TATE OF NEW MEXICO
ADMINISTRATIVE HEARINGS OFFICE
TAX ADMINISTRATION ACT

IN THE MATTER OF THE PROTEST OF
SANDIA BOTANICALS
TO ASSESSMENT ISSUED UNDER
LETTER ID NO. L0492757168

v. AHO Case Number 19.04-043A, D&O 22-09

NEW MEXICO TAXATION AND REVENUE DEPARTMENT

DECISION AND ORDER GRANTING SUMMARY JUDGMENT FOR TAXPAYER

This matter came before the Administrative Hearings Office, Hearing Officer Chris Romero, Esq., upon the competing motions for summary judgment in the protest of Sandia Botanicals ("Taxpayer") pursuant to the Tax Administration Act and the Administrative Hearings Office Act. Taxpayer is represented by Mr. Lewis Terr, Esq. The Taxation and Revenue Department ("Department") is represented by Mr. Richard Pener, Esq.

Taxpayer filed Taxpayer's Motion for Summary Judgment ("Motion") on October 3, 2019. The Department filed New Mexico Department of Taxation and Revenue's Response to Sandia Botanicals, Inc.'s Motion for Summary Judgment and Cross Motion and Memorandum in Support of Cross Motion for Summary Judgment on October 21, 2019 ("Response and Cross Motion"). On December 12, 2019, Taxpayer filed Taxpayer's Response to Taxation and Revenue Department's Cross Motion for Summary Judgment ("Response to Cross Motion").

The Hearing Officer delayed issuing this decision anticipating that a final decision in *Sacred Garden, Inc. v. New Mexico Taxation & Revenue Dep't*, 2021-NMCA-038, ¶17, 495 P.3d 576, 580, *cert. quashed Sacred Garden v. Taxation*, No. S-1-SC-38164 (Feb. 23, 2022) would be valuable to the issues now under consideration. The New Mexico Court of Appeals published its formal opinion in *Sacred Garden, Inc. v. New Mexico Taxation & Revenue Dep't*, 2021-NMCA-

038, 495 P.3d 576 on January 28, 2020. The New Mexico Supreme Court granted a writ of certiorari on March 29, 2021 in No. S-1-SC-38164. However, on February 23, 2022, the New Mexico Supreme Court quashed its writ of certiorari as improvidently granted and ordered that a mandate immediately issue.

The primary legal issue presented concentrates on whether New Mexico is either required or permitted to apply 26 U.S.C. Section 280E (hereafter "Section 280E") in disallowing certain business deductions in the computation of New Mexico income tax. Because the Hearing Officer concludes that application of Section 280E contradicts the intentions of the Legislature under New Mexico law, Taxpayer's motion and protest should be granted. The Department's motion should be denied. IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

1. Taxpayer was incorporated in New Mexico on October 19, 2009 and began business in New Mexico the same year. Taxpayer produces cannabis for medical use in New Mexico and sells it, as well as various derivatives, to qualified patients. [Response and Cross Motion (Affidavit of Daniel Armer, Para. 5 (a))]

2. Taxpayer produces and sells medicinal cannabis in New Mexico under the authority of the Lynn and Erin Compassionate Use Act, NMSA 1978, Chapter 26, Article 2B ("Compassionate Use Act"). [Response and Cross Motion (Affidavit of Daniel Armer, Para. 5 (a))]

3. Taxpayer was audited by the Department for the audit period beginning January 1, 2011 through December 31, 2016. [Response and Cross Motion (Affidavit of Daniel Armer, Paras. 4 and 5 (b))]

4. A true and correct copy of the Audit Report prepared by auditor Dung Nguyen after auditing Taxpayers New Mexico Corporate tax returns for the years 2011 through 2016 is attached to Daniel Armer's Affidavit as Exhibit A to Attachment 1. [Response and Cross Motion (Affidavit of Daniel Armer, Paras. 4 and 5 (b))]

5. The audit concluded that Taxpayer understated its income because it had deducted from its gross income ordinary and necessary business expenses. [Motion (Undisputed Fact No. 3); Response and Cross Motion (Affidavit of Daniel Armer, Para. 5 (d))]]

6. The Department's audit concluded that for tax years 2011 through 2016, the taxable income reported on Taxpayer's New Mexico corporate income tax returns matched what the Taxpayer reported on its federal corporate income tax returns, but that the taxable income amounts reflected adjustments for expenses in cost of goods sold ("COGS") that were not permissible under Section 280E. [Response and Cross Motion (Affidavit of Daniel Armer, Para. 5 (d))]

7. The Department went on to conclude that the expenses not related to production, and which would normally be classified as sales and administrative or managerial expenses should be disallowed pursuant to Section 280E and omitted from the calculation for COGS. Disallowed expenses included administrative and compliance (labor), administrative compliance benefits, administrative telephone, professional fees, bank charges, and contract labor. Disallowing ordinary and necessary business expenses resulted in an increase of taxable income. [Response and Cross Motion (Affidavit of Daniel Armer, Para. 5 (e)); Motion (Fact Nos. 3 – 4)]

