CAN YOU GET THERE FROM HERE?
FEDERAL TAXATION AND CANNABIS

STUART LEVINE

PRESENTED AT THE
MEDICAL CANNABIS EDUCATIONAL
AND BUSINESS DEVELOPMENT TRAINING PROGRAM

FEBRUARY 15, 2019

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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.

[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).

From the Desk of
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Sec. 280E. Expenditures in connection with the illegal sale of drugs

TITLE 26, Subtitle A, CHAPTER 1, Subchapter B, PART IX, Sec. 280E.

STATUTE

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.

Web edition produced by John Walker

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42 T.C.M. (CCH) 1533 (1981)
T.C. Memo. 1981-623.

Jeffrey Edmondson, a/k/a Jeff Edmondson

v.

Commissioner.

Docket No. 4586-76.

United States Tax Court.

Filed October 26, 1981.

1534 *1534 Saul A. Bernick and Neal Shapiro, 1024 Soo Line Bldg., Minneapolis, Minn., for the petitioner. James C. Lanning, for the respondent.

Memorandum Findings of Fact and Opinion

GOFFE, Judge:

The Commissioner determined a deficiency in petitioner's Federal income tax liability for the taxable year 1974 in the amount of $17,303.45 together with an addition to tax under section 6651 (a), Internal Revenue Code of 1954,[1] in the amount of $289.87. There are two issues for decision:

(1) whether respondent has properly disallowed portions of petitioner's cost of goods sold and expenses in recomputing petitioner's Federal income tax liability, and

(2) whether the Commissioner's determination of an addition to tax under section 6651 (a) is proper.

Findings of Fact

Some of the facts in this case have been stipulated. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioner Jeffrey Edmondson resided in Minneapolis, Minnesota, when he filed his petition in this case. Petitioner's Federal income tax return for the taxable year 1974 was filed on June 24, 1975, at the Internal Revenue Service Center in Ogden, Utah.

During the taxable year 1974, petitioner Jeffrey Edmondson was 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.

Petitioner did not keep books and records of these transactions because of the illegal nature of his business. Petitioner reconstructed these transactions in February of 1975 for the purpose of filing a Federal income tax return for 1974 in response to a jeopardy assessment made by the Commissioner. He reported on this return that his cost of goods sold for these products was $105,300.

In the taxable year 1974 petitioner 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.

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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.

In his notice of deficiency, the Commissioner disallowed all of petitioner's miscellaneous business expenses and his vehicle expense and disallowed $30,341.69 of petitioner's claimed cost of goods sold.

Opinion

We will first consider petitioner's cost of goods sold. Petitioner submits that his claimed cost of goods sold and expenses have been established through his testimony at trial and other evidence. Respondent maintains that the petitioner's uncorrobated testimony should not be accepted uncritically by this Court.

Petitioner was one link in a chain from the source of his controlled substances to the ultimate consumer. He was not the
1535 source of the drugs, he did not bear the *1535 risk of transporting them from foreign countries or from distant areas of the United States, and did not bear the risk of any financial investment in them. The drugs were "fronted" to him, i.e., he received the goods on consignment and paid his supplier out of funds which he received on sale. At trial in May of 1980 petitioner testified that this consignment price for amphetamine tablets ranged from 7½ cents to 10 cents per tablet, with an average price of 8 cents per tablet. Petitioner further testified that the consignment cost of the marijuana was $110 per pound. Finally, petitioner testified that the 13 ounces of cocaine were acquired in three transactions, the consignment price of which was $1,200 per ounce for the one ounce in the first transaction, $1,500 per ounce for the 4 ounces in the second transaction, and $1,000 per ounce for the 8 ounces in the third transaction. Petitioner asserts by his testimony that he had a cost of goods sold of $106,200. The nature of petitioner's role in the drug market, together with his appearance and candor at trial, cause us to believe that he was honest, forthright, and candid in his reconstruction of the income and expenses from his illegal activities in the taxable year 1974. While petitioner's testimony at trial indicates a larger cost of goods sold than his original reconstruction in February of 1975, we believe that petitioner's first reconstruction, made while the events were clear in his mind, is the most accurate. We, therefore, hold that petitioner's cost of goods sold for the taxable year 1974 was $105,300.

Petitioner's travel and entertainment expenses, consisting of air fare and food and entertainment for a trip to San Diego, California, must be disallowed because the petitioner has not complied with the substantiation requirements of section 274(d).

Petitioner claims that two-thirds of the rental cost of his residence is deductible because he used it as the office for his illegal drug business. While the rental attributable to such use would usually constitute an ordinary and necessary business expense which would be deductible under sections 161 and 162, section 262 disallows any deduction for personal, living, or family expenses, and section 1.262-1(b)(3), Income Tax Regs., provides:

> (3) Expenses of maintaining a household, including amounts paid for rent, water, utilities, domestic service, and the like, are not deductible. A taxpayer who rents a property for residential purposes, but incidentally conducts business there (his place of business being elsewhere) shall not deduct any part of the rent. If, however, he uses part of the house as his place of business, such portion of the rent and other similar expenses as is properly attributable to such place of business is deductible as a business expense.

The property which petitioner rented as his residence was also his only place of business. This is in contrast to the facts in *Sharon v. Commissioner* [Dec. 33,890], 66 T.C. 515 (1976), affd. per curiam [78-2 USTC ¶ 9834] 591 F. 2d 1273 (9th Cir. 1978), cert. denied 442 U.S. 941 (1979). In that case we disallowed the home office deduction of an employee who was provided office space at his employer's place of business but chose to also use his residence as an office. We found that under section 1.262-1(b)(3), Income Tax Regs., the expense of maintaining one's residence is a personal expense, and that a taxpayer can take part of his apartment rent out of the nondeductible category only by showing that a portion of his residence constitutes a place of business. We disallowed the petitioner's claimed home office deduction because the petitioner's use of his home failed to meet this requirement; the occasional use of his home, purely as a

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matter of convenience, did not make his home a place of business.

