Tackling Taxes

The Evolving Taxation of the Marijuana Industry

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Background of the Marijuana Industry

The "legal" marijuana industry is one of the fastest growing in the United States. Total "legalized" sales of marijuana were $5.4 billion in 2015 and were expected to grow by 24% in 2016 to $6.7 billion. This number is expected to increase by approximately 34% each year, with projected 2020 legalized sales of approximately $21.8 billion.[1] To help put this into perspective, the National Football League (NFL) is currently a $12 billion industry and projects $25 billion of revenues by 2027.

The driving force for this drastic increase in overall revenue is the growing number of states that have legalized marijuana use over the past few years. Prior to the November 8, 2016 election, 25 states (including Illinois) and the District of Columbia had legalized marijuana for medical purposes. Colorado, Washington, Alaska and Oregon allowed marijuana for recreational use as well. On November 8, 2016, Arkansas, Florida, and North Dakota all voted to legalize medical marijuana use, while California, Massachusetts, Maine and Nevada voted to allow recreational marijuana use. This brings the total number of states allowing marijuana use in some form to 28.[2] While the marijuana industry is growing and almost 60% of the states have legalized marijuana use in some form, it is still illegal under the federal statue.[3] This has far-reaching tax ramifications. According to Marijuana Business Daily,[4] the federal tax situation is the biggest threat to the marijuana business and could push the entire industry underground.

In the 1970s, under President Nixon, the United States deemed its number one enemy to be drug abuse, and launched a full "war on drugs." President Nixon increased the size and presence of drug control agencies in the United States and enacted stiffer penalties for the use and handling of drugs. Additionally, Congress passed the Comprehensive Drug Abuse Prevention and Control Act of 1970,[5] commonly referred to as the Controlled Substances Act (CSA), which aimed to curtail the manufacturing, distribution, and use of drugs. Controlled substances were assigned to five different categories based on the drug's acceptable medical

use, as well as the potential for dependency. According to the Drug Enforcement Agency's website, Schedule I drugs are the most likely to be abused and have the greatest likelihood for severe psychological and/or physical dependence (*e.g.*, heroin and various hallucinogenic drugs, including LSD). These drugs have no currently acceptable medical use. To contrast, Schedule V drugs have many acceptable medical uses and are least likely to be abused.

The "legal" marijuana industry is one of the fastest growing in the United States.

Marijuana is currently labeled as a Schedule I drug and is illegal under federal statute.[6] Marijuana is included in this group because it was considered to have a high potential for abuse and no accepted medical use at the time the CSA was enacted. Despite the current permitted medical use of marijuana in many states, marijuana remains classified as a Schedule I drug.

Taxation of Businesses Dealing in Illegal Substances

Even though illegal under federal law, businesses in the marijuana industry are still required to pay taxes on their income. Code Sec. 61(a) provides that "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items … (2) Gross income derived from business; (3) Gains derived from dealings in property." The statutes are very broad, and as such, encompass just about any type of income, including income derived from a business deemed to be illegal under federal law. This has been affirmed by the Supreme Court.[7]

Under the Sixteenth Amendment of the U.S. Constitution (Sixteenth Amendment), Congress is authorized to lay and collect taxes on income. In a series of cases, the Supreme Court has held that income in the context of a reseller or producer means gross income, not gross receipts. In other words, Congress may not tax the return of capital.[8]

Consistent with the Sixteenth Amendment, Code Sec. 61(a)(3) provides that gross income includes net gains derived from dealings in property. "Gains derived from dealings in property" means gross receipts less cost of goods sold (COGS), which is the term given to the adjusted basis of merchandise sold during the taxable year.[9] The COGS concept "embraces expenditures necessary to acquire, construct or extract a physical product which is to be sold; the seller can have no gain until he recovers the economic investment that he has made directly in the actual item sold."[10] COGS is determined 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. In general, the taxpayer first determines gross income by subtracting COGS from gross receipts.[11]

After determining gross income, the taxpayer is generally then allowed to deduct all other expenses deemed to be ordinary and necessary in the operation of its business.[12]

In a 1981 Tax Court decision, Jeffrey Edmondson, a drug dealer from Minnesota, was allowed as a tax deduction not only the cost of his controlled substances including marijuana, cocaine, and amphetamines (his COGS) but also expenses for his home office (where he operated the business), automobile mileage expense, and telephone, among others.[13] This angered many, including the U.S. Congress, which reacted by enacting Code Sec. 280E in 1982 to reverse the *Edmondson* holding by disallowing ordinary and necessary expenses to those trafficking[14] in Schedule I and II drugs.

