No. 17-1223

IN THE UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

ALPENGLOW BOTANICALS, LLC, a Colorado Limited Liability Company; CHARLES WILLIAMS; and JUSTIN WILLIAMS,

Plaintiffs-Appellants

v.

UNITED STATES OF AMERICA,
through its agency the Internal Revenue Service,

Defendant-Appellee

ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF COLORADO
Nos. 1:16-cv-00258
JUDGE RAYMOND P. MOORE

RESPONSE TO COMBINED PETITION FOR REHEARING AND REHEARING *EN BANC*

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INTRODUCTION

Alpenglow Botanicals, LLC, a Colorado medical marijuana dispensary, and its owners (together, taxpayers) challenge the decision of a panel of this Court that affirmed the District Court's dismissal of their refund suit for failure to state a claim upon which relief could be granted. (Op. 1–31.)[1] The panel held that the IRS had authority to investigate the applicability of Section 280E of the Internal Revenue Code (26 U.S.C.) (I.R.C.), which disallows deductions and credits for amounts incurred in carrying on a trade or business that consists of trafficking in controlled substances in violation of federal or state law. (Op. 8–14.) The panel also concluded that I.R.C. § 280E passed constitutional muster under the Eighth and Sixteenth Amendments. (Op. 14–23.)

In their rehearing petition, taxpayers challenge the panel's holding that the IRS had authority to investigate whether a taxpayer

[1] "Op." references are to the panel decision in this case. "App." references are to the documents contained in the appendix previously filed by appellants. "Doc." references are to documents contained in the record, as numbered by the clerk of the District Court. "Pet." references are to appellants' petition.

trafficked in controlled substances in violation of the Controlled Substances Act as part of its determination where I.R.C. § 280E applies. (Pet. 7–22.) Taxpayers contend that the panel erred in holding that the IRS could investigate "nontax crime," raising the specter that IRS determinations in the I.R.C. § 280E context could be applied, with preclusive effect, to subsequent criminal proceedings. (Pet. 7–11.) Taxpayers further assert that the panel's conclusion runs contrary to the principle that a single statute should be given the same construction no matter the context, and they contend that the purportedly different interpretation of "trafficking in controlled substances" in the tax context will lead to abuse. (Pet. 11–16.) Taxpayers finally argue that the panel's ruling essentially hands the IRS limitless investigatory power unchecked by the Fourth and Fifth Amendments. (Pet. 16–21.)

The panel's conclusion that the IRS has authority to investigate a taxpayer's proper tax liability is fully consistent with the Internal Revenue Code and this Court's precedent. The Code grants the IRS expansive investigatory power, which clearly extends to determining whether I.R.C. § 280E applies to disallow deductions, as this Court

(now) has twice concluded. Taxpayers' petition for rehearing accordingly should be denied.

ARGUMENT

The panel correctly held that the IRS has authority to investigate and enforce I.R.C. § 280E

Congress has conferred upon the Secretary of the Treasury the responsibility to make accurate determinations of tax liability and has given him broad authority to conduct investigations for that purpose. More specifically, the Commissioner of Internal Revenue, as the Secretary's delegate, is charged with the duty "to make the inquiries, determinations, and assessments of all taxes" imposed by the Internal Revenue Code. I.R.C. § 6201(a). *See also* I.R.C. §§ 6301, 7601. The IRS is further authorized to "examine any books, papers, records, or other data which may be relevant or material to" "determining the liability of any person for any internal revenue tax." I.R.C. § 7602(a).

As relevant here, I.R.C. § 280E prohibits the deduction of any amount incurred in carrying on a business that "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 business is conducted." Taxpayers offer

no valid reason for the panel to revisit its conclusion that the IRS has authority to investigate and determine the applicability of I.R.C. § 280E, or for the entire Court to question that conclusion.

1. Taxpayers first argue that the IRS cannot investigate or enforce I.R.C. § 280E because doing so involves an investigation into criminal activity. (Pet. 7–9.) Taxpayers assert that "it is well established that a civil tax auditor's investigatory power is constitutionally limited when it comes to criminal activity." (Pet. 8.) Taxpayers' conclusory assertion is incorrect. The Supreme Court long ago held that income from illegal sources is just as taxable as income from legitimate sources. *See United States v. Sullivan*, 274 U.S. 259 (1927); *James v. United States*, 366 U.S. 213 (1961). Moreover, as the panel correctly recognized (Op. 10), I.R.C. § 280E is not an outlier – multiple provisions of the Code require precisely such predicate determinations regarding criminal activity. *See, e.g.,* I.R.C. § 162(c)(2) (denial of deductions for "[i]llegal bribes, kickbacks, and other payments"); I.R.C. § 165(e) (permitting a deduction for theft loss, which has been interpreted by 26 C.F.R. (Treas. Reg.) § 1.165-8 (2016) to include losses arising out of "larceny, embezzlement, and robbery");

I.R.C. § 6663 (imposing a civil tax penalty for fraud). Thus, the notion that the IRS has no authority to investigate illegal conduct for the purpose of determining the correct tax liability of the persons involved in such conduct is wrong.