Petitioner in the present case meets the above requirement that his home be a place of business. His apartment was his only place of business. We are persauded that the petitioner made substantial use of his apartment in his drug business. His testimony, however, did not describe either the specific spatial portion of his apartment which he used as his office or the percentage of such use. Where we are persauded that a taxpayer incurred an expense, we may make an approximation thereof, "bearing heavily * * * upon the taxpayer whose inexactitude is of his own making." *Cohan v. Commissioner* [2 USTC ¶ 489], 39 F. 2d 540 (2d Cir. 1930). From the record as a whole we find that the appropriate portion of business use of the petitioner's apartment was one-half of the two-thirds asserted by petitioner. This is because the allocation must exclude personal use, both in space and time. We hold that one-third of petitioner's rental expense of $2,360, or $787, constitutes an ordinary and necessary expense of petitioner's trade or business and is to be allowed as a deduction.

1536 Petitioner's remaining claimed business expenses consist of the purchase of a small *1536 scale, packaging expenses, telephone expenses, and automobile expenses. We hold that these expenses were made in connection with petitioner's trade or business and were both ordinary and necessary.

The second issue for decision before this Court is whether the Commissioner's determination of an addition to tax under section 6651(a) is proper. This determination is presumptively correct. *Welch v. Helvering* [3 USTC ¶ 1164], 290 U.S. 111 (1933). The record indicates that petitioner's Federal income tax return for the taxable year 1974 was not timely filed. Petitioner has made no effort to show that his failure to timely file this return was the result of reasonable cause. We hold, therefore, that petitioner has failed to sustain his burden and that the Commissioner's determination of addition to tax is upheld.

Decision will be entered under Rule 155.

[1] All section references are to the Internal Revenue Code of 1954, as amended.

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128 T.C. No. 14

UNITED STATES TAX COURT

CALIFORNIANS HELPING TO ALLEVIATE MEDICAL PROBLEMS, INC.,
Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 20795-05. Filed May 15, 2007.

P provided counseling and other caregiving services (collectively, caregiving services) to its members, who were individuals with debilitating diseases. P also provided its members with medical marijuana pursuant to the California Compassionate Use Act of 1996, codified at Cal. Health & Safety Code sec. 11362.5 (West Supp. 2007). P charged its members a membership fee that generally reimbursed P for its costs of the caregiving services and its costs of the medical marijuana. R determined that all of P's expenses were nondeductible under sec. 280E, I.R.C., because, R determined, the expenses were incurred in connection with the trafficking of a controlled substance.

Held: Sec. 280E, I.R.C., precludes P from deducting its expenses attributable to its provision of medical marijuana.

Held, further, P's provision of its caregiving services and its provision of medical marijuana were separate trades or businesses for purposes of sec. 280E, I.R.C.; thus, sec. 280E, I.R.C., does not

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preclude P from deducting the expenses attributable to the caregiving services.

Matthew Kumin, Henry G. Wykowski, and Willian G. Panzer, for petitioner.

Margaret A. Martin, for respondent.

LARO, Judge: Respondent determined a $355,056 deficiency in petitioner's 2002 Federal income tax and a $71,011 accuracy-related penalty under section 6662(a).[1] Following concessions by respondent, including a concession that petitioner is not liable for the determined accuracy-related penalty, we decide whether section 280E precludes petitioner from deducting the ordinary and necessary expenses attributable to its provision of medical marijuana pursuant to the California Compassionate Use Act of 1996, codified at Cal. Health & Safety Code sec. 11362.5 (West

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[1] Unless otherwise indicated, section, subchapter, and chapter references are to the applicable versions of the Internal Revenue Code, and Rule references are to the Tax Court Rules of Practice and Procedure.

Supp. 2007).[2] We hold that those deductions are precluded. We also decide whether section 280E precludes petitioner from deducting the ordinary and necessary expenses attributable to its provision of counseling and other caregiving services (collectively, caregiving services). We hold that those deductions are not precluded.

FINDINGS OF FACT

Certain facts were stipulated and are so found. The stipulation of facts and the exhibits attached thereto are incorporated herein by this reference. When the petition was filed, petitioner was an inactive California corporation whose mailing address was in San Francisco, California.

Petitioner was organized on December 24, 1996, pursuant to the California Nonprofit Public Benefit Corporation Law, Cal.

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[2] At a general election held on Nov. 5, 1996, the California electors approved an initiative statute designated on the ballot as Proposition 215 and entitled "Medical Use of Marijuana". See People v. Mower, 49 P.3d 1067, 1070 (Cal. 2002). The statute, the California Compassionate Use Act of 1996, codified at Cal. Health & Safety Code sec. 11362.5 (West Supp. 2007), was intended

> To ensure that seriously ill Californians have the right to obtain and use marijuana for medical purposes where that medical use is deemed appropriate and has been recommended by a physician who has determined that the person's health would benefit from the use of marijuana in the treatment of * * * any * * * illness for which marijuana provides relief.

Id. sec. 11362.5(b)(1)(A); see also People v. Mower, supra at 1070. We use the term "medical marijuana" to refer to marijuana provided pursuant to the statute.

Corp. Code secs. 5110-6910. (West 1990).[3] Its articles of incorporation stated that it "is organized and operated exclusively for charitable, educational and scientific purposes" and "The property of this corporation is irrevocably dedicated to charitable purposes". Petitioner did not have Federal tax-exempt status, 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.

