Current Federal Tax Developments

Week of February 22, 2021

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CURRENT FEDERAL TAX DEVELOPMENTS
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SECTION: 280E
CHARITABLE CONTRIBUTIONS AND DEPRECIATION DEDUCTIONS BOTH ARE BARRED BY §280E - BUT FOR REASONS THAT MAY IMPACT OTHER TAXPAYERS

Citation: San Jose Wellness v. Commissioner, 156 TC No. 4, 2/17/21

In the case of *San Jose Wellness v. Commissioner*, 156 TC No. 4[1] the Tax Court again looked at the question of whether the bar on deductions other than cost of sales for marijuana dispensaries goes beyond just those allowed by IRC §162, and extends to deductions allowed under IRC §171 (charitable contributions) and §167 (depreciation). But the opinion looks at some interesting interpretations of language that may find application outside of cannabis industry cases.

IRC §280E provides:

> 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.

The opinion provides that a deduction will be disallowed under this provision if three conditions are satisfied:

- The deduction is for an amount paid or incurred during the taxable year;
- That amount was paid or incurred in carrying on any trade or business; and
- That trade or business (or the activities that comprise the trade or business) consisted of trafficking in certain defined controlled substances.

Prior Decision – Bar is Not Limited to Only §162 Expenses

The opinion notes that in 2019 the Tax Court decided a case on this particular issue in the case of *N. Cal. Small Bus. Assistants Inc. v. Commissioner* ("NCSBA"), 153 T.C. 65 (2019). The opinion summarizes this ruling as follows:

> There, NCSBA — also a medical marijuana dispensary — sought to save from disallowance the deductions it claimed for taxes (under section 164) and depreciation (under section 167). In support of its

[1] *San Jose Wellness v. Commissioner*, 156 TC No. 4, February 17, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/cannabis-dispensary-can%e2%80%99t-deduct-depreciation%2c-charitable-gifts/2zdsp (retrieved February 20, 2021)

position, NCSBA argued that "section 280E limits only deductions under section 162," such that "deductions under sections 164 and 167 are allowed notwithstanding section 280E." *NCSBA*, 153 T.C. at 72. In an Opinion reviewed by the full Court, we rejected the argument, stating in relevant part: NCSBA's "argument misses the first line of section 280E: 'No deduction or credit shall be allowed'. (Emphasis added.) Congress could not have been clearer in drafting this section of the Code." *Id.* at 73.

We found support for this conclusion in the Code's text and structure:

> The broader statutory scheme also supports our conclusion that section 280E means what it says — no deductions under any section shall be allowed for businesses that traffic in a controlled substance. Section 261, in part IX of subchapter B of chapter 1 of the Code, provides that "no deduction shall in any case be allowed in respect of the items specified in this part." Section 280E is in part IX. Similarly, section 161 provides that deductions found in part VI of subchapter B of chapter 1 of the Code are allowed "subject to the exceptions provided in part IX". Part VI provides a comprehensive list of allowable deductions for taxpayers. This list includes section 162 and section 165 deductions, which we have previously disallowed pursuant to section 280E. *See CHAMP*, 128 T.C. at 180-181 (disallowing section 162 deductions under section 280E); Beck v. Commissioner, T.C. Memo. 2015-149, at *18 (disallowing a section 165 loss deduction under section 280E). As relevant here, part VI also includes sections 164 and 167, two additional sections petitioner believes would allow it a deduction. Clearly, sections 164 and 167 are limited by the exceptions in part IX, including section 280E. Thus, section 280E precluded petitioner from taking any deductions under sections 164 and 167 that are tied to its medical marijuana dispensary.
>
> *Id.* (emphasis added).[2]

So why is this case being put forward as a published decision if the issue had already been decided? The Court notes that the taxpayer in this case "has advanced more nuanced textual arguments" than those raised in the earlier case—and the Court decided to deal with those issues in this opinion. But it turns out the result is the same as it was for the taxpayer in NCSBA.

Is Depreciation Paid or Incurred During the Year

The taxpayer first offers the argument that the depreciation deduction is not one that is "paid or incurred" during the year—the purchase of the item generating a depreciation deduction may have taken place years earlier. As §280E only applies to deductions paid

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[2] *San Jose Wellness v. Commissioner*, 156 TC No. 4

or incurred during the year, the taxpayer argues that the depreciation deduction is not affected by IRC §280E and a full deduction should be allowed.