Code Sec. 280E Disallowance

Code Sec. 280E reads as follows:

> 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.

Code Sec. 280E effectively disallows all of a taxpayer's overhead expenses incurred in carrying on an illegal trade or businesses.

The clear language of the statute has not precluded taxpayers from attempting to argue its inapplicability due to the activity being allowed under state statutes. The Tax Court held in *M. Olive*[15]: "The dispensing of medical marijuana, while legal in California (among other States), is illegal under Federal law. Congress in section 280E has set an illegality under Federal law as one trigger to preclude a taxpayer from deducting expenses incurred in a

medical marijuana dispensary business. This is true even if the business is legal under State law." Notwithstanding the decision in *Olive*, in 2016 Harborside Health Center challenged the IRS interpretation of Code Sec. 280E on the grounds that it was never intended to apply to medical cannabis dispensaries.[16]

Harborside is the country's largest marijuana dispensary and grosses $30 million in sales between its three locations. It was hit with a $2.4 million tax bill by the IRS and may have to close its doors if the assessment is upheld. By taking its case to the Tax Court, Harborside is essentially trying to get Code Sec. 280E repealed with the argument that Code Sec. 280E was never intended to apply to the medical marijuana industry, and other businesses that are legal under state law. Interestingly, Harborside has found support from an unsuspected source, Rep. Pete Stark (D-CA), the original sponsor of Code Sec. 280E. Stark questioned the IRS interpretation on the floor of Congress, saying it " … undercuts legal medical marijuana dispensaries by preventing them from taking the full range of deductions allowed for other small businesses … [and] punishes the thousands of patients who rely on them for safe, legal, reliable access to medical marijuana as recommended by a doctor."

Note that Code Sec. 280E still allows a taxpayer to recover its investment in the narcotics and does not disallow the taxpayer's COGS. Congress knew that any such disallowance could be challenged under constitutional grounds.[17] Under the Explanation of Provision, the Senate Report reads as follows:

> All deductions and credits for amounts paid or incurred in the illegal trafficking in drugs listed in the Controlled Substances Act are disallowed. To preclude possible challenges on constitutional grounds, the adjustment to gross receipts with respect to effective costs of goods sold is not affected by this provision of the bill.[18]

Code Sec. 280E disallows a deduction for expenses that are not illegal *per se* (*e.g.*, salaries, rent, and telephone). In this way, it is different from Code Sec. 162(c), which disallows a deduction for specified illegal payments (*e.g.*, bribes and kickbacks).

Congress justified Code Sec. 280E as necessary for public policy reasons. In the Joint Committee's 1982 General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, it noted:

> There is a sharply defined public policy against drug dealing. 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. Congress believed that such deductions must be disallowed on public policy grounds.[19]

It is important to note that Code Sec. 280E does not require the IRS to find that a crime has been committed or that a taxpayer has engaged in illegal activity. Code Sec. 280E is a civil statute, and an investigation into a suspected violation of Code Sec. 280E requires no "outside," "criminal," or "pseudo-criminal" determination or investigation of violation of the CSA. An IRS Agent conducting a civil investigation into tax liabilities may investigate whether a party is violating the CSA for the purposes of applying Code Sec. 280E without conducting a criminal investigation.[20]

Disallowing a taxpayer its overhead expenses can have a crippling effect on a business's cash flow and profits. Some businesses have seen tax rates of 80%, 90% or even 100% on its economic profits. The below hypothetical example shows the difference in taxable income and effective tax rate between a business in the marijuana industry and one in the agricultural industry (*see* Table 1)[21]:

TABLE 1.

	Agricultural	Marijuana
Sales	$ 100.00	$ 100.00
COGS	(50.00)	(50.00)
Gross Profit	50.00	50.00
Overhead Expenses	(30.00)	(30.00)
Income B4 Tax	20.00	20.00
Sec. 280E Disallowance		30.00
Taxable Income	20.00	50.00
Tax (35%)	(7.00)	(17.50)
Economic Profit (Loss)	$ 13.00	$ 2.50
Effective Tax Rate	35%	88%

As Table 1 shows, identical investments in the marijuana and agricultural industries that return the same pre-tax economic profits will provide for a much different after-tax economic profit and effective tax rate due to Code Sec. 280E.