Petitioner operated with a dual purpose. Its primary purpose was to provide caregiving services to its members. Its secondary purpose was to provide its members with medical marijuana pursuant to the California Compassionate Use Act of 1996 and to instruct those individuals on how to use medical marijuana to benefit their health. Petitioner required that each

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[3] Under California law, public benefit corporations are organized for a public or charitable purpose; they are not operated for the mutual benefit of their members but for a broader good. See Knapp v. Palisades Charter High School, 53 Cal. Rptr. 3d 182, 186 n.5 (Ct. App. 2007).

member have a doctor's letter recommending marijuana as part of his or her therapy and an unexpired photo identification card from the California Department of Public Health verifying the authenticity of the doctor's letter. Petitioner required that its members not resell or redistribute the medical marijuana received from petitioner, and petitioner considered any violation of this requirement to be grounds to expel the violator from membership in petitioner's organization.

Each of petitioner's members paid petitioner a membership fee in consideration for the right to receive caregiving services and medical marijuana from petitioner. Petitioner's caregiving services were extensive. First, petitioner's staff held various weekly or biweekly support group sessions that could be attended only by petitioner's members. The "wellness group" discussed healing techniques and occasionally hosted a guest speaker; the HIV/AIDS group addressed issues of practical and emotional support; the women's group focused on women-specific issues in medical struggles; the "Phoenix" group helped elderly patients with lifelong addiction problems; the "Force" group focused on spiritual and emotional development. Second, petitioner provided its low-income members with daily lunches consisting of salads, fruit, water, soda, and hot food. Petitioner also made available to its members hygiene supplies such as toothbrushes, toothpaste, feminine hygiene products, combs, and bottles of bleach. Third,

petitioner allowed its members to consult one-on-one with a counselor about benefits, health, housing, safety, and legal issues. Petitioner also provided its members with biweekly massage services. Fourth, petitioner coordinated for its members weekend social events including a Friday night movie or guest speaker and a Saturday night social with live music and a hot meal. Petitioner also coordinated for its members monthly field trips to locations such as beaches, museums, or parks. Fifth, petitioner instructed its members on yoga and on topics such as how to participate in social services at petitioner's facilities and how to follow member guidelines. Sixth, petitioner provided its members with online computer access and delivered to them informational services through its Web site. Seventh, petitioner encouraged its members to participate in political activities.

Petitioner furnished its services at its main facility in San Francisco, California, and at an office in a community church in San Francisco. The main facility was approximately 1,350 square feet and was the site of the daily lunches, distribution of hygiene supplies, benefits counseling, Friday and Saturday night social events and dinners, and computer access. This location also was the site where petitioner's members received their distribution of medical marijuana; the medical marijuana was dispensed at a counter of the main room of the facility, taking up approximately 10 percent of the main facility. The

peer group meetings and yoga classes were usually held at the church, where petitioner rented space. Pursuant to the rules of the church, petitioner's members were prohibited from bringing any marijuana into the church. Petitioner also maintained a storage unit at a third location in San Francisco. Petitioner used the storage unit to store confidential medical records; no medical marijuana was distributed or used there.

Petitioner paid for the services it provided to its members by charging a membership fee that covered, and in the judgment of petitioner's management approximated, both the cost of petitioner's caregiving services and the cost of the medical marijuana that petitioner supplied to its members. Petitioner notified its members that the membership fee covered both of these costs, and petitioner charged its members no additional fee. Members received from petitioner a set amount of medical marijuana; they were not entitled to unlimited supplies.

On May 6, 2002, petitioner's board of directors decided that petitioner would henceforth discontinue all of its activities. Petitioner thus ceased conducting any activity and filed a "Final Return" (Form 1120, U.S. Corporation Income Tax Return) for 2002. This return reported the following items on the basis of an accrual method of accounting:

Gross receipts or sales			$1,056,833
Less returns and allowances			8,802
Balance			1,048,031
Cost of goods sold:			
Inventory at beginning of year		$12,551	
Purchases		575,317	
Cost of labor		203,661	
Other costs:			
Cash (over/under)	$1,680		
Operating supplies	29,077		
Program costs	13,026		
Total other costs	43,783	43,783	
Inventory at end of year		-0-	
Total cost of goods sold		835,312	835,312
Gross profit			212,719
Deductions:			
Compensation of officers		14,914	
Salaries and wages		44,799	
Repairs and maintenance		1,456	
Rents		25,161	
Taxes and licenses		28,201	
Depreciation		8,409	
Advertising		200	
Employee benefit programs		24,453	
Other deductions:			
Accounting	5,086		
Auto and truck	308		
Bank charges	1,097		
Computer expense	961		
Dues and subscriptions	20		
Employee development training	1,940		
Insurance	7,727		
Internet service provider	2,238		
Janitorial	1,409		
Laundry and cleaning	105		
Legal and professional	5,500		
Meals and entertainment	402		
Miscellaneous	269		
Office expense	4,533		
Outside services	4,421		
Parking and toll	120		
Security	2,185		
Supplies	660		
Telephone	7,870		
Utilities	18,514		
Total other deductions	65,365	65,365	
Total deductions		212,958	212,958
Taxable loss			239

In a notice of deficiency mailed to petitioner on August 4, 2005, respondent disallowed all of petitioner's deductions and costs of goods sold, determining that those items were

"Expenditures in Connection with the Illegal Sale of Drugs" within the meaning of section 280E. Respondent has since conceded this determination except to the extent that it relates to the "Total deductions" of $212,958.[4] Respondent has also conceded that the expenses underlying the $212,958 of total deductions are substantiated.