8. The Department went on to conclude that for tax year 2011, Taxpayer was unable to provide a breakdown and supporting documents to separate the cost of labor that was related to COGS and the cost of labor that was not related to COGS. For 2011, the Auditor determined

the portion of labor to be allocated to COGS by using the average percentage of cost of labor related to COGS divided by the total cost of labor during the period from 2012 through 2016. [Response and Cross Motion (Affidavit of Daniel Armer, Para. 5 (f))]

9. The audit report noted no other bases for adjustments to Taxpayer's reported taxable income other than those resulting from its deduction of business expenses that would have been allowable but for the Department's application of Section 280E. [Motion (Fact No. 5)]

10. If the auditor had not disallowed deductions from gross income for all ordinary and necessary business expenses claimed by Taxpayer in arriving at its taxable income, the audit would not have resulted in any significant adjustments to the tax due for the tax periods covered by the audit. [Motion (Fact No. 24)]

11. On November 8, 2018, the Department issued a Notice of Assessment of Taxes and Demand for Payment under Letter ID L0492757168 in the amount of $96,897.52 comprised of corporate income taxes in the amount of $72,325.00, penalty in the amount of $14,465.00, and interest in the amount of $10,107.52 for the corporate income tax periods from December 31, 2011 to December 31, 2016 ("Assessment"). [Administrative File; Motion (Undisputed Fact No. 1)]

12. The Assessment derived from an audit of the Taxpayer conducted by the Department. [Response and Cross Motion (Affidavit of Daniel Armer, Paras. 4 and 5 (b)); Motion (Undisputed Fact No. 2)]

13. On January 25, 2019, Taxpayer filed a timely protest of the Assessment with the Department's Protest Office, which was accompanied by a Tax Information Authorization (TIA) form. [Administrative File; Response and Cross Motion, Page 4); Motion (Fact No. 6)]

14. On February 19, 2019, the Department acknowledged Taxpayer's protest under Letter ID No. L1700145328. [Administrative File; Motion (Fact No. 6)]

15. On April 5, 2019, the Department submitted a Hearing Request to the Administrative Hearings Office in which it requested that the protest be set for a scheduling hearing. [Administrative File]

16. On April 5, 2019, the Administrative Hearings Office entered a Notice of Telephonic Scheduling Hearing that set an initial scheduling hearing on April 26, 2019. [Administrative File]

17. On April 9, 2019, the Department, by and through counsel, filed a Motion for Continuance of the telephonic scheduling hearing. Taxpayer concurred in the request for a continuance by separate email to the Administrative Hearings Officed. [Administrative File]

18. On April 10, 2019, the Administrative Hearings Office entered a Continuance Order and Notice of Telephonic Scheduling Hearing that continued the initial scheduling hearing to April 29, 2019. [Administrative File]

19. A telephonic scheduling hearing occurred on April 29, 2019 at which time neither party objected that the hearing would satisfy the 90-day hearing requirement of Section 7-1B-6.

20. On April 29, 2019, the Administrative Hearings Office entered a Scheduling Order and Notice of Administrative Hearing that set a motions hearing for January 6, 2020, a hearing on the merits of Taxpayer's protest on January 27, 2020, and other associated deadlines. [Administrative File]

21. On October 3, 2019, the Taxpayer filed Taxpayer's Motion. [Administrative File]

22. On October 21, 2019, the Department filed New Mexico Taxation and Revenue Department's Unopposed Motion for Leave to File Its Response to Sandia Botanicals, Inc's

Motion for Summary Judgment and Cross-motion and Memorandum in Support of Cross Motion for Summary Judgment Out of Time. [Administrative File]

23. On October 21, 2019, the Department filed its Response and Cross Motion. [Administrative File]

24. On November 12, 2019, Taxpayer filed an Unopposed Motion to Vacate Hearing Date and Re-Set. [Administrative File]

25. On November 21, 2019, The Administrative Hearings Office entered an Order Vacating Motion Hearing and Notice of Telephonic Status Hearing. [Administrative File]

26. On November 25, 2019, the Administrative Hearings Office entered an Order Granting Department's Unopposed Motion for Leave to File Response, Cross Motion, and Memorandum in Support of Cross Motion. [Administrative File]

27. On December 10, 2019, Taxpayer filed its Unopposed Motion to File Response to Taxation and Revenue Department's Cross-Motion for Summary Judgment Out of Time. [Administrative File]

28. On December 10, 2019, the Administrative Hearings Office entered an Order Granting Unopposed Motion to File Response to Taxation and Revenue Department's Cross-Motion for Summary Judgment Out of Time. [Administrative File]

29. On December 11, 2019, the Administrative Hearings Office entered an Order Converting Merits Hearing to Motions Hearing. [Administrative File]

30. On December 12, 2019, Taxpayer filed its Response to Cross Motion. [Administrative File]

31. On January 9, 2020, the parties filed Joint Motion to Waive Oral Argument and Vacate Hearing. [Administrative File]

32. On January 27, 2020, the Administrative Hearings Office entered an Order Vacating Motion Hearing. [Administrative File]

DISCUSSION

Because the issue presented centers on a question of law, and there are no disputed material facts, both parties moved for summary judgment. In controversies involving a question of law, or application of law where there are no disputed facts, summary judgment is appropriate. *See Koenig v. Perez*, 1986-NMSC-066, ¶10-11, 104 N.M. 664. If the movant for summary judgment makes a prima facie showing that it is entitled to a judgment as a matter of law, the burden shifts to the opposing party to show evidentiary facts that would require a trial on the merits. *See Roth v. Thompson*, 1992-NMSC-011, ¶17, 113 N.M. 331.