The Court cited a Supreme Court decision (*Commissioner v. Idaho Power*, 418 US 1 (1974)) for support of the view that depreciation is a cost *incurred* in the year in which the deduction is allowed. The Court analyzes the Supreme Court ruling as follows:

> In *Idaho Power*, the Court considered whether a taxpayer that used its own equipment in the construction of its own capital facilities was entitled under section 167(a) to a depreciation deduction for the current year with respect to the use of that equipment, or whether the deduction was barred by section 263(a)(1). If the deduction was barred by section 263(a)(1), the amount of the deduction would be capitalized and recovered over the useful life of the constructed facilities.
>
> Focusing on the concept of depreciation, the Court noted:
>
>> Over a period of time a capital asset is consumed and, correspondingly over that period, its theoretical value and utility are thereby reduced. Depreciation is an accounting device which recognizes that the physical consumption of a capital asset is a true cost, since the asset is being depleted. As the process of consumption continues, and depreciation is claimed and allowed, the asset's adjusted income tax basis is reduced to reflect the distribution of its cost over the accounting periods affected. The Court stated in *Hertz Corp. v. United States*, 364 U.S. 122, 126 (1960): "[T]he purpose of depreciation accounting is to allocate the expense of using an asset to the various periods which are benefited by that asset." See also *United States v. Ludey*, 274 U.S. 295, 300-301 (1927); *Massey Motors, Inc. v. United States*, 364 U.S. 92, 96 (1960); *Fribourg Navigation Co. v. Commissioner*, 383 U.S. 272, 276-277 (1966). When the asset is used to further the taxpayer's day-to-day business operations, the periods of benefit usually correlate with the production of income. Thus, to the extent that equipment is used in such operations, a current depreciation deduction is an appropriate offset to gross income currently produced. It is clear, however, that different principles are implicated when the consumption of the asset takes place in the construction of other assets that, in the future, will produce income themselves. In this latter situation, the cost represented by depreciation does not correlate with production of current income. Rather, <u>the cost, although certainly presently incurred</u>, is related to the future and is appropriately allocated as part of the cost of acquiring an income-producing capital asset. [Fn. ref. omitted.]
>
> *Commissioner v. Idaho Power Co.*, 418 U.S. at 10-11 (emphasis added).
>
> *Idaho Power* leaves no doubt that, as a "cost * * * certainly presently incurred," *id.* at 11, depreciation constitutes an "amount paid or

> incurred during the taxable year," sec. 280E. Given that conclusion, section 280E applies by its express terms to SJW's circumstances.[3]

The holding that depreciation is an expense paid or incurred by the taxpayer may help ease the minds of some employers who were nervous about including depreciation amounts as part of an accountable reimbursement plan under IRC §62(a)(2)(A). The ruling clearly holds such depreciation is incurred by the taxpayer, and thus should qualify for reimbursement to an employee without having to treat the amount as payroll.

Charitable Deductions Were Incurred in Carrying on a Trade or Business

Next, the taxpayer argued that it should be allowed charitable deductions that the IRS disallowed, arguing that they were not paid or incurred "in carrying on any trade or business" as required for the deduction to be covered by IRC §280E. The taxpayer argues that while the charitable contribution might be in connection with the trade or business, §280E only impacts what the taxpayer argues is a narrower category of expenses paid in carrying on a trade or business.

The opinion notes:

> In support of this view, SJW compares the text of section 280E with that of section 162(a). The latter provides a deduction for "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." (Emphasis added.) SJW contends that the phrase "in carrying on" significantly limits the universe of expenditures to which section 162 applies and that a similar analysis of section 280E confirms that the section does not apply to SJW's charitable contributions.[4]

The Court did not accept this argument:

> SJW is correct that courts have construed section 162(a) as inapplicable to certain categories of expenditures — for example, distributions of profits, loans, and capital expenditures. But courts typically do not ground these exclusions in the phrase "in carrying on." Rather, they rely on other requirements of section 162(a), such as the condition that an expenditure must be an "expense" that is both "ordinary" and "necessary." Section 280E, which applies to "any amount paid or incurred," has no analogous requirements.[5]

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[3] *San Jose Wellness v. Commissioner*, 156 TC No. 4

[4] *San Jose Wellness v. Commissioner*, 156 TC No. 4

[5] *San Jose Wellness v. Commissioner*, 156 TC No. 4

The Court also found that these charitable contributions, even though arguably not deductible under IRC §162, are still incurred in carrying on the trade or business and fall under IRC §280E's coverage:

> SJW's argument that its charitable contributions by definition are not "business expenditures" misses the mark for similar reasons. Failing to qualify as a business expenditure may well be fatal under section 162, although the phrase does not appear in that section. The concept, however, has no relevance under section 280E, which applies to "any amount paid or incurred * * * in carrying on any trade or business." (Emphasis added.) The fact that the two provisions share one phrase ("in carrying on") does not import the other requirements of section 162 into section 280E.[6]

This part of the ruling might arguably give support to the position the IRS previously posited in instructions on the computation of qualified business income (QBI) under IRC §199A—that there does exist a class of charitable contributions that, while not allowed as a deduction under IRC §162(a), are still a deduction related to carrying on the trade or business.