The "Total deductions" were ordinary, necessary, and reasonable expenses petitioner incurred in running its operations during the subject year. The specific expenses underlying those deductions are as follows:

- The $14,914 deducted for compensation of officers reflects the salary of petitioner's executive director. The executive director worked 50 hours a week for 17 weeks. The executive director directed petitioner's overall operations and was not directly engaged in petitioner's provision of medical marijuana.
- The $44,799 deducted for salaries and wages reflects the compensation of petitioner's 24 other employees. Seven of the 24 employees were

[4] In other words, respondent concedes that the disallowance of sec. 280E does not apply to costs of goods sold, a concession that is consistent with the caselaw on that subject and the legislative history underlying sec. 280E. See Peyton v. Commissioner, T.C. Memo. 2003-146; Franklin v. Commissioner, T.C. Memo. 1993-184; Vasta v. Commissioner, T.C. Memo. 1989-531; see also S. Rept. 97-494 (Vol. 1), at 309 (1982).

involved in petitioner's provision of medical marijuana. The other 17 employees were involved with petitioner's provision of caregiving services.

! The $1,456 deducted for repairs and maintenance reflects expenses petitioner incurred to repair and maintain its main facility.

! The $25,161 deducted for rents reflects $15,000 of rent for the main facility, $5,700 of rent for the use of the church, and $4,461 of rent for the storage unit and a photocopier.

! The $28,201 deducted for payroll taxes reflects petitioner's liability for the payment of payroll taxes.

! The $8,409 deducted for depreciation reflects depreciation of petitioner's property.

! The $200 deducted for advertising reflects the cost of advertising by petitioner, including a $150 expense for the rental of a booth where petitioner distributed literature.

! The $24,453 deducted for employee benefit programs reflects the cost of a health insurance policy that petitioner maintained for its employees.

! The $5,086 deducted for accounting reflects the fees of petitioner's accountant.

! The $308 deducted for auto and truck reflects repairs made to a van used to transport members.

! The $1,097 deducted for bank charges reflects bank service charges petitioner incurred.

! The $961 deducted for computer expense reflects the cost of purchasing and maintaining computers petitioner used in its operations.

! The $20 deducted for dues and subscriptions reflects dues petitioner paid to an association comprising persons performing functions similar to those of petitioner.

! The $1,940 deducted for employee development training reflects costs petitioner incurred to train its bookkeeper and management team.

! The $7,727 deducted for insurance reflects the cost of petitioner's liability insurance.

! The $2,238 deducted for Internet service provider reflects the cost of petitioner's Internet services.

! The $1,409 deducted for janitorial reflects the cost of petitioner's garbage services.

! The $105 deducted for laundry and cleaning reflects costs petitioner incurred to clean and launder napkins used in its food distribution.

! The $5,500 deducted for legal and professional reflects the fees of petitioner's attorney. None of these fees involved any defense for criminal prosecution.

! The $402 deducted for meals and entertainment reflects costs that petitioner incurred for meals furnished to its employees who worked late or long hours.

! The $269 deducted for miscellaneous reflects miscellaneous expenses petitioner incurred.

! The $4,533 deducted for office expenses reflects costs petitioner incurred for office supplies such as paper and printer toner.

! The $4,421 deducted for outside services reflects the cost of petitioner's payroll service company.

! The $120 deducted for parking and toll reflects petitioner's reimbursement to its employees who paid parking fees and tolls on behalf of petitioner.

- The $2,185 deducted for security reflects the cost of security at the main facility, including the costs of an alarm company and medical service.
- The $660 deducted for supplies reflects the costs petitioner incurred to buy various supplies.
- The $7,870 deducted for telephone reflects the cost petitioner incurred for its telephone service.
- The $18,514 deducted for utilities reflects the cost of the gas and electricity petitioner used at its main facility.

OPINION

The parties agree that during the subject year petitioner had at least one trade or business for purposes of section 280E. According to respondent, petitioner had a single trade or business of trafficking in medical marijuana. Petitioner argues that it engaged in two trades or businesses. Petitioner asserts that its primary trade or business was the provision of caregiving services. Petitioner asserts that its secondary trade or business was the supplying of medical marijuana to its members. As to its trades or businesses, petitioner argues, the deductions for those trades or businesses are not precluded by section 280E in that the trades or businesses did not involve "trafficking" in a controlled substance. Respondent argues that

section 280E precludes petitioner from benefiting from any of its deductions.

Accrual method taxpayers such as petitioner may generally deduct the ordinary and necessary expenses incurred in carrying on a trade or business. See sec. 162(a). Items specified in section 162(a) are allowed as deductions, subject to exceptions listed in section 261. See sec. 161. Section 261 provides that "no deduction shall in any case be allowed in respect of the items specified in this part." The phrase "this part" refers to part IX of subchapter B of chapter 1, entitled "Items Not Deductible". "Expenditures in Connection With the Illegal Sale of Drugs" is an item specified in part IX. Section 280E provides:

> 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.

In the context of section 280E, marijuana is a schedule I controlled substance. See, e.g., Sundel v. Commissioner, T.C. Memo. 1998-78, affd. without published opinion 201 F.3d 428 (1st Cir. 1999). Such is so even when the marijuana is medical marijuana recommended by a physician as appropriate to benefit

the health of the user. See United States v. Oakland Cannabis Buyers' Coop., 532 U.S. 483 (2001).

Respondent argues that petitioner, because it trafficked in a controlled substance, is not permitted by section 280E to deduct any of its expenses. We disagree. Our analysis begins with the text of the statute, which we must apply in accordance with its ordinary, everyday usage. See Conn. Natl. Bank v. Germain, 503 U.S. 249, 253-254 (1992). We interpret that text with reference to its legislative history primarily to learn the purpose of the statute. See Commissioner v. Soliman, 506 U.S. 168, 174 (1993); United States v. Am. Trucking Associations, Inc., 310 U.S. 534, 543-544 (1940); Venture Funding, Ltd. v. Commissioner, 110 T.C. 236, 241-242 (1998), affd. without published opinion 198 F.3d 248 (6th Cir. 1999); Trans City Life Ins. Co. v. Commissioner, 106 T.C. 274, 299 (1996).