The material facts presented by this protest are not in dispute. Taxpayer is engaged in the business of producing, packaging, and dispensing medical cannabis, an activity that during all times relevant to the protest has been legal under the Lynn and Erin Compassionate Use Act, NMSA 1978, Chapter 26, Article 2B ("Compassionate Use Act"), the purpose of which "is to allow the beneficial use of medical cannabis in a regulated system for alleviating symptoms caused by debilitating medical conditions and their medical treatments." *See* NMSA 1978, Section 26-2A-2 (2007)

Presumption of Correctness

Pursuant to NMSA 1978, Section 7-1-17 (C) (2007), the Assessment of tax issued in this case is presumed correct and unless otherwise specified, for the purposes of the Tax Administration Act, "tax" includes interest and civil penalty. *See* NMSA 1978, Section 7-1-3 (X) (2013). Therefore, under Regulation 3.1.6.13 NMAC, the presumption of correctness under Section 7-1-17 (C) also extends to the Department's assessment of penalty and interest. *See*

Chevron U.S.A., Inc. v. State ex rel. Dep't of Taxation & Revenue, 2006-NMCA-050, ¶16, 139 N.M. 498, 134 P.3d 785 (agency regulations interpreting a statute are presumed proper and are to be given substantial weight).

As a result, the presumption of correctness in favor of the Department requires that Taxpayer carry the burden of presenting countervailing evidence or legal argument to establish entitlement to abatement of the Assessment. *See N.M. Taxation & Revenue Dep't v. Casias Trucking*, 2014-NMCA-099, ¶8, 336 P.3d 436. "Unsubstantiated statements that [an] assessment is incorrect cannot overcome the presumption of correctness." *See MPC Ltd. v. N.M. Taxation & Revenue Dep't,* 2003-NMCA-021, ¶13, 133 N.M. 217, 62 P.3d 308; *See also* Regulation 3.1.6.12 NMAC. If a taxpayer presents sufficient evidence to rebut the presumption, then the burden shifts to the Department to re-establish the correctness of the assessment. *See MPC*, 2003-NMCA-021, ¶13.

Since the central issue in dispute relates to the claim for business deductions, Taxpayer bears the burden of establishing entitlement to a clearly and unambiguously expressed statutory deduction. *See TPL, Inc. v. N.M. Taxation & Revenue Dep't*, 2003-NMSC-007, ¶9, 133 N.M. 447, 64 P.3d 474. Tax statutes must also be given "fair, unbiased, and reasonable construction, without favor or prejudice to either the taxpayer or the [s]tate, to the end that the legislative intent is effectuated and the public interests to be subserved thereby are furthered." *See Chavez v. Comm'r of Revenue*, 1970-NMCA-116, ¶7, 82 N.M. 97, 476 P.2d 67.

Application of 26 U.S.C. Section 280E

The central issue of this protest is the application of Section 280E in the computation of Taxpayer's New Mexico income tax liability.

At the federal level, Section 280E prohibits a Taxpayer and other similarly situated

businesses from taking deductions and claiming credits on their federal income taxes for any amounts paid or incurred in "trafficking[1]" in controlled substances. *See Californians Helping to Alleviate Med. Problems, Inc. v. Comm'r*, 128 T.C. 173, 182 (2007) ("Section 280E and its legislative history express a congressional intent to disallow deductions attributable to a trade or business of trafficking in controlled substances."). Although Section 280E does not define "trafficking," courts in this context have interpreted the term to mean "engaging in a commercial activity—that is, to buy and sell regularly." *Id*.

A sampling of the categories of deductions precluded include "ordinary and necessary" business expenses under IRC Section 162(a), state and local taxes under IRC Section 164, losses under IRC Section 165, and depreciation under IRC Section 167. Even charitable contributions incurred "in carrying on" the business of trafficking marijuana have been held nondeductible. *See Wellness v. Comm'r of Internal Revenue*, 156 T.C. 62 (2021). As a result, businesses lawfully engaged in the commercial activity at the state level of regularly buying or selling cannabis are prohibited from "writing off" many of their operating expenses and overhead costs including rent, utilities, and payroll expenses for federal income tax purposes because of their status under federal law.