Since removing the item from the instructions was not accompanied by any IRS discussion of why charitable contributions were not deductions related to the trade or business under IRC §199A, it is possible if the agency wants to again assert that QBI is reduced by such deductions it would cite this case to support that position.

SECTION: 104
ATTORNEY MALPRACTICE SETTLEMENT RELATED TO CLAIMED FAILURES IN REPRESENTING TAXPAYER IN A PHYSICAL INJURY CASE NOT EXCLUDABLE FROM INCOME

Citation: Blum v. Commissioner, TC Memo 2021-18, 2/18/21

Debra Jean Blum filed a lawsuit that clearly dealt with physical injuries she sustained, but which she claimed her attorneys had bungled—so she then filed suit against the law firm. This dispute was settled out of court, and Debra sought to claim that this settlement was excludable from income as damages received on account of personal physical injuries under IRC §104(a)(2).[7]

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[6] *San Jose Wellness v. Commissioner*, 156 TC No. 4

[7] *Blum v. Commissioner*, TC Memo 2021-18, February 18, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/settlement-for-malpractice-in-personal-injury-suit-was-income/2zf0m (retrieved February 20, 2021)

IRC §104(a)(2) provides:

> (a) In general
>
> Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include—
>
> > …
> >
> > (2) the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness;

Original Lawsuit Against the Hospital

The opinion describes Ms. Blum's original case and the failure of this case in court:

> In August 2007 Ms. Blum was admitted to Our Lady of Lourdes Hospital in Pasco d.b.a. Lourdes Health Network (hospital) for total left knee replacement surgery. While there, Ms. Blum allegedly suffered personal injuries after being directed by an admissions clerk to sit in a wheelchair, which turned out to be broken. When Ms. Blum attempted to sit in the wheelchair, she allegedly fell on the floor and sustained significant injuries.
>
> In March 2008 Ms. Blum retained an attorney to represent her in a suit against the hospital. The attorney filed a complaint in July 2010 in Washington State court, alleging that the hospital: (1) "was negligent in its care, moving, transportation and treatment of * * * [Ms. Blum] causing her to fall and sustain severe injuries" and (2) "failed to properly direct, supervise and prevent the contact of its other agents and employees * * * and was therefore negligent."
>
> While the lawsuit was pending, Ms. Blum's attorney retired from the practice of law and withdrew as her attorney of record. Ms. Blum retained another attorney from the same law firm to continue the representation. In September 2011, however, the trial court granted summary judgment to the hospital. Ms. Blum appealed the case pro se, but the Washington State Court of Appeals affirmed the trial court's decision.[8]

Had Ms. Blum been successful in being compensated in this case, the damages received would very likely have qualified for exclusion from income under IRC §104(a)(2), as the issue was clearly related to physical injuries that Ms. Blum suffered.

[8] *Blum v. Commissioner*, TC Memo 2021-18

Settlement with Law Firm Regarding Representation in Physical Injury Case

Ms. Blum was upset with the firm's representation of her in that failed case, and she filed a lawsuit against the attorneys:

> In June 2014 Ms. Blum brought a malpractice suit against her former attorneys in Washington State court, alleging that they had breached their duty of care in failing to properly prosecute her lawsuit against the hospital. In her complaint Ms. Blum alleged that her physical injuries were caused "solely by the negligence and/or fault of * * * [the hospital] and its employees" and that she "would have prevailed in * * * [her claim against the hospital] but for * * * [her former attorneys'] breach of the standard of care." In her prayer for relief Ms. Blum asserted that her former attorneys' representation "fell below the standard of care expected of a Washington attorney" and that she "sustained damage because of * * * [their] breaches of the standard of care." She did not allege in her complaint that she had suffered any physical injuries for which her former attorneys should be responsible, nor did she seek compensation for any physical injuries.
>
> The parties settled the malpractice lawsuit in June 2015 with Ms. Blum agreeing to drop any and all claims against her former attorneys "related to or arising out of * * * [their] representation of Blum in * * * [her claim against the hospital]" in exchange for a payment of $125,000. The parties' settlement agreement expressly stated that it was "entered into by the Parties for the purpose of compromising and settling the dispute between them", which the agreement described as a "malpractice claim". The settlement agreement further provided that "Blum maintains, and * * * [her former attorneys] do not dispute, that Blum [*5] did not sustain any physical injuries as a result of the alleged negligence of either * * * [of her former attorneys]" and that "Blum's physical injuries are * * * alleged to have resulted from the * * * [hospital] incident, which did not occur as a result of any fault or negligence by * * * [her former attorneys]".[9]

Ms. Blum did not include this payment in her income, arguing that the $125,000 represented the law firm paying her the damages for her physical injury that she claimed their malpractice prevented her from receiving.