Congress enacted section 280E as a direct reaction to the outcome of a case in which this Court allowed a taxpayer to deduct expenses incurred in an illegal drug trade. See S. Rept. 97-494 (Vol. 1), at 309 (1982). In that case, Edmondson v. Commissioner, T.C. Memo. 1981-623, the Court found that the taxpayer was self-employed in a trade or business of selling amphetamines, cocaine, and marijuana. The Court allowed the taxpayer to deduct his business expenses because they "were made in connection with * * * [the taxpayer's] trade or business and

were both ordinary and necessary." Id. In discussing the case in the context of the then-current law, the Senate Finance Committee stated in its report:

> Ordinary and necessary trade or business expenses are generally deductible in computing taxable income. A recent U.S. Tax Court case allowed deductions for telephone, auto, and rental expense incurred in the illegal drug trade. In that case, the Internal Revenue Service challenged the amount of the taxpayer's deduction for cost of goods (illegal drugs) sold, but did not challenge the principle that such amounts were deductible.
>
> On public policy grounds, the Code makes certain otherwise ordinary and necessary expenses incurred in a trade or business nondeductible in computing taxable income. These nondeductible expenses include fines, illegal bribes and kickbacks, and certain other illegal payments. [S. Rept. 97-494 (Vol. 1), supra at 309.]

The report then expressed the following reasons the committee intended to change the law:

> 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. Such deductions must be disallowed on public policy grounds. [Id.]

The report explained that the enactment of section 280E has the following effect:

> 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. [Id.]

Section 280E and its legislative history express a congressional intent to disallow deductions attributable to a trade or business of trafficking in controlled substances. They do not express an intent to deny the deduction of all of a taxpayer's business expenses simply because the taxpayer was involved in trafficking in a controlled substance. We hold that section 280E does not preclude petitioner from deducting expenses attributable to a trade or business other than that of illegal trafficking in controlled substances simply because petitioner also is involved in the trafficking in a controlled substance.

Petitioner argues that its supplying of medical marijuana to its members was not "trafficking" within the meaning of section 280E. We disagree. We define and apply the gerund "trafficking" by reference to the verb "traffic", which as relevant herein denotes "to engage in commercial activity: buy and sell regularly". Webster's Third New International Dictionary 2423 (2002). Petitioner's supplying of medical marijuana to its members is within that definition in that petitioner regularly bought and sold the marijuana, such sales occurring when petitioner distributed the medical marijuana to its members in

exchange for part of their membership fees.[5] Accord United States v. Oakland Cannabis Buyers' Coop., supra at 489.

We now turn to analyze whether petitioner's furnishing of its caregiving services is a trade or business that is separate from its trade or business of providing medical marijuana. Taxpayers may be involved in more than one trade or business, see, e.g., Hoye v. Commissioner, T.C. Memo. 1990-57, 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, see Collins v. Commissioner, 34 T.C. 592 (1960); sec. 1.183-1(d)(1), Income Tax Regs. The Commissioner generally accepts a taxpayer's characterization of two or more undertakings as separate activities unless the characterization is artificial or unreasonable. See sec. 1.183-1(d)(1), Income Tax Regs.

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

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[5] In support of its position, petitioner relies upon Raich v. Ashcroft, 352 F.3d 1222, 1228 (9th Cir. 2003), vacated and remanded sub nom. Gonzales v. Raich, 545 U.S. 1 (2005), where the Court of Appeals for the Ninth Circuit reasoned that the use of medical marijuana is "different in kind from drug trafficking". Petitioner's reliance on that reasoning is mistaken. The U.S. Supreme Court rejected the reasoning in Gonzales v. Raich, supra at 26-28, 31-33, holding that the Controlled Substances Act applied to individuals within the purview of California's medical marijuana law.

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 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.

Respondent argues that the "evidence indicates that petitioner's principal purpose was to provide access to marijuana, that petitioner's principal activity was providing access to marijuana, and that the principal service that petitioner provided was access to marijuana * * * and that all of petitioner's activities were merely incidental to petitioner's activity of trafficking in marijuana." We disagree. Petitioner's executive director testified credibly and without contradiction that petitioner's primary purpose was to provide caregiving services for terminally ill patients. He stated:

"Right from the start we considered our primary function as being a community center for seriously ill patients in San Francisco. And only secondarily as a place where they could access their medicine." The evidence suggests that petitioner's operations were conducted with that primary function in mind, not with the principal purpose of providing marijuana to members.

As stated by the Board of Tax Appeals in Alverson v. Commissioner, 35 B.T.A. 482, 488 (1937): "The statute is not so restricted as to confine deductions to a single business or principal business of the taxpayer. A taxpayer may carry on more than one trade or business at the same time." Moreover, as the Supreme Court has observed in the context of illegal, nondeductible expenditures: "It has never been thought * * * that the mere fact that an expenditure bears a remote relation to an illegal act makes it non-deductible." Commissioner v. Heininger, 320 U.S. 467, 474 (1943).

Respondent relies heavily on his assertion that "Petitioner's only income was from marijuana-related matters, except for a couple of small donations". The record does not support that assertion, and we decline to find it as a fact. Indeed, the record leads us to make the contrary finding that petitioner's caregiving services generated income attributable to those services. In making this finding, we rely on the testimony of petitioner's executive director, whom we had an opportunity to

hear and view at trial. We found his testimony to be coherent and credible, as well as supported by the record. He testified that petitioner's members paid their membership fees as consideration for both caregiving services and medical marijuana, and respondent opted not to challenge the substance of that testimony. While a member may have acquired, in return for his or her payment of a membership fee, access to all of petitioner's goods and services without further charge and without explicit differentiation as to the portion of the fee that was paid for goods versus services, we do not believe that such a fact establishes that petitioner's operations were simply one trade or business. As the record reveals, and as we find as a fact, petitioner's management set the total amount of the membership fees as the amount that management consciously and reasonably judged equaled petitioner's costs of the caregiving services and the costs of the medical marijuana.

