CAN YOU GET THERE FROM HERE?
FEDERAL TAXATION AND CANNABIS

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MEDICAL CANNABIS EDUCATIONAL
AND BUSINESS DEVELOPMENT TRAINING PROGRAM

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Stuart Levine received a B.A. from the University of Maryland (College Park) in 1972; a J.D. from the University of Baltimore in 1975; and an LL.M. (Taxation) from the Georgetown University Law Center in 1979. He practices primarily in the area of tax and business planning.

Mr. Levine was the Chairman of the Special Committee on Limited Liability Companies established by the Sections of Taxation and Business Law of the Maryland State Bar Association, which drafted the Maryland Limited Liability Company Act and subsequent amendments thereto, and was the co-chair of the Prototype Drafting Project of the Limited Liability Subcommittee of the Committee on Partnerships and Unincorporated Businesses of the A.B.A. Section of Business Law which drafted the Prototype Limited Liability Company Act. He was a member of the Task Force on Limited Liability Companies established by the A.B.A. Section of Taxation and is the past chair of the Subcommittee on Limited Liability Companies and Entity Classification of the Committee on Partnership Taxation of the ABA Section of Taxation. He had principal drafting responsibility for the comments submitted by the ABA Section of Taxation to the Internal Revenue Service on the entity classification (the "Check-the-Box") regulations.

Mr. Levine has authored or co-authored numerous professional articles, on tax and business topics. Mr. Levine is also one of the co-authors of the Maryland Limited Liability Company Forms and Practice Manual, published by Data Trace Legal Publishers, Inc.

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"That the power of taxing . . . may be exercised so as to destroy . . .is too obvious to be denied."
McCulloch v. Maryland*, *17 U.S. 327, 427 (1819)

1. *Introduction.*

1.1. I first became interested in the legalized sale of cannabis not, as one might suppose, out of, um, a desire to recapture my misspent youth. Rather, I was contacted by a client who had been approached to invest in a proposed medical cannabis operation in Maryland.

1.2. I began to ask questions. Most particularly, of course, how could one make a profit on the sale of cannabis given the provisions of **IRC § 280E.**[1] That section provides quite simply 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.

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[1] I have uploaded a copy of this outline, together with all of foundational material, all of which are set forth in red in the outline. The link to this material is: http://slnews.us/pb021519

1.3. Now, when, in the course of investigating my client's proposed investment, I raised one simple question: How the [expletive deleted] could one ever hope to make money dealing with cannabis on a retail level? After all:

1.3.1. The grower or distributor had to mark-up its product considerably in order to make a profit because IRC § 280E precluded it from deducting expenses.

1.3.2. While the sale price from the grower or distributor was an adjustment to the gross sales of the retailer for the purposes of calculating gross profit (because that amount constituted COGS, *i.e.*, cost of goods sold), by virtue of IRC § 280E, the gross profit and the net profit were the same for income tax purposes.

1.3.3. And, finally, the retail cannibis business had all of the normal expenses of any "legitimate" business, but some additional expenses that were quite high and not usually found in "legitimate" businesses.

1.4. It seemed to me that the operation of IRC § 280E coupled with the significant costs of operating a cannabis retail operation, virtually precluded the operation making a profit. So I raised the aforesaid question with the promoter. The answer(s) that I received were not at all comforting.

1.5. I discovered that the promoter was relying on a "cannabis consultant" who ostensibly, due to the wisdom gleaned by his many years in the cannabis business, knew exactly how to make money despite the provisions of IRC § 280E.[2] The consultant advised that:

1.5.1. One should operate ancillary business(es), not subject to IRC § 280E, out of the same location and allocate a goodly chunk of the expenses to those businesses; and

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[2]One definition of a "consultant" that I have found apt is the following: A glorified business hooker, typically hired by a consulting whorehouse, which pimps out its consultants to clients, then proceed to f**k the consultants over until they're pleased (or until the consultants are dead), pay the whorehouse big bucks, leaving the consultant with little commission (including some hotel and airline points) and lasting trauma.

1.5.2. The owners should create a management company and pay fees to the management company. The management company could somehow charge for services utilized in acquiring the cannabis, thus transforming operational expenses that were not deductible under IRC § 280E, into COGS.

1.6. Despite the fact that at the time my client was considering the investment there was little actual guidance in this area, my sense of smell caused me to advise against his making the investment. In what may have been the first time in my career, the client followed my advice.

1.7. IRC § 280E was enacted in 1982 as a response to the Tax Court's decision in ***Edmondson v. Commissioner*, T.C. Memo. 1981-623**, where a cocaine dealer was allowed to deduct the ordinary and necessary expenses of his illicit trade.