In a related vein, taxpayers contend that the IRS was required to halt its civil investigation into the taxpayer's tax liability when it came upon potentially criminal conduct, and transfer the case for criminal investigation. Taxpayers rely on two criminal cases involving motions to suppress evidence gathered during a civil tax investigation, asserting that the cases stand for the proposition that when the IRS finds firm indications of fraud or other criminal activity, it must put down its (civil) investigatory tools. *See United States v. Peters*, 153 F.3d 445 (7th Cir. 1998); *United States v. Grunewald*, 987 F.2d 531 (8th Cir. 1993).

Such a rule (if it actually existed) would make little sense, as it would prohibit the IRS from fulfilling its responsibility to determine the income of all taxpayers – essentially exempting those involved in criminal activities. Thus, it is not surprising that taxpayers' purported rule does not exist. The cases upon which taxpayers rely address when the IRS "engage[s] in impermissible deception" by conducting a criminal

tax investigation under civil auspices, as would justify a motion to suppress under the Fourth and Fifth Amendments to the Constitution. *See Peters*, 153 F.3d at 453; *Grunewald*, 987 F.2d at 534 (suppression justified where "there is clear and convincing evidence that the IRS affirmatively and intentionally misled the defendant"). These cases do not suggest that the IRS must halt any civil investigation into a taxpayer's correct tax liability where the IRS learns taxpayer has earned money through illegal activities or businesses. *See, e.g., Scharringhausen v. Commissioner*, T.C. Memo. 2012-350 (2012).[2]

2. Taxpayers further argue that the panel's ruling improperly subjects them (and others) to criminal liability based upon the administrative whims of the IRS. (Pet. 9–16.) They suggest that the decision would permit a criminal conviction (apparently under the Controlled Substances Act) based upon the IRS's determination that I.R.C. § 280E applied. (Pet. 9–11.) Taxpayers also claim that the

[2] Whether a business that holds itself out to the public as a marijuana dispensary (and openly advertises itself as such) is trafficking in a controlled substance requires little real "investigation," and presents few risks of the IRS using a civil tax audit to obtain information by trickery or deceit.

panel's decision erects different interpretations of what constitutes trafficking in controlled substances in the civil tax and criminal drug enforcement contexts, violating the "one-interpretation rule." (Pet. 13.) And taxpayers suggest that the panel has opened the door to abuse by the IRS of its power to investigate whether I.R.C. § 280E applies, particularly because, as they see it, the IRS will be accorded *Chevron* deference. (Pet. 13–16.)

Taxpayers' scattershot attack fails to hit its mark. As an initial matter, taxpayers are wrong that the I.R.C. § 280E has "binding effect" on subsequent criminal proceedings. (Pet. 9–11.) Taxpayers rely on two cases from the World War II era in which criminal liability was attached to administrative determinations relating to the selective service and price controls. *See Cox v. United States*, 332 U.S. 442 (1947); *Yakus v. United States*, 321 U.S. 414 (1944). Neither supports taxpayers' assertion that factual findings underlying a judgment as to a taxpayer's tax liability could be used for offensive collateral estoppel in the criminal context. All elements of a criminal violation must be proven beyond a reasonable doubt, and a finding by preponderance of

the evidence that a taxpayer trafficked in controlled substances cannot alone meet that burden, as taxpayers wrongly claim.

Along these same lines, taxpayers are mistaken in asserting that the IRS has advocated for, or that the panel has endorsed, a "tax interpretation" of the Controlled Substances Act. (Pet. 12.) Section 280E plainly incorporates the definition of controlled substances set forth in the Controlled Substances Act. Although the panel observed that the determination of whether one has trafficked in controlled substances is different in the tax and the criminal contexts, the panel was not promoting different interpretations of the same language. To the contrary, the panel was merely stating the obvious – a criminal prosecution for trafficking in controlled substances under the Controlled Substances Act must satisfy a higher burden of proof than a determination of trafficking in controlled substances for purposes of applying I.R.C. § 280E.

Taxpayers' contention that the panel's decision will allow the IRS to "create new drug law crimes at will," apparently because of *Chevron* deference, is meritless. (Pet. 13.) Taxpayers are plainly wrong that this case in any way implicates *Chevron* deference – the IRS has never

asserted that the statutory language of I.R.C. § 280E is ambiguous, nor has the IRS requested deference to its own interpretation.