In this protest, Taxpayer perceives the Department as improperly applying Section 280E in the computation of Taxpayer's "base income" as defined by Section 7-2A-2 (C) (2017, Amended 2021). In other words, the Department assumes the same position as the Internal Revenue Service under Section 280E regarding taxation of businesses in the medical cannabis sector despite the fact that New Mexico law and federal law view the activity in stark contrast to

[1] The Hearing Officer acknowledges that the term, "trafficking," may be perceived as suggesting criminal activities. The Hearing Officer does not intend for use of that term in this Decision and Order to imply such meaning with respect to Taxpayer (or any other similarly situated business). Use of the term, "trafficking," is merely intended to correspond with the language used in Section 280E.

one another.

Understandably, the Department does not see the issue through the same lens. The Department asserts that it is *required* by statute to determine "base income" with reference to "taxable income" as determined by a taxpayer's federal corporate income tax return. It cites NMSA 1978, Section 7-2A-2 (C) (2017, Amended 2021) which explains in relevant part:

> C. "base income" means that part of the taxpayer's *income defined as taxable income and upon which the federal income tax is calculated in the Internal Revenue Code for income tax purposes* plus [other enumerated items.]
>
> [Emphasis Added]

As such, the Department relies on the longstanding method of calculating state income tax by beginning with the income upon which a taxpayer must pay tax to the federal government. *See Holt v. New Mexico Dept. of Taxation & Revenue*, 2002-NMSC-034, ¶9, 133 N.M. 11, 13, 59 P.3d 491, 493; *Champion Int'l Corp. v. Bureau of Revenue*, 1975-NMCA-106, ¶39, 88 N.M. 411, 416, 540 P.2d 1300, 1305.

It asserts that the starting point for state taxation begins with "base income," as calculated under the requirements of the Internal Revenue Code. For that reason, "base income" will incorporate applicable deductions for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business" under 26 U.S.C Section 162 (a) with adjustment for the application of Section 280E when deemed to apply.

Despite the broad prohibitions established by Section 280E, it does not prevent cannabis businesses from reducing gross receipts by the cost of goods sold ("COGS") when computing their federal income tax liability.[2] COGS generally refers to "expenditures necessary to acquire, construct or extract a physical product which is to be sold." *See Reading v. Comm'r*, 70 T.C.

[2] https://www.irs.gov/businesses/small-businesses-self-employed/marijuana-industry-frequently-asked-questions

730, 733 (1978), *aff'd*, 614 F.2d 159 (8th Cir. 1980). "A taxpayer derives COGS using the following formula: beginning inventories plus current-year production costs (in the case of a producer) or current-year purchases (in the case of a reseller) less ending inventories." *See* FN2.

It is within this setting that the Department rejected Taxpayer's claim for deductions for ordinary and necessary business expenses explaining that the New Mexico Legislature had not provided for such deductions, and for that reason, it was obligated to strictly adhere to Section 280E in the same manner as the IRS. The Department's audit narrative (attached as Exhibit A, Page 3, to Attachment No. 1 to Response and Cross Motion) explained:

> NM CIT statutes and the Department income tax regulations follow the Federal IRC set by the Federal Treasury Department, Internal Revenue Service (IRS). No deviations from the IRC have been made in the Department regulations relative to the treatment of the deductions for illegal activities that would affect the treatment of the facts in this audit.

Therefore, the Department observed, "[i]n order for [Taxpayer] to remain in good standing with the New Mexico Taxation and Revenue Department […], the taxpayer will need to be Title 26 IRC §280 (E) compliant and present reasonable and reliable figures for the items that make up COGS." In other words, Taxpayer would be required to omit customarily deductible expenses from its gross income under Section 280E.

Therefore, the Department asserts that Taxpayer's "base income" should be adjusted to reflect the disallowance of deductions for ordinary and necessary business expenses prohibited by Section 280E, along with other expenses which it determined were inappropriately included in the computation of costs of goods sold. The result of the disallowance increases Taxpayer's "base income" and associated income tax, leading to the disputed Assessment at issue in this protest.

The referenced provision of the Internal Revenue Code, Section 280E, specifies:

> 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.

Notwithstanding the prohibition of medical cannabis under federal law, New Mexico has legislatively legalized and legitimized the production, packaging, and dispensing of medical cannabis under the Compassionate Use Act. Yet, the Department claims, "[t]he fact that Taxpayer produces and sells medical cannabis in a state where licensed producers and vendors are exempt from criminal prosecution is irrelevant for purposes of I.R.C. § 280E."

In light of direction from the New Mexico Court of Appeals and the New Mexico Supreme Court's recent quashing of its writ of certiorari in *Sacred Garden*, the Hearing Officer does not agree that the legalization (or decriminalization) of medical cannabis in New Mexico is irrelevant for the purposes of Section 280E because to do so disregards the intentions of the Legislature when it enacted the Compassionate Use Act.

Well-established principles of statutory construction guide the interpretation of state tax laws in which the primary goal is "to give effect to the intent of the [L]egislature." *See Dell Catalog Sales L.P. v. N.M. Taxation & Revenue Dep't*, 2009-NMCA-001, ¶19, 145 N.M. 419, 199 P.3d 863. Legislative intent is fulfilled "by first looking at the plain meaning of the language of the statute, reading the provisions ... together to produce a harmonious whole." *Id*.; *Sundance Mech. & Util. Corp. v. Armijo*, 1987-NMSC-078, ¶5, 106 N.M. 249, 250, 741 P.2d 1370, 1371.