1.7.1. The taxpayer in *Edmondson*:

> [W]as self-employed in the trade or business of selling amphetamines, cocaine, and marijuana. His primary source of controlled substances was one Jerome Caby, who delivered the goods to petitioner in Minneapolis on consignment. Petitioner paid Caby after the drugs were sold. Petitioner received on consignment 1,100,000 amphetamine tablets, 100 pounds of marijuana, and 13 ounces of cocaine during the taxable year 1974. He had no beginning inventory of any of these goods and had an ending inventory of only 8 ounces of cocaine.

1.7.2. However, like all people in business:

> Edmondson incurred various expenses in his business of selling controlled substances. He drove his automobile 29,000 miles, of which two-thirds of such mileage was attributable to business use. Petitioner made a business trip to San Diego, California, in December of 1974 in connection with which he incurred expenses of $250 for air fare and $200 for food and entertainment. The petitioner purchased a scale to be used in his business for $50.

> Petitioner incurred packaging expenses for the sale of controlled substances of $200. Telephone expenses which were attributable to petitioner's business consisted of $180 of long-distance charges and two-thirds of his base rate charges of $204, or $136. Petitioner paid rent in the amount of $2,360 for his apartment, which was also his only place of business.

1.7.3. The IRS disallowed all of Edmondson's miscellaneous business expenses and his vehicle expense and disallowed $30,341.69 of his claimed cost of goods sold.

1.7.4. The Tax Court analyzed Edmondson's business expense claims in the same way that it would have analyzed the claims of any taxpayer in any legitimate business: The court allowed an adjustment from income for some (*e.g.,* the scale) as ordinary and necessary business expenses, others (the costs of the illicit drugs) as cost of goods sold, and some (one-half of the amount claimed by Edmondson) of the rent paid by him for his apartment. It disallowed other claims (travel and entertainment expenses) due to lack of substantiation.

2. ***The Courts Grapple with IRC § 280E–The Pre-2018 Cases***

2.1. In ***Californians Helping to Alleviate Med. Problems, Inc. (CHAMP), 128 T.C. 173 (2007),*** the Tax Court examined a situation where the taxpayer operated two separate trades or businesses--one that provided caregiving services and one that sold marijuana.

2.1.1. The caregiving services were real and substantial. As described by the court:

> Petitioner did not have Federal tax-exempt status [but was organized pursuant to the California Nonprofit Public Benefit Corporation Law], and it operated as an approximately break-even (*i.e.,* the amount of its income approximated the amount of its expenses) community center for members with debilitating diseases. Approximately 47 percent of petitioner's members suffered

> from Acquired Immune Deficiency Syndrome (AIDS); the remainder suffered from cancer, multiple sclerosis, and other serious illnesses. Before joining petitioner, petitioner's executive director had 13 years of experience in health services as a coordinator of a statewide program that trained outreach workers in AIDS prevention work.

2.1.2. The IRS challenged all of the deductions taken by CHAMP, but not an exclusion from gross income of its cost of goods sold ("COGS").

2.1.3. The Tax Court first noted that:

> Taxpayers may be involved in more than one trade or business, and 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. The Commissioner generally accepts a taxpayer's characterization of two or more undertakings as separate activities unless the characterization is artificial or unreasonable.
> (Citations omitted.)

2.1.4. The court accepted CHAMP's executive director who "testified credibly and without contradiction that petitioner's primary purpose was to provide caregiving services for terminally ill patients."

2.1.5. The Court allocated CHAMP's expenses between its two trades or businesses on the basis of the number of petitioner's employees and the portion of its facilities devoted to each business. Thus, it allocated to CHAMP's caregiving services 18/25 of the expenses for salaries, wages, payroll taxes, employee benefits, employee development training, meals and entertainment, and parking and tolls (18 of CHAMP's 25 employees did not work directly in CHAMP's provision of medical marijuana) and a greater percentage of other expenses (e.g., rent) to the caregiving services based upon the relative space each "business" used.

2.1.6. Based upon the court's allocations, the taxpayer was allowed to deduct the expenses that it properly allocated to its caregiving business, but not those allocated to its marijuana-sales business.

2.2. In ***Olive*, 139 T.C. 19 (2012), *aff'd*, 792 F.3d 1146 (9th Cir. 2015)**, the Tax Court held that a dispensary that derived all its revenue from marijuana sales but also provided free activities and services to its patrons was but a single trade or business. However, because that single trade or business was selling marijuana, the Tax Court also held that section 280E precluded the deduction of any of the taxpayer's operating expenses, but did not prevent the taxpayer from adjusting for costs of goods sold.