While Code Sec. 280E is fairly straightforward in its plain language reading, the biggest question is what

costs are includible in COGS? If a taxpayer were able to capitalize and increase its total amount of inventory costs, it would be able to decrease its gross profits thereby decreasing the ultimate amount of income tax for which it is liable. While advisors may have differing opinions on which costs can be included in COGS, the IRS positions on the interaction of Code Sec. 280E and the Uniform Capitalization (UNICAP) rules of Code Sec. 263A are expressed in CCA 201504011.[22]

Inventoriable Costs—Pre-1987 Code Sec. 471 Rules

Code Sec. 280E was enacted in 1982, four years before the enactment of the UNICAP rules in 1986. At that time, Code Sec. 471 provided the rules for determining inventoriable costs without reference to the UNICAP rules. Specifically, resellers were subject to Reg. §1.471-3(b), and producers were subject to Reg. §§1.471-3(c) and 1.471-11 (full-absorption regulations). Therefore, for a reseller of marijuana, inventoriable costs include the invoice price of the marijuana, less any trade or other discounts, plus acquisition costs including transportation or other necessary charges required to take possession of the inventory.[23] In regards to a marijuana producer, the calculation is slightly different. It is direct materials (the costs of the marijuana plants or seeds), plus direct labor costs (the costs of planting, harvesting, cultivating, or growing), plus what are known as Category 1 indirect costs,[24] plus potentially, what are known as Category 3 indirect costs.[25]

The following Category 1 costs must be taken into account when determining inventoriable costs to the extent they are incident and necessary to the production or manufacturing processes:

(a) Repair expenses;
(b) Maintenance;
(c) Utilities, such as heat, power and light;
(d) Rent;
(e) Indirect labor and production, supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay, shift differential, payroll taxes and contributions to a supplemental unemployment plan;
(f) Indirect materials and supplies;
(g) Tools and equipment not capitalized; and
(h) Costs of quality control and inspection.

The following Category 3 costs can be included in inventory as long as they were properly included in the company's GAAP financial statements. These include:

1. Taxes that are deductible under Code Sec. 164 (excluding state, local, and foreign income taxes) and attributable to assets incident and necessary to the production or manufacturing processes;
2. Depreciation and cost depletion;
3. Pension and profit-sharing contributions representing current service costs otherwise allowable as a deduction under Code Sec. 404 and other employee benefits incurred on behalf of labor incident to and necessary for production[26];
4. Costs pertaining to strikes, rework labor, scrap, and spoilage;
5. Administrative expenses related to production;
6. Officers' salaries related to production; and
7. Insurance costs related to production (*e.g.,* insurance on production machinery and equipment).

Based on the additional inventoriable costs allowed, the benefits of producing GAAP financial statements will likely outweigh the costs for marijuana manufacturers/producers. Table 2 presents an example of three taxpayers in the marijuana industry, the different costs allocated to inventory under each scenario, and the tax ramifications and benefits of producing GAAP financial statements. The first column portrays a reseller of marijuana, which is only allowed to deduct its cost of sales (including its acquisition costs). The second and third columns both represent marijuana producers. However, the second column is a company that does not prepare GAAP financial statements, while the company in the third column does prepare

TABLE 2.

	Reseller		Producer (no FS)		Producer (wth FS)	
	GAAP	TAX	GAAP	TAX	GAAP	TAX
Gross Receipts	$ 100	$ 100	$ 100	$ 100	$ 100	$ 100
Prod. & Purch. Costs	(75)	(75)	(35)	(35)	(35)	(35)
Acquisition Costs	(5)	(5)	(5)	(5)	(5)	(5)
Indirect Costs - Category I	0	-	(25)	(25)	(25)	(25)
Indirect Costs - Category III	0	-	(15)	-	(15)	(15)
MKTG & Selling Costs	(2)	-	(2)	-	(2)	-
Income	$ 18	$ 20	$ 18	$ 35	$ 18	$ 20
Tax (35%)	$	$ 7.00	$	$ 12.25	$	$ 7.00

GAAP financial statements. Since the producer in the second column did not prepare GAAP financial statements, it would have had an additional $15 of taxable income, resulting in an additional $5.25 of tax.