Despite its status under federal law, Taxpayer engages in a permissible business activity under the authority of the Compassionate Use Act which "was expressly intended 'to allow the beneficial use of medical cannabis in a regulated system for alleviating the symptoms caused by

debilitating medical conditions and their medical treatments.'" *See* NMSA 1978, Section 26-2A-2 (2007); *Sacred Garden, Inc. v. New Mexico Taxation & Revenue Dep't*, 2021-NMCA-038, ¶17, 495 P.3d 576, 580, *cert. quashed Sacred Garden v. Taxation*, No. S-1-SC-38164 (Feb. 23, 2022).

In *Sacred Garden*, the Court of Appeals said, "the Compassionate Use Act was intended to make medical marijuana accessible to those with debilitating medical conditions who might benefit from the use thereof." *Id*. In evaluating whether a similarly situated taxpayer could obtain the benefit of a gross receipts tax deduction reserved for prescription drugs, the Court of Appeals observed that, "[i]t is reasonably self-evident that the deduction from gross receipts for prescription drugs was similarly intended to make medical treatment more accessible, by lessening the expense to those who require it. These statutes should be read harmoniously, to give effect to their commonality of purpose." *Id*. Although this observation was directed to a deduction from gross receipts under the Gross Receipts and Compensating Tax Act, the same logic applies in the present case. *Sacred Garden* observed that affordability was a key component of the Legislature's intentions, emphasizing, "it is noteworthy that the financial impact report issued in association with the Compassionate Use Act did not contemplate that any tax revenue would be generated thereby." *See Sacred Garden, Inc.*, 2021-NMCA-038, ¶16.

If pursuant to the observation made in *Sacred Garden* that affordability was a key component of the Legislature's intent, then the Department's proposed application of Section 280E to prohibit deduction of medical cannabis business expenses simply because of its status under federal law surely contradicts those intentions. Refusing Taxpayer the benefits of income tax deductions commonly allowed for other, "traditional" forms of business increase Taxpayer's costs which ultimately get passed on to the consumer in the form of a higher price, which is the result the Legislature, according to *Sacred Garden*, wanted to avoid.

Despite the Department's perception that the application of Section 280E is unyielding, a close review of the introductory paragraphs of NMSA 1978, Sections 7-2-2 and 7-2A-2 (defining "base income" for purposes of the Income Tax Act and the Corporate Income and Franchise Tax Act) reveal that the Legislature intended to allow some reasonable flexibility and discretion depending on the circumstances presented. Both sections state with concern for all the defined terms that follow, including the definitions of "base income" that:

> For the purpose of the [Income Tax Act and Corporate Income and Franchise Tax Act] *and unless the context requires otherwise*[…]
>
> [Emphasis Added]

This simple phrase, clear and unambiguous, and perhaps easily overlooked, exemplifies the Legislature's intention to avoid absurd results. Conversely stated, it signifies the desire that none of the terms be inflexibly construed when a literal construction under some circumstances would contradict the Legislature's intentions. *See Quintero v. N.M. Dept. of Transp.*, 2010-NMCA-081, ¶13, 148 N.M. 903, 906, 242 P.3d 470, 473 (observing that a similar phrase, "unless the context otherwise requires," is used to acknowledge that certain factual situations will not come within the literal language of a statute.)

Continuing with the analysis, it would be clearly contradictory to the Legislature's intention to permit a deduction from gross receipts on one hand, for the reasons the Court of Appeals found reasonably self-evident in *Sacred Garden*, yet deny Taxpayer and other similarly situated businesses the benefits of deducting ordinary and necessary business expenses for income tax purposes on the other. The results would be that the increased tax burden on one end would consume the benefits provided on the other. This construction fails to produce a "harmonious whole" and leads to absurd results whereby the Legislature's intentions, as recognized in *Sacred Garden*, are not effectuated, but instead trampled; where the public

interests to be subserved thereby are not furthered (evoking *Chavez*, 1970-NMCA-116, ¶7).

Instead, the scenario now at hand represents the sort of unique circumstances the Legislature contemplated when it permitted the Department to deviate from its definitions by use of the exception, "unless the context requires otherwise" to regard Taxpayer as it would other traditional forms of businesses, such as, for example, pharmacies as seen in *Sacred Garden*.

In another example illustrative of the Legislature's intent, the Compassionate Use Act, at NMSA 1978, Section 26-2B-4 (F) (2007, amended 2019, 2021) provides that, "*A licensed producer shall not be subject to … penalty, in any manner*, for the production, possession, distribution or dispensing of cannabis pursuant to the Lynn and Erin Compassionate Use Act." This language not only embodies the intentions of the Legislature that no criminal or civil penalties be imposed on licensed producers engaging in business under the Compassionate Use Act, but that they be viewed analogous with any other "traditional" business.