2.2.1. As noted by the Ninth Circuit in its opinion upholding the Tax Court's decision:

> Established in 2004, the Vapor Room [the taxpayer's trade name] provides its patrons a place where they can socialize, purchase medical marijuana, and consume it using the Vapor Room's vaporizers. The Vapor Room sells medical marijuana in three forms: dried marijuana leaves, edibles, and a concentrated version of THC. Customers who purchase marijuana at the Vapor Room pay varying costs, depending on the quantity and quality of the product and on the individual customer's ability to pay.
>
> The Vapor Room is set up much like a community center, with couches, chairs, and tables located throughout the establishment. ***Games, books, and art supplies are available for patrons' general use. The Vapor Room also offers services such as yoga, movies, and massage therapy. Customers can drink complimentary tea or water during their visits, or they can eat complimentary snacks, including pizza and sandwiches. The Vapor Room offers these activities and amenities for free.***
> (Footnote omitted; emphasis added.)

2.2.2. Stated simply, the court believed that there was really only one business: The cannabis business.

2.3. Finally, in ***Canna Care, Inc.*, T.C. Memo. 2015-206, *aff'd*, 694 F. App'x 570 (9th Cir. 2017)**, the Tax Court found that the taxpayer--which stipulated that it was "in the business of distributing medical marijuana"--was engaged in one trade or business because its sale of non-marijuana items such as books and socks "was an activity incident to its business of distributing medical marijuana." ("Individuals were not charged a membership fee and paid only for medical marijuana or other products (e.g., books, T-shirts, and hats) that they purchased.") The Court therefore held that IRC § 280E barred deductions for any of its business expenses.

3. ***The 2018 Court Decisions***

3.1. In 2018, the Tax Court handed down three cannabis/IRC § 280E decisions:

***Patients Mutual Assistance Collective Corporation, d.b.a., Harborside Health Center*, 151 T.C. No. 11** (November 29, 2018) ("Harborside I")

***Patients Mutual Assistance Collective Corporation, d.b.a., Harborside Health Center*, T.C.M. 2018-208** (December 20, 2018) ("Harborside II")

and

Alternative Health Care Advocates, 151 T.C. No. 13

3.2. *Harborside I.* A good portion of the Court's opinion in *Harborside I.* deals with the issue of *res judicata* due to a civil forfeiture action brought against the taxpayer in 2012. The Court disposed of that argument rather summarily and it really is not of particular interest to us today. The Court then addressed the taxpayer's substantive arguments.

3.2.1. First, the taxpayer argued that IRC § 280E applies only to businesses that exclusively or solely traffic in controlled substances and not to those that also engage in other activities. Even though *CHAMP* and *Olive* pretty well closed the door of this line of argument, the Court exhaustively examined the statute

both with respect to its history and its textual meaning within the larger context of the Internal Revenue Code. Citing Shakespeare at least twice, the Court found the taxpayer's argument wanting.

3.2.2. Next, the Court jumped to the "more than one business" argument. The court noted at slip op. 37 that:

> A single taxpayer can have more than one trade or business or multiple activities that nevertheless are only a single trade or business. Even separate entities' activities can be a single trade or business if they're part of a "unified business enterprise" with a single profit motive.

(Citations omitted.)

3.2.3. The Court distinguished *CHAMP* and *Olive*. Recall that in *CHAMP*, the taxpayer provided both caregiving services and medical marijuana. However, the majority of the employees provided only caregiving services and the marijuana dispensing occurred in one of only three facilities run by the taxpayer there. In contrast, in *Olive* the taxpayer sold medical marijuana and provided, at no additional charge, such complimentary services as movies, board games, yoga classes, massages, snacks, personal counseling, and advice on how to best consume marijuana. Thus, there, it was obvious that there was but one business–the sale of marijuana.

3.2.4. As noted above, in *Canna Care*, there was some income from the sale of non-marijuana products such as tee-shirts, etc., but these were deemed to be merely ancillary to the main business of marijuana sales.

3.2.5. The taxpayer in *Harborside* was prepared to address the triad of *CHAMP*, *Olive*, and *Canna Care*. Its proposal fell on deaf ears, however. The Court concluded that neither (i) the sale of ancillary items, (ii) the free "holistic services" offered by the taxpayer, or (iii) the alleged "branding" expenditures, constituted lines of business separate from the cannabis business.