Given petitioner's separate trades or businesses, we are required to apportion its overall expenses accordingly. Respondent argues that "petitioner failed to justify any particular allocation and failed to present evidence as to how * * * [petitioner's expenses] should be allocated between marijuana trafficking and other activities." We disagree. Respondent concedes that many of petitioner's activities are legal and unrelated to petitioner's provision of medical

marijuana. The evidence at hand permits an allocation of expenses to those activities. Although the record may not lend itself to a perfect allocation with pinpoint accuracy, the record permits us with sufficient confidence to allocate petitioner'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. Accordingly, in a manner that is most consistent with petitioner's breakdown of the disputed expenses, we allocate to petitioner'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 petitioner's 25 employees did not work directly in petitioner's provision of medical marijuana), all expenses incurred in renting facilities at the church (petitioner did not use the church to any extent to provide medical marijuana), all expenses incurred for "truck and auto" and "laundry and cleaning" (those expenses did not relate to any extent to petitioner's provision of medical marijuana), and 9/10 of the remaining expenses (90 percent of the square footage of petitioner's main facility was not used in petitioner's provision of medical marijuana).[6] We disagree with

[6] While we apportion most of the $212,958 in "Total deductions" to petitioner's caregiving services, we note that the costs of petitioner's medical marijuana business included the $203,661 in labor and $43,783 in other costs respondent conceded

(continued...)

respondent that petitioner must further justify the allocation of its expenses, reluctant to substitute our judgment for the judgment of petitioner's management as to its understanding of the expenses that petitioner incurred as to each of its trades or businesses. Cf. Boyd Gaming Corp. v. Commissioner, 177 F.3d 1096 (9th Cir. 1999), revg. T.C. Memo. 1997-445.

All arguments by the parties have been considered. We have rejected those arguments not discussed herein as without merit. Accordingly,

Decision will be entered under Rule 155.

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[6](...continued)
to have been properly reported on petitioner's tax return as attributable to cost of goods sold in the medical marijuana business.

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FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

MARTIN OLIVE, *Petitioner-Appellant*, v. COMMISSIONER OF INTERNAL REVENUE, *Respondent-Appellee*.	No. 13-70510 Tax Ct. No. 14406-08 OPINION

Appeal from a Decision of the
United States Tax Court
Diane Kroupa, Tax Court Judge, Presiding

Argued and Submitted
April 16, 2015—San Francisco, California

Filed July 9, 2015

Before: Alex Kozinski and Susan P. Graber, Circuit Judges, and Dee V. Benson,[*] Senior District Judge.

Opinion by Judge Graber

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[*] The Honorable Dee V. Benson, Senior United States District Judge for the District of Utah, sitting by designation.

From the Desk of
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SUMMARY[**]

Tax

The panel affirmed the Tax Court's decision assessing deficiencies and penalties arising from taxpayer's operation of a medical marijuana dispensary in San Francisco.

The panel affirmed the Tax Court's conclusion that 26 U.S.C. § 280E precluded taxpayer from deducting any amount of ordinary or necessary business expenses associated with operation of the Vapor Room dispensary because it is a "trade or business . . . consist[ing] of trafficking in controlled substances . . . prohibited by Federal law."

COUNSEL

Henry G. Wykowski (argued), Henry G. Wykowski & Associates, San Francisco, California, for Petitioner-Appellant.

Kathryn Keneally, Assistant Attorney General, and Richard Farber (argued) and Patrick Urda, Attorneys, Tax Division, United States Department of Justice, Washington, D.C., for Respondent-Appellee.

[**] This summary constitutes no part of the opinion of the court. It has been prepared by court staff for the convenience of the reader.

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OPINION

GRABER, Circuit Judge:

Petitioner Martin Olive appeals the Tax Court's decision assessing deficiencies and penalties for tax years 2004 and 2005, which arise from Petitioner's operation of the Vapor Room Herbal Center ("Vapor Room"), a medical marijuana dispensary in San Francisco. The Tax Court held, among other things, that 26 U.S.C. (I.R.C.) § 280E precluded Petitioner from deducting any amount of ordinary or necessary business expenses associated with operation of the Vapor Room because the Vapor Room is a "trade or business . . . consist[ing] of trafficking in controlled substances . . . prohibited by Federal law." I.R.C. § 280E. Reviewing that legal conclusion de novo, *DHL Corp. v. Comm'r*, 285 F.3d 1210, 1216 (9th Cir. 2002), we agree and, therefore, affirm the Tax Court's decision.

Established in 2004, the Vapor Room provides its patrons a place where they can socialize, purchase medical marijuana, and consume it using the Vapor Room's vaporizers.[1] 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

[1] A "vaporizer" is an apparatus that extracts from marijuana its principal active component, tetrahydrocannabinol or "THC." Using a vaporizer allows the user to inhale vapor instead of smoke.

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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.

Each of the Vapor Room's staff members is permitted under California law to receive and consume medical marijuana. Petitioner purchases, for cash, the Vapor Room's inventory from licensed medical marijuana suppliers. Patrons who visit the Vapor Room can buy marijuana and use the vaporizers at no charge, or they can use the vaporizers (again, at no charge) with marijuana that they bought elsewhere. Sometimes, staff members or patrons sample Vapor Room inventory for free. When staff members interact with customers, occasionally one-on-one, they discuss illnesses; provide counseling on various personal, legal, or political matters related to medical marijuana; and educate patrons on how to use the vaporizers and consume medical marijuana responsibly. All these services are provided to patrons at no charge.