Taxpayers' scaremongering about third parties (Pet. 14–16) is of no moment. Section 280E applies to strip deductions and credits from those taxpayers whose businesses consist of trafficking in controlled substances. Contrary to taxpayers' fevered assertions (Pet. 14), this provision does not open the door to criminal prosecution of welders or utility companies. As to investigations related to I.R.C. § 280E, the IRS's robust investigatory power is linked concretely to "ascertaining the correctness of any return" or "determining the liability for any internal revenue tax," among other purposes. I.R.C. § 7602. *See also* I.R.C. § 6201(a). Although the IRS possesses broad investigatory power, the Code does not permit the free-roaming investigation that taxpayers ostensibly fear. And, to the extent that taxpayers object to the IRS's investigatory powers, those powers are defined by statute, *see, e.g.*, I.R.C. § 7602, and are not a byproduct of the panel decision.[3]

[3] Taxpayers' hypothetical assertion that the IRS is likely to go on fishing expeditions at large pharmacies is wholly fanciful. Here, it is obvious that taxpayers sold marijuana, which is illegal (under Federal law). The IRS has discretion to decide where to focus its resources, and

2. Taxpayers make two final arguments in search of some defect in the panel's decision, but neither is persuasive. Taxpayers first argue that the panel's ruling puts them at risk of self-incrimination, based upon their obligation to keep and maintain books relating to their business. (Pet. 16–17.) Generally, taxpayers are required to "keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information." 26 C.F.R. § 1.6001-1. This Court has made clear, however – in the very context of a marijuana dispensary – that a taxpayer may invoke the Fifth Amendment against self-incrimination during an audit. *See Feinberg v. Commissioner*, 808 F.3d 813, 816 (10th Cir. 2016). Taxpayers' concerns thus are illusory.

Finally, taxpayers claim that the panel erred in rejecting its argument based on a series of cases striking regulations involving the taxation of illegal conduct – *Leary v. United States*, 395 U.S. 6 (1969);

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which taxpayers to audit. And the IRS's enforcement of this provision as to openly operating marijuana dispensaries does not require it to scour the records of pharmacies and pharmaceutical companies to see if it might apply to them.

Grosso v. United States, 390 U.S. 62 (1968); and *Marchetti v. United States*, 390 U.S. 39 (1968) (together, *Leary*/*Grosso*/*Marchetti*). (Br. 17–21.) Relying on a case currently pending in a district court in which the IRS has summoned information from third parties, taxpayers assert that the IRS is using the investigatory authority recognized by the panel here "to compel the disclosing of the sellers and buyers of marijuana, their licenses and registration numbers, and the quantity of product sold." (Pet. 19.) This case (or the *Standing Akimbo* case referenced by taxpayers) is not comparable to the *Leary*/*Grosso*/*Marchetti* line of cases invoked by taxpayer. As an initial matter, *Standing Akimbo* involves summonses issued to third parties, and in no way involves the self-incrimination concerns at the heart of the *Leary*/*Grosso*/*Marchetti* line of cases. This line of cases is inapplicable for a second reason – claiming a deduction as a marijuana dispensary is not compulsory, as was the case of the taxes on illegal activities in *Leary*/*Grosso*/*Marchetti*. For example, in *Leary*, the Court held that the Fifth Amendment's privilege against self-incrimination prohibited a criminal prosecution for failing to notify the IRS of taxable marijuana transactions that were themselves illegal. 395 U.S. at 16–

18, 27. That decision, however, involved an excise tax imposed under the now-repealed Marijuana Tax Act, *see id.* at 14–15, not deductions from gross income that a taxpayer voluntarily chose to claim on its tax return. Because taxpayers were under no compulsion to claim those deductions, and "the burden of clearly showing the right to [a] claimed deduction is on the taxpayer," *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593 (1943), any objection on grounds of self-incrimination would not save taxpayers.

CONCLUSION

For the foregoing reasons, the petition for panel rehearing and rehearing *en banc* should be denied.

Respectfully submitted,

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AUGUST 2018

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Date: August 31, 2018 /s/ Patrick J. Urda

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CERTIFICATE OF SERVICE AND DIGITAL SUBMISSION

I hereby certify that on August 31, 2018, I electronically filed the foregoing using the court's CM/ECF system which will send notification of such filing to the following:

Mr. James D. Thorburn: jdt@thorburnlaw.com;
Mr. Richard Walker: rwalker@thorburnwalker.com.

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Date: August 31, 2018 /s/ Patrick J. Urda

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