No. 18-1122

IN THE

Supreme Court of the United States

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

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

REPLY BRIEF FOR PETITIONERS

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QUESTIONS PRESENTED

1) Did Congress, under 26 U.S.C. §280E, empower the IRS and its civil auditors to investigate federal drug law crimes and administratively determine whether a taxpayer is criminally culpable under federal drug laws?

2) Is Section 280E – a provision that strips the taxpayer of the benefit of taking otherwise lawful deductions and credits if it is found that the taxpayer is a criminal drug trafficker – a penalty for a crime?

CORPORATE DISCLOSURE STATEMENT

The Petitioner entity does not have a parent corporation or any publicly held company owning 10% or more of the corporation's stock.

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REPLY BRIEF FOR PETITIONERS

1. Tenth Circuit Judge, Carlos F. Lucero, summarized the marijuana federalism dispute at hand:

> "[T]hese cases are frustrating, because under the Constitution, under the Tenth Amendment, of course the powers of the federal government are limited to the powers granted under the Constitution, and the States reserve certain powers. What we have here, basically, is a huge federalism dispute."
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> * * *
>
> "So, the IRS says in this case, even though the business is legal in Colorado, because the federal government says it is not legal to sell marijuana, "traffic in marijuana", you're going to have to pay taxes on the whole bloody thing. No costs of goods sold. No costs of production. *Colorado, up yours!* We are going to ignore anything that you as a State, under the United States Constitution, have the power to do and has done."
>
> "So, it's your interest here to raise taxes. But you're saying is' "ok we're not only going to raise taxes, we are going to punish this business, to the point of destruction", and you get into this huge mess of tax raising and criminal law."

Oral Argument, *Feinberg II*, beginning 13:30, https://www.ca10.uscourts.gov/oralarguments/18/18-9005.MP3

2. The Government does not contest that the IRS seeks to destroy state-legal marijuana under interagency agreement. It only asserts that it has the full

right to do so. Nor does it contest that §280E takes in excess of 100% of net income.

Also uncontested by the Government is the IRS's refusal to grant immunity; the IRS having authority to share the results of the audit investigation with law enforcement; and tax on gross receipts if a taxpayer refuses to admit the trafficking crime.

3. The Government's revisions of the Questions Presented are misplaced. The first question is not whether the IRS can deny an unsubstantiated deduction. Rather, the question is whether the IRS can investigate and make the predicate determination that the taxpayer is a criminal drug trafficker[1]. Criminality must be determined *before* deductions and expenses can be addressed. Absent criminality, §280E cannot apply.

The second revised question is improper because it is not whether an "inability to take a tax deduction" violates the Eighth Amendment. Rather, it is whether §280E is a penalty for crime, since it sanctions only criminal drug traffickers.

4. The Government argues that it has the power to tax gross income and that deductions are a matter of legislative grace. However, this is a mischaracterization. Taxation is based upon net, not gross income.

> "It is clear that the Congress intended the income tax laws 'to tax earnings and profits

[1] The Government may assert that without the power, the IRS could not enforce §280E. This is untrue. Courts are the proper body to determine drug crimes. Once there has been a conviction, the predicate criminal act is established. The IRS can then move forward with actually denying deductions, as it did prior to 1996. Any claim by the IRS to adjudicate drug crimes is an overreach.

> less expenses and losses,' (citation omitted), carrying out a broad basic policy of taxing 'net, not . . . gross, income . . . .'" (citation omitted)"

Tank Truck Rentals v. Comm'r, 356 U.S. 30, 33 (1958).

Congress only taxes on gross income when allowing deductions would otherwise violate "sharply defined national or state policies". *Id*. at 35.

Thus, taxing gross income is not a standard practice of "legislative grace". It is an exceptional circumstance.

Section 280E is the only provision of the Tax Code that requires taxation on gross income. Criminal drug traffickers, *and only criminal drug traffickers*, are taxed on gross income.

5. The Government relies extensively upon the District Court's order concluding that the IRS did not have to determine illegality to determine unlawful trafficking. See Resp., p. 5. The problems with that analysis abound. First, the Tenth Circuit did not follow that logic. Next, Section 280E only applies if there is "trafficking" of a "Schedule I or II" controlled substance "prohibited" by federal or state law. Ignoring illegality is contrary to the statute.