Although strict application of Section 280E may not technically be perceived as a penalty as seen in cases such as *N. California Small Bus. Assistants Inc. v. Comm'r of Internal Revenue*, 153 T.C. 65, 68 (2019), its strict application to Taxpayer under New Mexico law sets it apart from other businesses engaged in lawful business activity. Indeed, application of Section 280E places Taxpayer at a disadvantage to the extent it denies the benefit of common tax deductions which will increase its state income tax liability based solely on how it is perceived under federal law despite engaging in "the production, possession, distribution or dispensing of cannabis," activities that have long been permissible under the Compassionate Use Act in New Mexico. *Id.*

As previously observed, federal law and state law view Taxpayer's business activities in stark contrast to one another. However, the fact that the IRS views the activity contrarily does not circumvent the will of the New Mexico Legislature which is entitled to establish a different

policy for New Mexico, "to make medical marijuana accessible to those with debilitating medical conditions who might benefit from the use thereof."

"Federal or state deductions are a matter of legislative grace and a way of achieving policy objectives." *See Sutin, Thayer & Browne v. Revenue Div. of Taxation & Revenue Dept.*, 1985-NMCA-047, ¶17, 104 N.M. 633, 636, 725 P.2d 833. As observed by the Court of Appeals in *Sacred Garden*, the policy objective of the Compassionate Use Act is readily apparent and encompasses the intent to minimize costs to those who could benefit from the use of medical cannabis. Omitting Section 280E from the computation of Taxpayer's New Mexico state income tax liability promotes the Legislature's objective and is consistent with the discretion afforded to the Department to consider its definitions within the context of the given circumstances. For this reason, Taxpayer's protest should be granted.

In 2021, the New Mexico Legislature passed the Cannabis Regulation Act during its first special session[3] of 2021. It was signed by the governor of the State of New Mexico on April 12, 2021 and became effective on June 29, 2021. Among various other enactments, including the legalization of recreational adult-use cannabis, it amended the definition of "base income" in NMSA 1978, Sections 7-2-2 and 7-2A-2 to explicitly exclude "an amount equal to any expenditure that is eligible to be claimed as a federal income tax deduction but is disallowed pursuant to Section 280E of the Internal Revenue Code[.]" *See* NMSA 1978, Section 7-2-2 (B) (5) (2021); NMSA 1978, Section 7-2A-2 (C) (4) (2021); 2021 New Mexico Laws 1st Sp. Sess. Ch. 4 (H.B. 2).

Given that the same bill clarified the application of NMSA 1978, Section 7-9-73.2[4]

[3] *See* https://www.governor.state.nm.us/wp-content/uploads/2021/12/House-Executive-Message-1-Proclamation.pdf

[4] The 2021 enactment of the Cannabis Regulation Act codified the ruling of the New Mexico Court of Appeals in *Sacred Garden* by inserting the italicized language in the following quotation which was not previously explicit in

consistent with the court's ruling in *Sacred Garden*, the Hearing Officer perceives the amendment to "base income" in a similar light – that is, to clarify the existing law consistent with the purpose expounded by *Sacred Garden*, rather than change it. *See Aguilera v. Bd. of Educ. of Hatch Valley Sch.*, 2006-NMSC-015, ¶ 20, 139 N.M. 330, 335, 132 P.3d 587, 592 (Changing a definition is "[s]uch a modest step [that it] is not usually a harbinger of radical change.")

The Hearing Officer does not reach Taxpayer's assertions that the Department's application of Section 280E contradicts Taxpayer's right to equal protection under the state (or even federal) constitutions because the determination is not necessary to the disposition of the protest. *See Advance Sch., Inc. v. Bureau of Revenue*, 1976-NMSC-007, ¶11, 89 N.M. 79, 82, 547 P.2d 562, 565 ("Constitutional questions are not decided unless they are necessary to the disposition of the case."); *Allen v. LeMaster*, 2012-NMSC-001, ¶28, 267 P.3d 806, 812–13; *Schlieter v. Carlos*, 1989-NMSC-037, ¶13, 108 N.M. 507, 510, 775 P.2d 709, 712 ("[Courts] have repeatedly declined to decide constitutional questions unless necessary to the disposition of the case.")

In conclusion, the Hearing Officer will emphasize that "base income" is the figure from which the computation of New Mexico income tax begins. The various mathematical processes for computing that figure may vary from taxpayer to taxpayer but should always result in a computation that accurately reflects the taxpayer's federal tax obligation, but from which the Department possesses the latitude to deviate when necessary. *See Holt*, 2002-NMSC-034, ¶22

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the statute. *See* NMSA 1978, Section 7-9-73.1 (2007). It now reads, "Receipts from the sale of prescription drugs and oxygen and oxygen services provided by a licensed medicare durable medical equipment provider *and cannabis products that are sold in accordance with the Lynn and Erin Compassionate Use Act* may be deducted from gross receipts and governmental gross receipts." *See* NMSA 1978, Section 7-9-73.1 (A) (2021) (italics in quotation emphasizing new material)

("Department has the authority to examine records in order to determine the extent of the taxpayers' liability[.]"). Under the facts of this protest, that authority to deviate derives from the discretion provided by Section 7-2A-2, the Compassionate Use Act, as well as *Holt* which recognized the Department's authority to make an independent evaluation of a taxpayer's liability despite whatever information the taxpayer reported to the federal tax authorities.