Each of the above examples assumes an accrual-basis taxpayer that buys and sells its entire inventory in the same taxable year. In reality, this may not be the case. The equation for determining COGS is as follows (*see* Equation 1):

EQUATION 1.

Beginning Inventory
Plus: Current Year Production Costs/Purchases
Equals: Costs of Goods Available for Sale
Less: Ending Inventory
Equals: Cost of Goods Sold

While this is still an oversimplified view of the COGS calculation, as it does not address different types of inventory methods such as FIFO, LIFO, Average Cost, *etc.*, it is helpful to put into perspective the flow of costs that are allocated to the goods and offset against gross receipts when sold. Costs, like those associated with acquisition and production, accumulate in the inventory account and are relieved into cost of goods when the actual units of product are sold. In this way, taxpayers are taxed on the gross income from a sale rather than its gross receipts.

Code Sec. 263A—UNICAP Rules

In 1986, Congress added the UNICAP rules of Code Sec. 263A, which increases the amount of costs that must be capitalized into inventoriable costs. At the same time, Code Sec. 471(b) was added (later redesignated as Code Sec. 471(c) in 1997) to cross reference Code Sec. 263A. These additional inventoriable costs would in effect recast expenses not deductible under Code Sec. 280E as part of COGS. Some additional costs that resellers are required to capitalize under Code Sec. 263A include handling and storage expenses. In addition, purchasers are required to capitalize a portion of their service costs, which include costs pertaining to payroll, legal, and personnel functions.

As a result, UNICAP rules have a favorable income tax effects for marijuana businesses. However, the IRS took the opposite position in CCA 201504011 that costs not being deductible under Code Sec. 280E are not capitalized under the UNICAP rules. In other words, taxpayers in the marijuana business must capitalize inventory costs based on pre-1987 Code Sec. 471 rules without regard to UNICAP rules.

CCA 201504011

The CCA noted that Code Sec. 263A is a timing provision. It does not transform non-deductible costs into deductible costs. The IRS pointed to the flush language at the end of Code Sec. 263A(2), which states "Any cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph." This flush language was not originally included in the Code Section but was added by Reg. §1008(b)(1) of the Technical and Miscellaneous Revenue Act of 1988 as a retroactive technical correction.

Under Explanation of Provision, the Senate Report reads as follows:

> The bill also clarifies that a cost is subject to capitalization under this provision only to the extent it would otherwise be taken into account in computing taxable income for any taxable year. Thus, for example, the portion of a taxpayer's interest expense that is allocable to personal loans, and hence is disallowed under section 163(h), may not be included in a capital or inventory account and recovered through depreciation or amortization deductions, as a cost of sales, or in any other manner.[27]

While legal for state purposes, it is still illegal under federal law. With being illegal, there are unfavorable tax effects associated with businesses in this industry, most notably Code Sec. 280E that disallows ordinary and necessary business deductions for federal income tax purposes.

Based on the above, the CCA concluded that Code Sec. 263A is not applicable to the marijuana industry.

Commentators have taken a contrary view, expressing the view that the CCA 201504011 is "an overly technical, and in our opinion, mistaken view of applicable law."[28] They believe that Code Sec. 263A rules should be universally applied to all manufacturers and that Congress only intended there to be one set of inventory capitalization rules rather than two. They also noted that had Congress not wanted Code Sec. 263A to apply to "illegal" businesses

such as those in the marijuana industry, they could have specifically noted that in either the statute or the technical correction that was enacted two years later.

Only time will tell which opposing view will prevail in litigation. It should be noted that under Code Sec. 263A(b)(2)(B), UNICAP rules generally do not apply to resellers if the average annual gross receipts of the reseller for the preceding three taxable year periods do not exceed $10 million.

State Excise Taxes

States that have legalized marijuana sales have enacted different ways to tax revenues generated. Some, such as Washington, have enacted excise taxes. Does Code Sec. 280E apply to such excise taxes? CCA 201531016 addressed this issue based on Code Sec. 164.[29]

The first sentence in Code Sec. 164(a) provides, in part:

> Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:
> (1) State and local, and foreign, real property taxes.
> (2) State and local personal property taxes.
> (3) State and local, and foreign, income, war profits, and excess profits taxes …

This is then followed by these two sentences: "In addition, there shall be allowed as a deduction State and local, and foreign, taxes not described in the preceding sentence which are paid or accrued within the taxable year in carrying on a trade or business or an activity described in section 212 (relating to expenses for production of income). *Notwithstanding the preceding sentence, any tax (not described in the first sentence of this subsection) which is paid or accrued by the taxpayer in connection with an acquisition or disposition of property shall be treated as part of the cost of the acquired property or, in the case of a disposition, as a reduction in the amount realized on the disposition (emphasis added)*."