Further, if the illegality did not matter, the entire U.S. medical system would come under §280E and §280E would destroy it. Many pharmaceutical products fall under "Schedule I or II", see, e.g., Vicodin - Schedule II. While the IRS continues to advocate this interpretation, adoption would be dangerous.

6. The Government contends that it does not seek *Chevron* deference of §280E and corresponding drug laws. However, its actions belie its assertions.

There is no law specifically stating that regulated, state-legal marijuana sales constitute unlawful drug trafficking. Nevertheless, the IRS interprets state-legal marijuana sales as a "criminal enterprise". *Patients Mut. Assistance Collective Corp. v. Commissioner*, 151 T.C. No. 11, at *8 n.7 (T.C. Nov. 29, 2018). Thus, "[t]o the Commissioner that just makes [marijuana dispensaries] a giant drug trafficker." *Id.* at 1.

The IRS interpretation of unlawful drug trafficking has been given deference. The IRS interpretation was "presumed" correct, and taxpayers must "bear the burden of proving the IRS erred in determining a business was engaged in unlawful trafficking. . . [T]he burden falls on [the taxpayer] to show error, not on the IRS to prove trafficking." *Feinberg v. Commissioner*, 916 F.3d 1330, 1335 (10th Cir. 2019)(*Feinberg II*).

The Government claims this power is not derived from §280E. Rather, the power to interpret and enforce the federal drug laws is derived from its general powers. See Resp., p. 7. This claim tremendously expands IRS power.

Hundreds of cases for illegal distribution of opioids have been filed by states and cities. See., e.g., *Town of Glenville, W.V. v. Amerisourcebergen Drug Corp., et. al*, 1:18-op-45384-DAP (S.D. W.V.). It is alleged that:

> "The unlawful diversion of prescription opiates is a direct and proximate cause of the prescription opiate epidemic…"

Glenville, supra, Complaint Doc. 1, ¶92.

Under *Alpenglow*, the IRS can step in, audit, investigate, and determine that these defendants (including defendant Wal-Mart Stores) are Schedule-

II drug traffickers. At more than 100% tax, Wal-Mart would be destroyed. Investigation and adjudication would occur without any Fourth, Fifth and Sixth Amendment protections. Transmitting the investigation to law enforcement would be in the arbitrary discretion of the IRS.

Effect on the pending cases? Under Fed.R.Evid. 803(8), the administrative determinations are admissible.

7. The Government contends that the power to administratively determine drug crimes would not have preclusive effect in a criminal trial. The Government argues precisely what criminal defendants argue when faced with the Government's contrary position. For example, the Government obtained a conviction for tax fraud based upon the administrative determination of tax fraud. See, *United States v. England*, 229 F. Supp. 493 (E.D. Ill 1964), *rev*., *United States v. England*, 347 F.2d 425, 431 (7th Cir. 1965). The Government claimed the IRS had the power to determine the crime. The Seventh Circuit reversed in a 2-1 decision. The split is informative. The question is whether the administrative determination is a resolution of law or fact. If it is an issue of law, proof beyond reasonable doubt does not apply.

In a later case, the Government again obtained a trial-court conviction on the same tax-fraud contention. *United States v. Silkman*, 156 F.3d 833, 835 (8th Cir. 1998). The Eighth Circuit reversed, claiming that there should not be a conclusive presumption.

Other circuits have not yet ruled on this issue. The Pandora's Box is still open.

8. The Government sidesteps the criminal adjudication restriction by claiming the IRS is not determining

unlawful trafficking. Rather, "Congress has defined federal drug offenses" and §280E "provides that a business that traffics in illegal drugs[2] in violation of federal law cannot deduct its ordinary and necessary business expenses." Resp., p. 8.

However, the Government does not explain how the IRS skips the step of applying law to fact to determine whether unlawful trafficking occurred. The Government simply exclaims that there is "no serious doubt" that the crime was committed. As the Queen said in Alice in Wonderland, "Sentence First, Verdict Afterwards!" Therefore, under some "obvious" standard, the IRS can sanction for criminality before a court verdict is in. No such power should be implied.

9. The Government asserts that the IRS civil auditor has full power to investigate and determine drug crimes. The Government claims that as long as the civil auditor does not deceive the taxpayer, it can proceed with this quasi-criminal investigation, make administrative findings of criminal activity, and turn over the spoils of the investigation to law enforcement.