For the reasons stated, Taxpayer's protest is GRANTED.

CONCLUSIONS OF LAW

A. Taxpayer filed a timely, written protest to the Assessment. Jurisdiction lies over the parties and the subject matter of this protest.

B. The Department made a timely request for hearing and the Administrative Hearings Office conducted a timely hearing within 90 days of Taxpayer's protest under NMSA 1978, Section 7-1B-8 (2019).

C. The parties did not object that conducting the scheduling hearing satisfied the 90-day hearing requirements of Section 7-1B-8 (A) while still allowing meaningful time for completion of the other statutory requirements under Section 7-1B-6 (D). *See also* Regulation 22.600.3.8 (E) NMAC.

D. Taxpayer carries the burden to present countervailing evidence or legal argument to show entitlement to an abatement of an assessment. *See Casias Trucking*, 2014-NMCA-099, ¶8.

E. If Taxpayer presents sufficient evidence to rebut the presumption, then the burden shifts to the Department to re-establish the correctness of the assessment. *See MPC Ltd.*, 2003-NMCA-021, ¶13.

F. Taxpayer overcame the presumption of correctness with respect to the computation

of its income tax liability. *See* Section 7-1-17(C).

G. Taxpayer bears the burden of establishing entitlement to a clearly and unambiguously expressed statutory deduction. *See TPL, Inc. v. N.M. Taxation & Revenue Dep't*, 2003-NMSC-007, ¶9, 133 N.M. 447, 64 P.3d 474.

H. "Federal or state deductions are a matter of legislative grace and a way of achieving policy objectives." *See Sutin, Thayer & Browne v. Revenue Div. of Taxation & Revenue Dept.*, 1985-NMCA-047, ¶17, 104 N.M. 633, 636, 725 P.2d 833.

I. Statutory provisions must be given "fair, unbiased, and reasonable construction, without favor or prejudice to either the taxpayer or the [s]tate, to the end that the legislative intent is effectuated and the public interests to be subserved thereby are furthered." *See Chavez v. Comm'r of Revenue*, 1970-NMCA-116, ¶7, 82 N.M. 97, 476 P.2d 67.

J. The primary goal of statutory interpretation is "to give effect to the intent of the [L]egislature." *See Dell Catalog Sales L.P. v. N.M. Taxation & Revenue Dep't*, 2009-NMCA-001, ¶19, 145 N.M. 419, 199 P.3d 863.

K. Legislative intent is fulfilled "by first looking at the plain meaning of the language of the statute, reading the provisions ... together to produce a harmonious whole." *See Dell Catalog Sales L.P. v. N.M. Taxation & Revenue Dep't*, 2009-NMCA-001, ¶19, 145 N.M. 419, 199 P.3d 863; *Sundance Mech. & Util. Corp. v. Armijo*, 1987-NMSC-078, ¶5, 106 N.M. 249, 250, 741 P.2d 1370, 1371.

L. 26 U.S.C. Section 280E prohibits businesses engaged in trafficking cannabis from taking deductions and claiming credits on their federal income taxes for any amounts paid or incurred in such business activity. *See Californians Helping to Alleviate Med. Problems, Inc. v. Comm'r*, 128 T.C. 173, 182 (2007) ("Section 280E and its legislative history express a

congressional intent to disallow deductions attributable to a trade or business of trafficking in controlled substances.").

M. "Trafficking" for the purpose of 26 U.S.C. Section 280E means "engaging in a commercial activity—that is, to buy and sell regularly." *See Californians Helping to Alleviate Med. Problems, Inc. v. Comm'r*, 128 T.C. 173, 182 (2007)

N. The business of producing, packaging, and dispensing medical cannabis is legal in New Mexico under the Lynn and Erin Compassionate Use Act, NMSA 1978, Chapter 26, Article 2B.

O. The business of producing, packaging, and dispensing medical cannabis, although legal in New Mexico under the Lynn and Erin Compassionate Use Act, NMSA 1978, Chapter 26, Article 2B, constitutes "trafficking" for the purpose of 26 U.S.C. Section 280E. *See Californians Helping to Alleviate Med. Problems, Inc. v. Comm'r*, 128 T.C. 173, 182 (2007).

P. The Lynn and Erin Compassionate Use Act, NMSA 1978, Chapter 26, Article 2B "was expressly intended 'to allow the beneficial use of medical cannabis in a regulated system for alleviating the symptoms caused by debilitating medical conditions and their medical treatments.'" *See* NMSA 1978, Section 26-2A-2 (2007); *Sacred Garden, Inc. v. New Mexico Taxation & Revenue Dep't*, 2021-NMCA-038, ¶17, 495 P.3d 576, 580, *cert. quashed Sacred Garden v. Taxation*, No. S-1-SC-38164 (Feb. 23, 2022).