The above last sentence of Code Sec. 164(a) was added by the Tax Reform Act of 1986, to make it clear that State, local, or foreign taxes (other than the taxes enumerated in the first sentence of Code Sec. 164(a)) that are incurred in a trade or business or in an income-producing activity and that are connected with the acquisition or disposition of property are to be capitalized or treated as a reduction of amount realized.

Therefore, the CCA concluded that the Washington marijuana excise tax should be treated as a tax paid or accrued in connection with the disposition of property by a trade or business. Accordingly, a taxpayer who paid the Washington marijuana excise tax should treat the tax as a reduction in the amount realized on the sale of the property rather than as either a part of the inventoriable cost of that property or a deduction from gross income. Though Code Sec. 280E prohibits deductions and credits for these businesses, this excise tax is neither a deduction from gross income nor a tax credit. Consequently, Code Sec. 280E does not preclude a taxpayer from accounting for this excise tax as a reduction in the amount realized on the sale of the property.

This favorable tax result raises an opportunity for states to review, modify and reclassify some taxes labeled as "income taxes" as taxes other than those described in the first sentence of Code Sec. 164(a) to provide the benefit of treating such taxes by marijuana businesses as a reduction in the amount realized on the sale of marijuana.[30]

Method of Accounting Implications

According to Code Sec. 446(a) of the Code, "[t]axable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books."[31] The most widely used tax methods of accounting are cash, accrual, or a hybrid of the two. A taxpayer elects its method of accounting by the filing of its initial tax return, so long as it is a permissible method of accounting. If a method of accounting is not permissible, the taxpayer's election generally does not go into effect until its second tax return is filed.[32] A taxpayer must remain on its method of accounting to provide for consistency unless it obtains the IRS permission to change, which is done by filing a Form 3115. If the IRS deems that a method of accounting does not clearly reflect income, it has the authority to change to a method of accounting that does.[33]

Generally, in order to clearly reflect taxable income, inventories at the beginning and end of each taxable year are necessary where the production or purchase or sale of merchandise is an income-producing factor.[34] When required to use an inventory method, a taxpayer also is required to use an accrual method for purchases and sales of merchandise.[35] This allows for a matching of the costs of the products sold with the revenue generated from sales. In other words, the taxpayer will capitalize inventoriable costs when incurred and will remove these costs from inventory when units of merchandise are sold.

However, not all taxpayers are required to use an accrual method of accounting (for example, small taxpayers properly using the modified cash method under Rev. Proc. 2001-10 or Rev. Proc. 2002-28 or farmers). Under

the cash method of accounting, receipts are taken into revenue in the year of collection, and disbursements are deducted as expenses in the year paid. For a cash-method taxpayer in the marijuana industry, this causes a matching issue when the basis in the inventory (*i.e.,* production or purchase costs) is deducted in one tax year, and the revenue is recognized when the actual sale of inventory occurs in a later tax year. This creates the illusion that some expenses (*i.e.,* production or purchase costs) are being deducted from gross income. Under Code Sec. 280E, all deductions from gross income are disallowed, meaning that income tax is assessed on gross income for a marijuana business. For a cash-method taxpayer in marijuana business, the obligation to pay income tax on gains derived from the sale of marijuana creates a tension between the accepted interpretation of "income" under the Sixteenth Amendment and the disallowance of ordinary business expenses under Code Sec. 280E.