Petitioner filed business income tax returns for tax years 2004 and 2005, which reported the Vapor Room's net income during those years as $64,670 and $33,778, respectively. Although Petitioner reported $236,502 and $417,569 in Vapor Room business expenses for 2004 and 2005, the Tax Court concluded that § 280E of the Internal Revenue Code precluded Petitioner from deducting any of those expenses. Petitioner timely appeals.

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The Internal Revenue Code provides that, for the purpose of computing taxable income, an individual's or a business's "gross income" includes "all income from whatever source derived," including "income derived from business." I.R.C. § 61(a)(2). The Code further allows a business to deduct from its gross income "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on [the] trade or business." *Id.* § 162(a). But there are exceptions to § 162(a). *See, e.g.*, *id.* §§ 261–280H (listing "Items Not Deductible"). One such exception applies when the "amount paid or incurred during the taxable year" is for the purpose of "carrying on any trade or business . . . consist[ing] of trafficking in controlled substances." *Id.* § 280E. Although the use and sale of medical marijuana are legal under California state law, *see* Cal. Health & Safety Code § 11362.5, the use and sale of marijuana remain prohibited under federal law, *see* 21 U.S.C. § 812(c).

We turn first to the text of I.R.C. § 280E. *See Blue Lake Rancheria v. United States*, 653 F.3d 1112, 1115 (9th Cir. 2011) (holding that statutory interpretation begins with the statute's text). To determine whether Petitioner may deduct the expenses associated with the Vapor Room, then, we must decide whether the Vapor Room is a "trade or business [that] consists of trafficking in controlled substances . . . prohibited by Federal law." We start with the phrase "trade or business."

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.'" *United States v. Am. Bar Endowment*, 477 U.S. 105, 110 n.1 (1986) (quoting *Brannen v. Comm'r*, 722 F.2d 695, 704 (11th Cir. 1984)); *see also Vorsheck v. Comm'r*, 933 F.2d 757, 758

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(9th Cir. 1991) (per curiam) (applying the same standard to § 162(a) deductions). The parties agree, and the Tax Court found, that the *only* income-generating activity in which the Vapor Room engaged was its sale of medical marijuana. The other services that the Vapor Room offered—including, among other things, the provision of vaporizers, food and drink, yoga, games, movies, and counseling—were offered to its patrons at no cost to them. The only activity, then, that the Vapor Room "entered into with the dominant hope and intent of realizing a profit," *Am. Bar Endowment*, 477 U.S. at 110 n.1, was the sale of medical marijuana. Accordingly, Petitioner's "trade or business," for § 162(a) purposes, was limited to medical marijuana sales.

Given the limited scope of Petitioner's "trade or business," we conclude that the business "consist[ed] of trafficking in controlled substances . . . prohibited by Federal law." The income-generating activities in which the Vapor Room engaged consisted *solely* of trafficking in medical marijuana which, as noted, is prohibited under federal law. Under § 280E, then, the expenses that Petitioner incurred in the course of operating the Vapor Room cannot be deducted for federal tax purposes.

Petitioner's argument relies primarily on the phrase "consists of," rather than on the phrase "trade or business." According to Petitioner, the use of the words "consists of" is most appropriate "when a listing is meant to be exhaustive"; the word "consisting," he argues, is not synonymous with the word "including." Relying on that proposition, Petitioner contends that, for § 280E purposes, a business "consists of" a service only when that service is the *sole* service that the business provides. Because the Vapor Room provides caregiving services *and* sells medical marijuana, Petitioner

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concludes that his business does not "consist of" either one alone and therefore does not fall within the ambit of § 280E.

To support that line of reasoning, Petitioner cites the Tax Court's decision in *Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner* (*CHAMP*), 128 T.C. 173 (2007). His reliance on *CHAMP* is misplaced. In *CHAMP*, the petitioner's income-generating business included the provision not only of medical marijuana, but also of "extensive" counseling and caregiving services. *Id.* at 175. The Tax Court noted that the business's "primary purpose was to provide caregiving services to its members" and that its "secondary purpose was to provide its members with medical marijuana." *Id*. at 174. The court found, after considering the "degree of economic interrelationship between the two undertakings," that the petitioner was involved in "more than one trade or business." *Id.* at 183. That is not the case here. Petitioner does not provide counseling, caregiving, snacks, and so forth for a separate fee; the only "business" in which he engages is selling medical marijuana.

An analogy may help to illustrate the difference between the Vapor Room and the business at issue in *CHAMP*. 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

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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.

Petitioner's arguments related to congressional intent and public policy are similarly unavailing. He contends that I.R.C. § 280E should not be construed to apply to medical marijuana dispensaries because those dispensaries did not exist when Congress enacted § 280E. Congress added that provision, he maintains, to prevent street dealers from taking a deduction. According to Petitioner, Congress could not have intended for medical marijuana dispensaries, now legal in many states, to fall within the ambit of "items not deductible" under the Internal Revenue Code. We are not persuaded.

That Congress might not have imagined what some states would do in future years has no bearing on our analysis. It is common for statutes to apply to new situations. And here, application of the statute is clear. *See Chamber of Commerce of U.S. v. Whiting*, 131 S. Ct. 1968, 1980 (2011) (stating that "Congress's authoritative statement is the statutory text" (internal quotation marks omitted)). Application of the statute does not depend on the illegality of marijuana sales under state law; the only question Congress allows us to ask is whether marijuana is a controlled substance "prohibited by Federal law." I.R.C. § 280E. If Congress now thinks that the policy embodied in § 280E is unwise as applied to medical marijuana sold in conformance with state law, it can change the statute. We may not.

