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The High Cost of Schedule I Status: Hemp and Federal Taxes (/full-blog/ngoens)

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By: Nathan Goens, Staff Member

In the Bluegrass and the United States, hemp has enjoyed a very rocky history. Mankind has cultivated the plant for thousands of years.[i] Notwithstanding the historical significance of this plant and its many uses, Congress passed the Controlled Substance Act. This Act categorizes any material, compound, mixture, or preparation that contains the specific chemical designation associated with either marijuana or Tetrahydrocannabinols



(<http://www.kentucky.com/2013/09/12/2818014/kentucky-hemp-commission-asks.html>)

(hereinafter "THC") as a controlled substance[ii] and makes it a crime to manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense such substances.[iii] Various penalties are assessed against violators, including prison, fines, and forfeiture of property used for production or distribution of controlled substances.[iv]

In addition to these criminal penalties, and in line with the public policy goal of deterring illegal enterprises,[v] Congress prohibited the deduction of "any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business . . . consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act)."[vi] Since hemp is botanically related to marijuana, it does contain low levels of naturally occurring THC.[vii] Therefore, the cultivation of hemp has been interpreted to be a violation of the Controlled Substances Act.[viii] Because cultivation of industrial hemp has been held by federal courts to be subject to Controlled Substances Act,[ix] it can reasonably be inferred that the Internal Revenue Service, under the authority of I.R.C. § 280(E), will consider any expenses incurred in the cultivation of hemp as nondeductible expenses.

With the recent passing of the Agriculture Act of 2014, which authorizes institutions of higher education and state departments of agriculture to cultivate hemp for research purposes,[x] the hemp cultivation movement has gained momentum. Kentucky has five such pilot programs in the works. [xi] However, in the midst of this momentum is the absence of clear legislative direction, in the form of creating an exception for hemp from the list Schedule I substances and clearing the air of any deductibility uncertainty for those who wish to till the soil and plant hemp seeds.

Although the Internal Revenue Service has taken a rigid stance against the deductibility of business expenses related to the novel trade of selling of medical marijuana, finding support in both I.R.C. § 280(E) and the Supreme Court in *United States v. Oakland Cannabis Buyers' Co-op.*, 532 U.S. 483 (2001),[xii] pro-hemp litigants have found success arguing that de facto classification of hemp as a Schedule I substance by government agencies is void for failure to follow the Controlled Substances Act's scheduling rules.[xiii] Until the legislature abandons half-measures and creates an exception for hemp from the list of Schedule I drugs listed in the Controlled Substance Act, winning the classification battle in court may be the only outlet to ensure the deductibility of hemp-cultivation related expenses for hemp cultivators. Without such legislative support, creating a coalition of farmers who are willing to face the economic and criminal uncertainty of growing hemp will continue to be a challenge.

[i] Robert Deitch, *Hemp: American History Revisited: The Plant with a Divided History 1* (Algora Publishing, 2003).

[ii] 21 U.S.C.A. § 812(c)(1)(c)(10), (17) (2012).

[iii] 21 U.S.C.A. § 841(a)(1) (2012).

[iv] 21 U.S.C.A. §§ 841-863 (2012).

[v] Benjamin Moses Leff, *Tax Planning for Marijuana Dealers*, 523 Iowa L. Rev. 526 (1999) (citing S. REP. NO. 97-494, at 309 (1982) ("To allow drug dealers the benefit of business expense 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.")).

[vi] I.R.C. § 280E (2012).

[vii] David P. West, *Hemp and Marijuana: Myths & Realities 8* (North American Industrial Hemp Council, 1998).

[viii] *See United States v. White Plume*, 447 F.3d 1067, 1073 (8th Cir. 2006).

[ix] *Id.*

[x] Agricultural Act of 2014, Pub. L. No. 113-79, § 7606(a)(1)-(2), 128 Stat. 649.

[xi] *Industrial Hemp Program, Ky.* Dep't of Agric., <http://www.kyagr.com/marketing/hemp-pilot.html> (last visited Nov. 17, 2014).

[xii] Letter from Andrew J. Keyso, Deputy Assoc. Chief Counsel, Internal Revenue Serv., to The Honorable Fortney Pete Stark, U.S. House of Representatives (March 25, 2011) *available at* <http://www.irs.gov/pub/irs-wd/11-0005.pdf>.

[xiii] *Hemp Industries Ass'n. v. Drug Enforcement Admin.*, 357 F.3d 1012, 1019 (9th Cir. 2004).

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631 SOUTH LIMESTONE, LEXINGTON, KY

40508 (859) 257-4747 [BLOG.KJEANRL@GMAIL.COM](mailto:blog.kjeanrl@gmail.com) ([MAILTO:BLOG.KJEANRL@GMAIL.COM](mailto:blog.kjeanrl@gmail.com))