

## Code §280E Planning Observations: 'Harborside' Case Hinges on Definition of 'Consists of'

July 18, 2022

By Melinda Fellner. Published in the *New York Law Journal*.

Cannabis related businesses should take note of an interesting U.S. Tax Court case affecting their industry. Though not a pro-taxpayer case—the IRS won on the major counts—the *Harborside* case provides some insight into structuring cannabis-related businesses with a view to deduction of business expenses.

The taxpayer in the case, Patients Mutual Assistance Collective Corporation (doing business as Harborside Health Center), was a medical marijuana dispensary that sold a wide variety of marijuana-related products and products not related to marijuana, as well as providing patients with services such as hypnotherapy, acupuncture and yoga.

The case arose from the IRS denying most of Harborside's deductions and cost of goods sold for six tax years. The primary reason for the disallowance came straight from Internal Revenue Code §280E: "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."

Marijuana is currently a controlled substance under §280E.

Section 280E operates as an exception to the general rule of the code in §162, which allows a business to deduct all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Accordingly, the application of §280E clearly impacts a cannabis business in its computation of taxable income since it cannot deduct most business expenses under §162.

The crux of the *Harborside* opinion lies in the interpretation of the words "consists of" from §280E. Harborside argued that "consists of" should be interpreted as an "exhaustive list," meaning that it applies only to businesses that "exclusively or solely traffic in controlled substances and not to those that also engage in other activities." The government took the position that a single business with several activities can still be seen as "consisting of" trafficking if any of its activities are trafficking. The opinion provides an interesting and detailed discussion of this phrase, mostly centering on the fact that the code itself, as well as case law, all seem to show that "consists of" can introduce either an exhaustive list or a non-exhaustive list of items when dealing with tax issues. The court concluded that a non-exhaustive list was the appropriate option for maintaining the effectiveness of §280E. Thus, §280E was meant to deny business expense deductions to any business involved in trafficking controlled substances, even if its business included other activities.

As such, *Harborside* was interpreted to have one single business—trafficking in controlled substances—and could not deduct business expenses related to its non-cannabis businesses such as apparel and wellness services. The court also held that Harborside could not apply the rules of §263A to permit its costs to instead be capitalized as part of its inventory.

---

The *Harborside* opinion is interesting, especially considering the passage of the Agriculture Improvement Act of 2018, which removes hemp from the controlled substances schedule. Further, planning for §280E issues has become interesting at the state level, as many states have chosen to de-couple from the federal disallowance of deductions (i.e. to permit these deductions) or to provide a tax credit in the amount of the disallowed federal deduction. Notably New York has joined several states (Colorado, Oregon, California and Massachusetts), and its Cannabis businesses will be permitted to take these deductions beginning Jan. 1, 2023, pursuant to the provisions of the 2022-2023 budget.

As such, cannabis-related businesses should be aware of the *Harborside* opinion and discuss with their tax advisers their ability to separate different lines of businesses to segregate expenses and better navigate the IRS waters and take advantage of state laws on same.

---

**Melinda Fellner** is a partner and chair of the tax practice at Carter Ledyard & Milburn in New York City. She represents clients in federal, state and international tax issues. Her recent work includes assisting cannabis businesses and investors navigate complex tax and regulatory legal issues. She can be reached at [fellner@clm.com](mailto:fellner@clm.com).

*Reprinted with permission from the July 8, 2022 edition of the New York Law Journal © 2022 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited, contact 877-257-3382 or [reprints@alm.com](mailto:reprints@alm.com).*

## related professionals

**Melinda Fellner** / Partner

D 212-238-8750

[fellner@clm.com](mailto:fellner@clm.com)