The inventory method of a taxpayer trafficking in a Schedule I or Schedule II controlled substance such as marijuana was another issue addressed by the IRS in CCA 201504011. Due to Code Sec. 280E and potential mismatching of revenues and costs, a cash-basis producer or reseller in the marijuana industry will have taxable income substantially higher than that of a taxpayer operating under an accrual basis of accounting if production and purchase costs are disallowed. This mismatching of revenues and production/purchase costs under the cash-basis method of accounting raises the issue of whether the IRS would require a marijuana business to use an inventory method, when the business currently deducts otherwise inventoriable costs from gross income under the cash method, a potential perceived violation of Code Sec. 280E. The IRS understands this and wrote the following in the CCA:

> However, if that taxpayer is not required to use an inventory method (for example, small taxpayers properly using the modified cash method under Rev. Proc. 2001-10 or Rev. Proc. 2002-28 or farmers), it is not an appropriate exercise of authority for Examination or Appeals to require that taxpayer to use an inventory method. Instead, Examination or Appeals should permit that taxpayer to continue recovering, as a return of capital deductible from gross income, the same types of costs that are properly recoverable by a taxpayer both trafficking in a Schedule I or Schedule II controlled substance and using an inventory method under § 471. Thus, for example, a producer of a Schedule I or Schedule II controlled substance should be permitted to deduct wages, rents, and repair expenses attributable to its production activities, but should not be permitted to deduct wages, rents, or repair expenses attributable to its general business activities or its marketing activities.

This position of the CCA is taxpayer friendly and permits an eligible cash method taxpayer to use the cash method of accounting and deduct production and purchase costs from gross income.

Separate Business Activities

One of the most important (and well known) cases pertaining to the medical marijuana industry was *Californians Helping to Alleviate Medical Problems, Inc. (or CHAMP).*[36] In this 2007 case, the Tax Court allowed CHAMP to allocate its expenses between its two distinct businesses (its caregiving facilities and marijuana dispensary) and that the expenses allocable to the caregiving facilities were not subject to Code Sec. 280E.

A key factor in *CHAMP* was that the taxpayer was able to prove that there were two distinct businesses. Whether an activity is a trade or business separate from another trade or business is a question of fact that depends on (among other things) the degree of economic interrelationship between the two undertakings.[37] The court found "We do not believe it to have been artificial or unreasonable for petitioner to have characterized as separate activities its provision of caregiving services and its provision of medical marijuana. Petitioner was regularly and extensively involved in the provision of caregiving services, and those services are substantially different from petitioner's provision of medical marijuana. By conducting its recurring discussion groups, regularly distributing food and hygiene supplies, advertising and making available the services of personal counselors, coordinating social events and field trips, hosting educational classes, and providing other social services, petitioner's caregiving business stood on

Additionally, taxpayers in the marijuana business not preparing GAAP financial statements should consider doing so in order to increase the costs that can be included in cost of goods sold (i.e., Category 3 costs).

its own, separate and apart from petitioner's provision of medical marijuana. On the basis of all of the facts and circumstances of this case, we hold that petitioner's provision of caregiving services was a trade or business separate and apart from its provision of medical marijuana."

In contrast, in *Olive,*[38] the court found, after considering the degree of economic interrelationship between the two undertakings, that the taxpayer was not involved in "more than one trade or business." The taxpayer did not provide counseling, caregiving, snacks, and so forth for a separate fee; the only "business" in which the taxpayer engaged was selling medical marijuana.[39]

The court explained its reasoning by way of the following analogy:

> Bookstore A sells books. It also provides some complimentary amenities: Patrons can sit in comfortable seating areas while considering whether to buy a book; they can drink coffee or tea and eat cookies, all of which the bookstore offers at no charge; they can obtain advice from the staff about new authors, book clubs, community events, and the like; they can bring their children to a weekend story time or an after-school reading circle. The "trade or business" of Bookstore A "consists of" selling books. Its many amenities do not alter that conclusion; presumably, the owner hopes to attract buyers of books by creating an alluring atmosphere. By contrast, Bookstore B sells books but also sells coffee and pastries, which customers can consume in a cafe-like seating area. Bookstore B has two "trade[s] or business[es]," one of which "consists of" selling books and the other of which "consists of" selling food and beverages.

The Tax Court in its decision referenced factors listed in *M.A. Tobin*[40] as relevant in determining whether there are separate businesses:

1. Are the undertakings conducted at the same place?
2. Were the undertakings formed as separate activities?
3. Does one undertaking benefit from the other?
4. Does the taxpayer use one undertaking to advertise the other?
5. To what degree do the undertakings share management?
6. To what degree does the management oversee the assets of both undertakings?
7. Do the taxpayers use the same accountant for the undertakings?
8. What degree do the undertakings share books and records?