3.2.6. The taxpayer also argued that certain "indirect costs" should be included in calculating COGS by virtue of the capitalization rules of IRC § 263A. That argument was rejected because:

> Section 263A expressly prohibits capitalizing expenses that wouldn't otherwise be deductible, and drug traffickers don't get deductions. Because federal law labels [the taxpayer] a drug trafficker, it must calculate its COGS according to section 471.

3.2.7. Finally, the taxpayer argued that with respect to "marijuana bud" sales, it was a producer rather than a reseller, thus entitled to certain costs that it incurred. In essence, the taxpayer here purchased "clones" and directed growers to produce marijuana from those clones following a closely defined regime of best practices and quality control standards that the taxpayer developed and imposed on its suppliers.

3.2.8. The Court rejected this argument as well, concluding that:

> [The taxpayer] merely sold or gave members clones that it had purchased from nurseries and bought back bud if and when it wanted. In between these two steps it had no ownership interest in the marijuana plants. [The taxpayer] is therefore a reseller for purposes of section 471 and must adjust for its COGS according to section 1.471-3(b), Income Tax Regs.

3.2.9. Finally, the Court turned to the question of accuracy-related penalties and—Punted. This is where we step away from the fog of specialized tax analysis found in of *Harborside I* and step into the smog of the analyses comparing the manner in which the Court dealt with the accuracy-related penalty issue in *Alternative Health Care Advocates* and its handling of the question in *Harborside II.* A comparison of the two cases is valuable any practitioner whether tax, business, tort, or criminal law.

3.3. *Alternative Health Care Advocates*. While the taxpayer in *Harborside* made arguments that were ultimately rejected by the Tax Court, its business practices

were exemplary. In contrast, the taxpayer's business practices in *Alternative Health Care Advocates* were, to be charitable, less so.

3.3.1. In *Alternative Health Care Advocates*, the Court had to address many of the same substantive issues it had addressed in *Harborside I*. However, there was an important issue that was not presented in Harborside I.

3.3.2. Specifically, in *Alternative Health Care Advocates* the retail operation was structured as a C corporation. The principals, however, formed an S corporation to handle daily operations for the retail operation including paying employee wages and salaries. This fast shuffle caused the taxpayers, collectively, dearly. The Service argued and the Tax Court affirmed that:

> [B]oth [entities] sole trade or business was trafficking in a controlled substance and that I.R.C. sec. 280E precluded [both of them from] deducting business expenses. In light of that determination, [the principals had underreported their flowthrough income from [the S (management) corporation].

3.3.3. Ouch.

3.3.4. The Court made short shrift of the argument that the retail operation, Alternative, and the "management" operation, Wellness, were engaged in a uniform business, namely trafficking in marijuana:

> [T]he only difference between what Alternative did and what Wellness did (since Alternative acted only through Wellness) is that Alternative had title to the marijuana and Wellness did not. Wellness employees were directly involved in the provision of medical marijuana to the patient-members of Alternative's dispensary. While Wellness and Alternative were legally separate, Wellness employees were engaged in the purchase and sale of marijuana (albeit on behalf of Alternative); that was Wellness' primary business. We do not read the term "trafficking" to require Wellness to have had title to the

> marijuana its employees were purchasing and selling. Neither that section nor the nontax statute on trafficking limits application to sales on one's own behalf rather than on behalf of another. Without clear authority, we will not read such a limitation into these provisions. We, therefore, hold that Wellness was engaged in the business of "trafficking in controlled substances" during the taxable years at issue.

3.3.5. Then, double-ouch, the Court applied the well known "tough noogies" rule:[3]

> Petitioners also argue that applying section 280E to both Alternative and Wellness is inequitable because deductions for the same activities would be disallowed twice. These tax consequences are a direct result of the organizational structure petitioners employed, and petitioners have identified no legal basis for remedy.
>
> We, therefore, hold that Mr. Duncan, Mr. Kwit, and Mr. Rozmarin each have additional taxable income from Wellness resulting from the denial of deductions pursuant to section 280E.

3.3.6. And now, triple-ouch. The Court imposed penalties under IRC § 6662.

3.3.7. First, the Court held that the taxpayers had waived any argument that they had substantial authority for their position or that they had disclosed the IRC § 280E issue on their returns.

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[3]For a definition of the "tough noogies rule" go here: https://www.urbandictionary.com/define.php?term=Tough%20Noogies

3.3.8. Then, the Court pointed out that while they had hired an accountant believed to have experience with marijuana dispensaries, the taxpayers provided no evidence that they relied upon the accountant's advice.