Q. "A licensed producer shall not be subject to … penalty, in any manner, for the production, possession, distribution or dispensing of cannabis pursuant to the Lynn and Erin Compassionate Use Act." *See* NMSA 1978, Section 26-2B-4 (F) (2007, amended 2019, 2021)

R. The computation of New Mexico income tax begins with "base income" as defined by NMSA 1978, Section 7-2A-2 (C) (2017, Amended 2021); *See Holt v. New Mexico*

Dept. of Taxation & Revenue, 2002-NMSC-034, ¶9, 133 N.M. 11, 13, 59 P.3d 491, 493; *Champion Int'l Corp. v. Bureau of Revenue*, 1975-NMCA-106, ¶39, 88 N.M. 411, 416, 540 P.2d 1300, 1305.

S. "'[B]ase income' means that part of the taxpayer's income defined as taxable income and upon which the federal income tax is calculated in the Internal Revenue Code for income tax purposes plus [other enumerated items.]" *See* NMSA 1978, Section 7-2A-2 (C) (2017, Amended 2021)

T. NMSA 1978, Section 7-2A-2 (2017, Amended 2021) permits the Department to exercise discretion with regard for the definitions provided therein, including the definition of "base income" (NMSA 1978, Section 7-2A-2 (C) (2017, Amended 2021)) by allowing flexibility in circumstances where "the context requires otherwise" consistent with the intentions of the Legislature.

U. Omitting 26 U.S.C. Section 280E from the computation of "base income" reflects a "fair, unbiased, and reasonable construction, without favor or prejudice to either the taxpayer or the [s]tate, to the end that the legislative intent is effectuated and the public interests to be subserved thereby are furthered." *See Chavez v. Comm'r of Revenue*, 1970-NMCA-116, ¶7, 82 N.M. 97, 476 P.2d 67.

V. By applying Section 280E to Taxpayer merely because of federal law treatment of medical cannabis, the Department's proposed construction of the statute inflates the cost of the otherwise legal production of medical cannabis in New Mexico compared to any other non-cannabis medical businesses in the state permitted to claim all applicable deductions, not limited to COGS. The Legislature did not intend for state taxes to inflate the cost of products for those requiring them, but intended "to make medical treatment more accessible." *See* NMSA 1978,

Section 26-2A-2 (2007); *Sacred Garden, Inc. v. New Mexico Taxation & Revenue Dep't*, 2021-NMCA-038, ¶17, 495 P.3d 576, 580, *cert. quashed Sacred Garden v. Taxation*, No. S-1-SC-38164 (Feb. 23, 2022).

W. Omitting 26 U.S.C. Section 280E from the computation of "base income" is consistent with legislative intent with respect for taxation of Taxpayer's business under the Compassionate Use Act. *See Sacred Garden, Inc. v. New Mexico Taxation & Revenue Dep't*, 2021-NMCA-038, ¶17, 495 P.3d 576, 580, *cert. quashed Sacred Garden v. Taxation*, No. S-1-SC-38164 (Feb. 23, 2022).

X. The Cannabis Regulation Act clarified that "base income" explicitly excludes "an amount equal to any expenditure that is eligible to be claimed as a federal income tax deduction but is disallowed pursuant to Section 280E of the Internal Revenue Code[.]" *See* NMSA 1978, Section 7-2-2 (B) (5) (2021); NMSA 1978, Section 7-2A-2 (C) (4) (2021); 2021 New Mexico Laws 1st Sp. Sess. Ch. 4 (H.B. 2).

For the reasons stated, Taxpayer's protest is GRANTED. Assessed tax, penalty and interest shall be abated, and any amounts paid to satisfy the Assessment from which this protest arose shall be refunded.

DATED: April 7, 2022

Chris Romero
Hearing Officer
Administrative Hearings Office
P.O. Box 6400
Santa Fe, NM 87502

NOTICE OF RIGHT TO APPEAL

Pursuant to NMSA 1978, Section 7-1-25 (2015), the parties have the right to appeal this decision by *filing a notice of appeal with the New Mexico Court of Appeals* within 30 days of the date shown above. If an appeal is not timely filed with the Court of Appeals within 30 days, this Decision and Order will become final. Rule of Appellate Procedure 12-601 NMRA articulates the requirements of perfecting an appeal of an administrative decision with the Court of Appeals. Either party filing an appeal shall file a courtesy copy of the appeal with the Administrative Hearings Office contemporaneous with the Court of Appeals filing so that the Administrative Hearings Office may begin preparing the record proper. The parties will each be provided with a copy of the record proper at the time of the filing of the record proper with the Court of Appeals, which occurs within 14 days of the Administrative Hearings Office receipt of the docketing statement from the appealing party. *See* Rule 12-209 NMRA.

CERTIFICATE OF SERVICE

I hereby certify that I served the foregoing on the parties listed below this 7th day of April 2022 in the following manner:

E-Mail *E-Mail*

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