Olive shows that care must be taken to keep one business as separate as possible from another business.

Conclusions

The legalized marijuana industry is one of the fastest growing industries in the United States. As attitudes toward marijuana evolved, an increasing number of states (currently 28) have legalized marijuana use in some form. While legal for state purposes, it is still illegal under federal law. With being illegal, there are unfavorable tax effects associated with businesses in this industry, most notably Code Sec. 280E that disallows ordinary and necessary business deductions for federal income tax purposes. The IRS released CCA 201504011 on its position on the inventory methodology that should be used for businesses that operate in the marijuana industry (and any schedule I or Schedule II drug). They believe businesses should use pre-1987 Code Sec. 471 rules, or full-absorption costing, in determining which costs should be included in inventory. However, some commentators believe that Code Sec. 263A should also govern inventoriable costs.

Additionally, taxpayers in the marijuana business not preparing GAAP financial statements should consider doing so in order to increase the costs that can be included in cost of goods sold (*i.e.,* Category 3 costs). They should also carefully examine whether they may be conducting another separate trade or business so that certain costs (*e.g.,* fixed costs) can be allocated to such trade or business.

Finally, while the CCA is not binding and holds no precedential value, it gives us an important look into the IRS thought process on these important issues. Over the past few years, there have been various challenges to Code Sec. 280E. So far all attempts have been unfruitful. However, with the docketed *Harborside Health Center* case, there may be hope for taxpayers in the marijuana industry.

ENDNOTES

* This column represents the views of the authors and does not necessarily represent the views or professional advice of Plante Moran, Bronswick Benjamin PC, and De Paul University.

1 Tom Huddleston, Jr., *Legal Marijuana Sales could hit $6.7 Billion in 2016,* FORTUNE (Feb. 1, 2016).

2 Katy Steinmetz, *How the 2016 Election Became a Watershed for Weed,* TIME (Nov. 10, 2016).

3 The production, distribution or possession of a controlled substance such as marijuana is a federal criminal offense. When there is conflict between federal law and state law, the federal law trumps the state law under the Supremacy Clause in the Constitution. *See Gibbons v. Ogden*, SCt, 22 US 1 (1824); *Ableman v. Booth*, SCt, 62 US 506 (1859).

4 *Marijuana Business Conference Wrapup: 36 Tips, Lessons & Takeaways for the Cannabis Industry*, MARIJUANA BUSINESS DAILY (Nov. 15, 2012).

5 Code Sec. 801-971 (1970).

[6] Drug Schedules. U.S. Drug Enforcement Administration, available online at *www.dea.gov/druginfo/ds.shtml.*

[7] *E.C. James*, SCt, 61-1 USTC ¶9449, 366 US 213, 218, 81 SCt 1052.

[8] Gross receipts must be reduced by cost of goods sold (COGS) to arrive at gross income before income tax can be assessed. Any further deductions and credits to gross income are a matter of legislative grace. *See, Doyle v. Mitchell Bros. Co.*, SCt, 1 USTC ¶17, 247 US 179, 185, 38 SCt 467 (1918) ("As was said in *Stratton's Independence v. Howbert*, [citation omitted], 'Income may be defined as the gain derived from capital, from labor, or from both combined.' ...Of course, gross income and not gross receipts is the foundation of income-tax liability, for it is only earnings, profits and gains which the statute subjects to tax. And manifestly, gross receipts cannot be called gross income, insofar as they consist of borrowings of capital, returns of capitals, or any of the other items ... excluded from gross income ..."); *New Colonial Ice Co. v. Helvering*, SCt, 4 USTC ¶1292, 292 US 435, 440, 54 SCt 788 (1934) ("The power to tax like that of the new corporation is plain and extends to the gross income. Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefore can only particular deduction be allowed.")

[9] Reg. §1.61-3(a).

[10] *W.H. Reading*, 70 TC 730, 733, Dec. 35,354 (1978).

[11] *See* CCA 201504011 (Jan. 23, 2015).

[12] Code Sec. 162(a).

[13] *J. Edmondson*, 42 TCM 1533, Dec. 38,379(M), TC Memo. 1981-623.

[14] Trafficking has been defined as regularly engaging in buying and selling activities. *Californians Helping to Alleviate Medical Problems, Inc. (CHAMP),* 128 TC 173, Dec. 56,935 (2007).

