" because it was paired with the terms "enjoin" and "suspend," which are terms of art that involve restrictions imposed by a court that preclude certain actions. *Id.* at *18-*19. The Tenth Circuit then contrasted the language from the Tax Injunction Act that the Supreme Court considered in *Direct Marketing* with the language of the AIA, which bars a "suit for the purpose of restraining the assessment or collection of any tax." In the Tenth Circuit's view, this language had a potentially broader reach: "Thus . . . , the injunctive relief barred under the AIA need not *actually* restrain an assessment or collection, it need only have a restraint of those functions as its purpose." *Id.* at *19 (emphasis by the court). Next, the court cited Justice Ginsburg's concurrence, which emphasized that the litigants in *Direct Marketing* were not challenging anyone's tax liability. *Id.* at *20 (discussing *Direct Mktg*., 135 S. Ct. at 1136 (Ginsburg, J. concurring)). Given this statement in a concurrence joined by two other justices, the Tenth Circuit reasoned that "[w]hen three concurring Justices say that *Direct Marketing* did not reach the situation now before us, and no Justice disputed that statement, we can hardly say that *Direct Marketing* so undermined the authority of *Lowrie* in this context that we must retreat from its holding." *Id.* at *20.

The Court of Appeals then turned to the taxpayer's alternative arguments. Green Solution argued that the IRS was acting outside of its authority in investigating whether it had trafficked in a controlled substance because that was a function to be carried out by the Office of the United States Attorney. In the Tenth Circuit's view, section 280E of the Code did not call for the IRS to conduct a criminal investigation because the provision was not triggered by a criminal conviction. The IRS was simply making a determination whether particular deductions were allowable or not. *Id.* at *22.

In a similar vein, the Court of Appeals rejected the taxpayer's argument that it was being subjected to a penalty, not a tax, noting that deductions were a matter of legislative grace. *Id.* at *22-*23.

The court's reasoning on the impact of *Direct Marketing* is not particularly persuasive. In explaining its decision that *Direct Marketing* was not controlling, the court focused primarily on minor differences between the AIA and the Tax Injunction Act, which was modeled on it. The result is an opinion that often appears strained. And when the court focuses on a compelling distinction, Justice Ginsburg's observation that no taxpayer was directly involved in *Direct Marketing*, the Tenth Circuit's opinion stretches that point by concluding that the other Justices who did not join her concurrence must have endorsed her view because they did not dispute it. The court's opinion would have been more persuasive if it had simply acknowledged that the case was a close one and that *Direct Marketing* was distinguishable because it did not involve any taxpayers.

By the same token, the approach of the IRS to this case and others involving this industry is more than a little puzzling. The dispensaries are licensed by the state, they operate openly, and the revenue agent conducting an audit can presumably observe the operation of the business. Yet the IRS is utilizing extraordinary measures to establish that marijuana dispensaries sell marijuana. In *Green Solution*, the IRS determined that the taxpayer had trafficked, then sought additional documents and answers to specific questions relevant to that issue. In other cases, the IRS has issued multiple summonses to third parties doing business with dispensaries. *See High Desert Relief, Inc. v. United States*, No. 16-cv-1255 WJ/KBM, 2017 U.S. Dist. LEXIS 55058 (D. New Mex. April 11, 2017). The customary position of the IRS is

that the burden of proof is on the taxpayer to establish its entitlement to a deduction. Accordingly, I would normally expect the IRS to simply deny all deductions on the basis that the taxpayer was operating a dispensary. Instead, the IRS is going to extraordinary lengths to establish the obvious. Growers and dispensaries dealing with the IRS should consider whether these intrusive inquiries serve some broader purpose, such as an investigation into money laundering.

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