3.3.9. It is here that there is a meaningful contrast with the taxpayer in *Harborside II*, a contrast that we should all be mindful of.

3.4. *Harborside II*–Except for the bifurcation of operations from management as the taxpayers in *Alternative Health Care Advocates* attempted, much of the essential structure of *Harborside* was the same.

3.4.1. First, the Court found that, under the circumstances, the *Harborside* taxpayer's reporting position was reasonable:

> Not only had its main argument for the inapplicability of section 280E to its business not yet been the subject of a final unappealable decision, but as discussed at length in [Harborside I], the meaning of "consists of" as used in section 280E is subject to more than one reasonable interpretation. See [Harborside I], 151 T.C. at ___ (slip op. at 24-37). Even by 2012--the last of the tax years at issue here--the only addition to this caselaw was our own opinion in Olive, and it too was still years away from a final appellate decision.

3.4.2. Next, the Court addressed the taxpayer's good faith.

3.4.2.1. After *Olive* was released, even before it was affirmed on appeal, the taxpayer in *Harborside* instituted practices conforming to the *Olive* holding.

3.4.2.2. Next, the Court found that:

> Keeping good books and records was one of Harborside's strengths, and the Commissioner agreed in pretrial stipulations in each of these cases that Harborside had substantiated all its claimed deductions and COGS for all

the tax years at issue and that all of them were paid or incurred in a trade or business.

3.4.2.3. Finally, the Court stated that "We also believe the testimony of Steve DeAngelo--Harborside's cofounder and boss--that he actively sought to comply with California law and our caselaw."

3.5. There is a larger message in these cases: One employing sharp practice will sometimes get sliced up.[4] Simply do do the math. The operation of IRC § 280E makes it tougher to make money in the "legal" marijuana business. And, as has been reported, marijuana prices in Colorado have declined 70% in four years and prices are collapsing elsewhere. https://perma.cc/RA8A-PYDK Indeed, the cost per pound in Oregon is sometimes as low as $100. https://perma.cc/LZ4P-MRQ7 While I, of course, have little first-hand knowledge of this, my understanding that a pound of marijuana in the 1968-72 period was approximately $160.

4. *The Definition of "Cost of Goods Sold"*

4.1. In all of these cases, the courts (and the IRS) acknowledge that an adjustment for cost of goods sold ("COGS") is not barred by IRC § 280E. In other words: In the cannabis business one will pay income tax on Gross Sales minus COGS.

4.2. In **CCM 201504011**, the IRS held that:

4.2.1. The determination of COGS in a cannabis business is determined using the applicable inventory-costing regulations under IRC § 471 as they existed when IRC § 280E was enacted.

4.2.2. Thus, the more liberal rules of IRC §263A, enacted after the enactment of IRC § 280E, do not apply.

4.2.3. The taxpayer is required to capitalize inventoriable costs when incurred and will remove these costs from inventory when units of merchandise are sold. Stated differently, the taxpayer will compute COGS as an adjustment to gross

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[4] Or, as is often said: "Pigs get fat, hogs get slaughtered."

receipts. On the other hand, when not required to use an inventory method, a taxpayer might be permitted to use the cash method.

4.2.4. A cannabis reseller using an inventory method has to capitalize the invoice price of the marijuana purchased, less trade or other discounts, plus transportation or other necessary charges incurred in acquiring possession of the marijuana.

4.2.5. Similarly, a marijuana producer using an inventory method would have capitalized direct material costs (marijuana seeds or plants), direct labor costs (*e.g.*, planting; cultivating; harvesting; sorting).

4.2.6. As a practical matter, as compared to a seller at retail, the grower will be able to classify a greater percentage of its costs as COGS, thus deducting those costs when it sells its inventory.

5. ***A Few Thoughts on Choice of Entity.***

5.1. The Bradford Tax Institute has published an interesting Q&A about the cannabis industry.[5]

5.2. The Q&A states that "Because Section 280E creates "phantom" income for tax purposes (that is, the income doesn't exist in real cash), it makes the S corporation and other pass-through entities less attractive overall for the cannabis business."

5.3. I am less than certain that this is the case. My take on the cannabis business is that virtually no one will make significant profit so long as IRC § 280E remains in place. It seems to me that the goal of a cannabis entrepreneur is to hang on to the business until IRC § 280E is repealed or significantly modified, with the goal being to sell out when the business matures and consolidation occurs.

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[5] ***See here:*** https://bradfordtaxinstitute.com/Content/QA-Tax-Reform-and-the-Cannabis-Industry.aspx (last visited: February 15, 2019).