As discussed in the Petition, a civil tax audit proceeding moves forward with relaxed standards of

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[2] As the caption of Section 280E states, the proscribed conduct is the "illegal sale of drugs", not the sale of "illegal drugs". This is an important difference. The substances scheduled under the CSA are not illegal by themselves. Rather, human interaction is criminalized. See, e.g., 21 U.S.C. §841. Thus, "unlawful trafficking" is not simply whether there is a marijuana or opium plant involved. It is whether the conduct surrounding the plant is proscribed. The Government blurs this distinction. The IRS claims authority to determine whether the human interaction is unlawful. It is for courts, not an administrative agency, to determine unlawfulness of conduct.

Fourth and Fifth Amendment protections. The Government concedes the relaxed standard in its Response. Amazingly, the Government does not explain how the civil auditor, in a quasi-criminal investigation, can compel the taxpayer to provide incriminating documents and testimony without constitutional protection. This is not a situation where the auditor simply falls on criminal activity during a civil audit. Rather, the civil auditor is charged with investigating evidence of unlawful drug trafficking. See, e.g., *Green Sol. Retail, Inc. v. United States*, 855 F.3d 1111, 1113 (10th Cir. 2017) ("The IRS made initial findings that Green Solution trafficked in a controlled substance and is criminally culpable under the CSA).

The Government's contentions inescapably lead to the conclusion that civil-auditor power is coextensive with a criminal investigator. If the Government is correct, Fourth and Fifth Amendment rights are now sacrificed to the tax power.

Even the Internal Revenue Manual requires suspension of civil auditor investigations when they encroach upon criminal fraud activities. See IRM 25.1.2(8). See also, *United States v. McKee*, 192 F.3d 535, 540-41 (6th Cir. 1999). There is no constitutional basis to give a civil auditor such power.

The Government's claim to power is dangerous. Certiorari must be granted.

9. The IRS is not authorized to claim that federal criminal law supersedes contrary state law. In the Petition, it was discussed that the question of unlawfulness of the Petitioners' activity would necessarily require an examination of preemption. Pet., p. 33. To this end, the IRS claims power to decide the

federalism issue because there is "no serious doubt" as to the guilt.

The Government concedes that the Petitioners were "operating consistent with state law". Resp., p. 3. However, it asserts boldly that "Alpenglow bought and sold a drug in violation of federal law." Resp., p. 8. Thus, the Petitioners engaged in criminal trafficking, subjecting them to §280E. *Id.* This analysis necessarily requires giving the IRS power to determine the federalism issue, which is an overreach.

This Court has held that, absent express delegation by Congress, agencies do not have power to determine issues of supremacy and preemption. *Wyeth v. Levine*, 555 U.S. 555, 577 (2009). Nor has the Court ever "deferred to an agency's *conclusion* that state law is pre-empted." *Id.* (Emphasis in original).

Despite the clash of federal law and the law of thirty-three states, the Government claims that "there can be no serious doubt" that those operating legally under state law are committing federal crimes. As discussed below, this supremacy question is far from answered.

10. Preemption is the doctrine arising from the Supremacy Clause and determines whether federal law supersedes state law. *Medtronic, Inc. v. Lohr*, 518 U.S. 470, 485 (1996). The party asserting preemption bears a heavy burden to show that preemption was the "clear and manifest purpose of Congress." See *Wyeth v. Levine*, 555 U.S. at 565-69.

There is a presumption against preemption. Courts must "start with the assumption that the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and

manifest purpose of Congress." *Medtronic*, 518 U.S. at 485.

Under principles of federalism, a federal criminal statute will not make a state-legal act unlawful unless "explicitly" directed by Congress. *Bond v. United States*, 572 U.S. 844, 858 (2014).

Local criminal activity has "traditionally been the responsibility of the States." *Id.* at 865.

> "[W]e will not be quick to assume that Congress has meant to effect a significant change in the sensitive relation between federal and state criminal jurisdiction. In traditionally sensitive areas, such as legislation affecting the federal balance, the requirement of clear statement assures that the legislature has in fact faced, and intended to bring into issue, the critical matters involved in the judicial decision."

United States v. Bass, 404 U.S. 336, 349 (1971).

Under 21 U.S.C. §903, Congress limited the reach of the CSA, stating "no provision shall [indicate] an intent [by] Congress to occupy the field in which that provision operates, including criminal penalties, to the exclusion of any State law on the same subject matter . . ." There is nothing in the CSA that *explicitly* criminalizes conduct which has been made *expressly* legal under state law.