[15] *M. Olive,* 139 TC 19, 38, Dec. 59,146 (2012), *aff'd* CA-9, 2015-2 USTC ¶50,377. *See also Californians Helping to Alleviate Medical Problems, Inc. (CHAMP)*, 128 TC 173, Dec. 56,935 (2007) and *Canna Care, Inc.*, 110 TCM 408, Dec. 60,432(M), TC Memo. 2015-206.

[16] *Patients Mutual Assistance Collective Corporation DBA Harborside Health Center*, Docket No. 014776-14.

[17] As nicely summarized by the Tax Court in *L. Sullenger*, 11 TC 1076, Dec. 16,735 (1948), "(T)he Commissioner has always recognized, as indeed he must to stay within the Constitution, that the cost of goods sold must be deducted from gross receipts in order to arrive at gross income. No more than gross income can be subjected to income tax upon any theory."

[18] S. Rep. No. 97-494 (Vol. I), at 309 (1982). The Senate bill was adopted in conference. Conf. Rep. No. 97-760, at 598 (1982), 1982-2 CB 661.

[19] Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982*, at 264 (Dec. 31, 1982).

[20] *Alpenglow Botanicals, LLC, et al., Plaintiffs v. United States of America, Defendant*, 2017-1 USTC ¶50,127 (Dec. 1, 2016); *High Desert Relief, Inc., a New Mexico Nonprofit Corporation*, *Petitioner*, through its Agency the IRS, Defendant., U.S. District Court, D. New Mexico, 2017-1 USTC ¶50,201 (Mar. 31, 2017).

[21] *See* a more detailed example in Jeffrey Gramlich & Kimberly Houser, *Marijuana Business and Sec 280E: Potential Pitfalls for Client and Advisers*, 46 The Tax Adviser 524 (July 1, 2015).

[22] CCA 201504011 (Jan. 23, 2015).

[23] Transportation costs include the amounts paid for hauling, loading, handling, freight, and associated direct labor costs. Any fees, tariffs, compensations, or other charges that are specifically traced to specific goods that are required solely in the acquisition of the goods are inventoriable costs. In essence, all charges up to delivery of the goods that are necessary in acquiring the goods are includible in the inventory cost unless it is an item specifically excluded under a Code provision. *See* Rev. Rul. 66-145, 1966-1 CB 98; GCM 38177 (Nov. 23, 1979).

[24] Reg. §1.471-11(c)(2)(i).

[25] Reg. §1.471-11(c)(2)(iii).

[26] Other employee benefits include workmen's compensation expenses, payments under a wage-continuation plan, amounts includible in the gross income of employees under nonqualified pension, profit-sharing and stock bonus plans, premiums on life and health insurance and miscellaneous benefits provided for employees such as safety, medical treatment, cafeteria, recreational facilities, membership dues, *etc.*, which are otherwise allowable as deductions under chapter 1 of the Code.

[27] S. Rep. No. 100-445, at 104 (1988).

[28] Michael Kosnitzky & Matt Kaden, *IRS Interpretation Causes Reefer Madness*, Taxes the Tax Magazine, May 2015, at 75.

[29] CCA 201531016 (July 31, 2015).

[30] Presumably regulations and case law under Code Secs. 901 and 903 may be relevant in making a determination of whether a tax is an income tax.

[31] Code Sec. 446(a).

[32] Rev. Rul. 90-38, 1990-1 CB 57.

[33] Code Sec. 446(b).

[34] Reg. §1.471-1.

[35] Reg. §1.446-1(c)(2)(i).

[36] *Californians Helping to Alleviate Medical Problems, Inc. (CHAMP),* 128 TC 173, Dec. 56,935 (2007).

[37] *J.M. Collins*, 34 TC 592, Dec. 24,248 (1960).

[38] *M. Olive*, 139 TC 19, Dec. 59,146 (2012) *aff'd* CA-9, 2015-2 USTC ¶50,377, 792 F3d 1146.

[39] The test for determining whether an activity constitutes a "trade or business" is "whether the activity 'was entered into with the dominant hope and intent of realizing a profit.'" *Am. Bar Endowment*, SCt, 86-1 USTC ¶9482, 477 US 105, 106 SCt 2426.

[40] *M.A. Tobin*, 78 TCM 517, Dec. 53,568(M), TC Memo. 1999-328.