Nature of the Damages Received Were Not for Physical Injuries

Unfortunately for Ms. Blum, the Tax Court did not determine that it should project this award back as compensation for Ms. Blum's physical injuries. Rather, the Court looked at the particular lawsuit for which Ms. Blum received the payment.

[9] *Blum v. Commissioner*, TC Memo 2021-18

The Court explains why it does not look beyond the particular agreement under which the damages were paid:

> Ms. Blum counters that the payment was received "on account of personal physical injuries or physical sickness" because "but for" her former attorneys' allegedly negligent representation, she "would have received damages from the hospital * * * [which] would be * * * excludable under section 104(a)(2)." Both we and the Court of Appeals for the Ninth Circuit have explained, however, that a taxpayer "must show that there is 'a direct causal link between the damages and the personal injuries sustained.'" *Doyle v. Commissioner*, at *11 (quoting *Rivera*, 430 F.3d at 1257).[10]

The opinion notes that the agreement itself provides what the compensation relates to:

> In the settlement agreement the parties made clear that the amount paid was not directly linked to the personal injuries suffered by Ms. Blum. According to the settlement agreement the nature of the claim for which Ms. Blum was compensated was legal malpractice, which plainly lies outside the scope of section 104(a)(2).[11]

The Court refused accept Ms. Blum's view that the law firm intended to compensate her for her physical injuries:

> Ms. Blum further argues that her former attorneys actually intended to compensate her for the physical injuries she allegedly sustained at the hospital. The settlement agreement dooms her contention. Even if we looked outside that agreement, the complaint filed against the former attorneys related only to legal malpractice and described damages stemming from such malpractice. There is simply no support for Ms. Blum's attempt to recharacterize her suit or settlement.[12]

Payment Was not a Return of Capital

Damages received that are meant to be a recovery of capital (such as reimbursing for a car destroyed by the defendant in an auto accident) are also excludable from income. Ms. Blum argued, in the alternative, that this payment was just that—the law firm was replacing the tax-free funds she would have received except for their malpractice.

But the Court did not accept this view either:

> The purported loss that she claims was the amount that she might have received from winning her personal injury lawsuit, which strikes us as a highly speculative proposition. Moreover, Ms. Blum fails to convince us that the settlement payment was meant to replace this purported loss, rather than for any of the other reasons that might have prompted her former attorneys to settle. In short, we do not view

[10] *Blum v. Commissioner*, TC Memo 2021-18

[11] *Blum v. Commissioner*, TC Memo 2021-18

[12] *Blum v. Commissioner*, TC Memo 2021-18

> her recovery in the malpractice case as restoring her capital but instead as compensating her for distinct failings by her former lawyers. Consequently, this amount is not a recovery of capital and is includable in her gross income.[13]

SECTION: 6011
IRS POSTS RELEASE STATING IT HAD SENT OUT 260,000 YOU HAVE FAILED TO FILE A 2019 TAX RETURN LETTER BEFORE PROCESSING ALL TIMELY FILED 2019 RETURNS

Citation: "IRS Statement about CP59 notices," IRS website, 2/18/21

A number of tax professionals had been reporting in early February that clients had been receiving notices from the IRS that the agency did not show that they had filed a 2019 tax return. In such cases a return had been filed, with most reporting the return had been filed electronically and accepted by the IRS.

The IRS has now come forward with a release on their website[14] that indicates that these erroneous notices should be ignored if a taxpayer actually filed their 2019 tax return.