Certiorari must be granted.

11. The Government contends that giving the IRS power to investigate and find drug crimes does not implicate the Fifth Amendment because it does not "force a taxpayer to turn over incriminating information". This is untrue.

The IRS claims general powers to investigate and find the commission of drug crimes. If true, the taxpayer must keep books and records of the drug crimes under penalty of law. 26 U.S.C. §6101. These records must be turned over to the IRS upon demand. *Id.* "We perceive no meaningful difference between an obligation to maintain records for inspection, and such an obligation supplemented by a requirement that those records be filed periodically with officers of the United States." *Marchetti v. United States*, 390 U.S. 39, 56, n.14 (1969). The requirement to maintain records of drug crimes implicates Fifth Amendment. *Id.*

The Government does not contest that the alleged marijuana trafficking is an "area permeated with criminal statutes", and §280E is directed to a group "inherently suspect of criminal activity". Under those circumstances, the *Leary* line of cases requires a tax statute to either prohibit the IRS from sharing the information obtained with law enforcement or provide full immunity from prosecution. Section 280E does neither.

While "this Court must give deference to Congress' taxing powers, and to measures reasonably incidental to their exercise; [ ] we are no less obliged to heed the limitations placed upon those powers by the Constitution's other commands." *Haynes v. United States*, 390 U.S. 85, 98 (1969). "We are fully cognizant of the Treasury's need for accurate and timely information, but other methods, entirely consistent with constitutional limitations, exist by which such information may be obtained." *Id.*

If the power to investigate and find drug crimes is given to the civil IRS auditors to enforce §280E, the statute would be rendered unconstitutional, since

§280E does not have the necessary constitutional protections.

12. The Government states that if the taxpayer does not take deductions on its tax returns, the IRS won't investigate and compel books and records of drug crimes. On the other hand, the IRS is in fact compelling such books and records to "establish whether a marijuana business properly reported its gross receipts and allowed deductions for cost of goods sold." *Magistrate Recommendation, August 7, 2018, Standing Akimbo v. United States*, 1:17-mc-00169 (D.C. Colo). Certainly, the compelling of marijuana "Harvest Reports", third party "Transfer Reports", and Monthly Plant Inventory reports, are the type of documents which could be used to "incriminate overwhelmingly". *Grosso v. United States*, 390 U.S. 62, 75 (1969). Without the constitutional protections, §280E should not be construed as to allow civil auditors to embark on quasi-criminal investigations of drug crimes.

13. The Government contends that §280E is not a penalty because it has the function of denying deductions for criminal activity. However, this Court has already found that denial of a tax exemption based upon criminal conduct can be a penalty for crime. *Speiser v. Randall*, 357 U.S. 513, 525 (1958).

"[C]anceling out a deduction has the natural effect of increasing taxable income." *Am. Mut. Life Ins. Co. v. United States*, 46 Fed. Cl. 445, 450 (2000). When taxable income increases, so does the tax. Thus, §280E causes an increase in tax for crime.

When evidence of crime is essential to the assessment, the statute "lacks all the ordinary characteristics of a tax, whose primary function 'is to provide for

the support of the government,' and clearly involves the idea of punishment for infraction of the law – the definite function of a penalty." *United States v. One Ford Coupe Auto.*, 272 U.S. 321, 339 (1926)

> "[T]he federal income tax is a tax on net income, not a sanction against wrongdoing. . . . the statute does not concern itself with the lawfulness of the income that it taxes. *Income from a criminal enterprise is taxed at a rate no higher and no lower than income from more conventional sources.*"

Commissioner v. Tellier, 383 U.S. 687, 691 (1966) (Emphasis Added).

Section 280E causes a criminal drug trafficker to pay a higher price than its lawful counterpart on the same income. It is inescapable that §280E is a penalty and not a tax.

14. The Government claims that the Petitioners waived the penalty argument. In a novel manner, the Government expands the question presented, then says that the Petitioners waived the expanded question. On the Eighth Amendment issue, the Court of Appeals ruled solely on the penalty aspect of the Eighth Amendment. It is this ruling for which the Petitioners seek certiorari. There is no waiver.

CONCLUSION

The Court should grant certiorari on the Questions Presented by Petitioners.

Respectfully submitted,

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