The web page states:

> Earlier this month, the IRS issued notices to approximately 260,000 taxpayers stating they haven't filed their 2019 federal tax return. These notices, referred to as CP59 notices, are issued yearly to identified taxpayers who have failed to file a tax return that was due the prior calendar year (Tax Year 2019). Due to pandemic related shutdowns, the IRS has not completed processing all 2019 returns at this time. Therefore, the CP59 notices should not have been sent because some portion of the recipients may actually have filed a return that is still being processed. People who filed their 2019 return but nevertheless received the CP59 notice, can disregard the letter and do not need to take any action. There is no need to call or respond to the CP59 notice because the IRS continues to process 2019 tax returns as quickly as possible. The IRS regrets any confusion caused by this mailing.[15]

While useful to know, actually following the IRS advice poses a risk unless the agency remails any of the 260,000 letters where the agency still doesn't find a record of the return after processing the backlog. The IRS notice does not commit to taking that

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[13] *Blum v. Commissioner*, TC Memo 2021-18

[14] "IRS Statement about CP59 notices," IRS website, February 18, 2021, https://www.irs.gov/newsroom/irs-statement-about-cp59-notices#:~:text=Earlier%20this%20month%2C%20the%20IRS,year%20(Tax%20Year%202019) (retrieved February 20, 2021)

[15] "IRS Statement about CP59 notices," IRS website, February 18, 2021

action. This could pose a risk to taxpayers where the agency has truly lost track of their 2019 return, since now it could easily appear to the IRS systems that the taxpayer had ignored a notice and failed to cooperate.

So, unfortunately, prudence suggests at least following up with a response to the notice. Presumably following up by citing the website information, pointing out that the taxpayer has records showing the return was filed and accepted, and asking the agency to contact the taxpayer if the agency does not believe this taxpayer is in the "no need to contact us" group may help keep the taxpayer from being treated as "nonresponsive" down the line if the agency has truly misplaced the documents.

SECTION: 6011
EIGHT DEMOCRATIC WAYS AND MEANS MEMBERS ASK IRS COMMISSIONER TO PUSH BACK THE APRIL 15 DEADLINE

Citation: Letter from Eight House Ways and Means Committee Democratic Members, House Ways & Means Committee website, 2/18/21

Eight Democratic members of the House Ways & Means Committee penned a letter to IRS Commissioner Charles Rettig on February 18, asking that the due date again be extended beyond April 15 this year.[16]

The letter, after reminding the Commissioner about last year's extension of the deadline through July 15, outlined the following challenges facing tax preparers and taxpayers this year:

> One year later, another unique filing season is underway, and many of these same pandemic-related difficulties and challenges persist for taxpayers, practitioners, and the IRS. For starters, health and safety concerns continue to keep taxpayer assistance sites closed and taxpayers homebound. As a result, taxpayers are having a much harder time receiving the crucial assistance they are accustomed to and require. These challenges are especially acute for low-income taxpayers with limited digital or English proficiency.
>
> Further, an added challenge this year is the condensed filing season, as April 15 will come just two months after the opening of the 2021 filing season. We are troubled that this reduced timeline will exacerbate difficulties for many taxpayers who may be unprepared for the amount due with their return and will have no savings to turn to and less time to consider their options. Importantly, as well, the IRS is still processing millions of returns from last year and has had less time to

[16] Letter from Eight House Ways and Means Committee Democratic Members, House Ways & Means Committee website, February 18, 2021, https://waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/documents/2021.02.18%20WM%20Letter%20on%20Filing%20Extension.pdf (retrieved February 20, 2021)

> adjust to the training and safety needs of newly-hired or recalled employees.[17]

Thus, the letter calls for pushing the due date back beyond April 15:

> At the Ways and Means Oversight Subcommittee's recent hearing, "Free Tax Preparation Services During the Pandemic," we learned that the demand for free tax preparation services this year already has been extraordinary and that some preparers believe an extension of the filing season is needed. Accordingly, we request that you consider an extension of the tax return filing season with an announcement made as soon as possible to eliminate unnecessary taxpayer and practitioner anxiety. We sincerely believe that an early extension of the filing and payment deadlines will benefit and be a comfort to taxpayers, practitioners, and the IRS alike.[18]

The letter was signed by the following members of the Committee:

- Rep. Bill Pascrell Jr., Chairman, Subcommittee on Oversight
- Rep. Danny K. Davis, Chairman, Subcommittee on Worker and Family Support
- Rep. Judy Chu
- Rep. Gwen Moore
- Rep. Dwight Evans
- Rep. Bradley S. Schneider
- Rep. Thomas R. Suozzi and
- Rep. Steven Horsford

Conspicuously absent from that list of signatories is the Committee Chair, Rep. Richard Neal. As well, the IRS has not responded to this letter yet.

For now, the original due date remains April 15 and advisers should plan on that being the date by which returns or extensions will need to be filed for individual returns.

[17] Letter from Eight House Ways and Means Committee Democratic Members, House Ways & Means Committee website, February 18, 2021

[18] Letter from Eight House Ways and Means Committee Democratic Members, House Ways & Means Committee website, February 18, 2021