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Finally, for three reasons, we are not persuaded by Petitioner's argument that section 538 of the Consolidated and Further Continuing Appropriations Act, 2015, Pub. L. No. 113-235, 128 Stat. 2130, precludes the government from continuing to defend Petitioner's appeal. First, statements by a later Congress do not inform us about the intent of a previous Congress. *See Mackey v. Lanier Collection Agency & Serv., Inc.*, 486 U.S. 825, 840 (1988) ("The views of a subsequent Congress form a hazardous basis for inferring the intent of an earlier one." (internal quotation marks and brackets omitted)). Second, a decision not to expend funds to enforce a particular statute says nothing about the meaning of that statute. "What one house of Congress thinks, in the 2010s, about enforcement priorities for the agency is entirely uninformative about the intent of Congress when it enacted a statute in [an earlier year]." *Navarro v. Encino Motorcars, LLC*, 780 F.3d 1267, 1277 n.5 (9th Cir. 2015). Third, section 538 does not apply. It provides that certain funds may not be used to prevent states, such as California, "from implementing their own State laws that *authorize* the use, distribution, possession, or cultivation of medical marijuana." Pub. L. No. 113-235, § 538 (emphasis added). Here, the government is enforcing only a tax, which does not prevent people from using, distributing, possessing, or cultivating marijuana in California. Enforcing these laws might make it more costly to run a dispensary, but it does not change whether these activities are *authorized* in the state.

In summary, the Tax Court properly concluded that I.R.C. § 280E precludes Petitioner from deducting, pursuant to I.R.C. § 162(a), the ordinary and necessary business expenses

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associated with his operation of the Vapor Room. We therefore affirm the Tax Court's decision.

AFFIRMED.

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T.C. Memo. 2015-206

UNITED STATES TAX COURT

CANNA CARE, INC., A CALIFORNIA NOT-FOR-PROFIT CORPORATION, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 5678-12. Filed October 22, 2015.

William R. McPike, for petitioner.

Randall G. Durfee and Sarah E. Sexton Martinez, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

HAINES, Judge: Respondent determined deficiencies in petitioner's Federal income tax of $229,473, $304,090, and $339,604 for 2006, 2007, and 2008, respectively. The issue for decision is whether respondent properly

[*2] disallowed deductions for petitioner's operating expenses pursuant to section 280E.[1]

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. We incorporate herein by this reference the stipulation of facts filed on March 16, 2015, with attached exhibits.

When the petition was timely filed, petitioner's principal place of business was in Sacramento, California.[2]

In 1996 California voters approved the Compassionate Use Act of 1996 (CUA) to ensure that seriously ill Californians had the right to obtain and use marijuana for medical purposes. Cal. Health & Safety Code sec. 11362.5 (West

[1]Unless otherwise indicated, all section references are to the Internal Revenue Code, as amended and in effect for the years at issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

[2]This case was tried before Judge Diane L. Kroupa on February 24 and 25, 2014. On June 16, 2014, Judge Kroupa retired from the Court. The Court issued an order informing the parties of her retirement and proposing to reassign this case to another judicial officer for purposes of preparing the opinion and entering the decision based on the record of trial, or, alternatively, allowing the parties to request a new trial. Pursuant to petitioner's motion requesting a new trial, this case was submitted to Judge Robert P. Ruwe on August 18, 2014. On February 3, 2015, the Court issued an order submitting the case to Judge Harry A. Haines for disposition. On March 16 and 17, 2015, this case was tried again before Judge Haines.

[*3] 2007). In 2003 the Medical Marijuana Program Act was approved to promote uniform and consistent application of the CUA, clarify the scope of its application, and enhance patients' and caregivers' access to medical marijuana through collective, cooperative cultivation projects. Id. secs. 11362.7-11362.9 (West 2007). The Federal Controlled Substances Act (CSA), however, classifies marijuana as a schedule I controlled substance, and marijuana is a controlled substance within the meaning of section 280E. Californians Helping to Alleviate Med. Problems, Inc. v. Commissioner (CHAMP), 128 T.C. 173, 181 (2007); 21 C.F.R. sec. 1308.11(d)(22) (West 2007 & 2008).

Bryan and Lanette Davies are the parents of six children. Faced with financial hardship compounded by his children's mounting tuition expenses, Mr. Davies turned to his faith for a solution. After much prayer, Mr. Davies was convinced that God wanted him to open a medical marijuana dispensary to solve his family's financial woes.

Petitioner was incorporated under the laws of the State of California on July 5, 2005, and is in the business of distributing marijuana for medical purposes as permitted by California law. Petitioner is a mutual benefit corporation, and, pursuant to California law, is prohibited from distributing marijuana for profit. See Cal. Health & Safety Code sec. 11362.765 (West 2007). At the time of its

[*4] incorporation and for all years at issue, Mr. and Mrs. Davies and an acquaintance, Jeff Cowen, were petitioner's officers and directors.

In order to purchase medical marijuana from petitioner, an individual was required to produce a written recommendation from a physician which was verified by petitioner's receptionist. 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. Mr. Davies determined the price at which petitioner would sell marijuana, but the method he used to determine the price is unclear from the record.

During the years at issue petitioner occupied an approximately 2,250-square-foot space in a business park. The lobby area was open to the general public and had a table with medical marijuana pamphlets, legal information, and free bibles. After petitioner's receptionist verified their written physicians' recommendations, individuals were allowed to walk down a hallway into the locked sales area where marijuana was sold. The premises also had offices, storage rooms, restrooms, and a break room with a kitchen.

Mrs. Davies and Ryan Landers used two of the offices during the years at issue. Mr. Landers was a marijuana education activist. He and Mrs. Davies were involved in educating the public on the different uses of cannabis, organized

[*5] protests and rallies, and arranged for people to be present in court to show support in marijuana-related cases. During the years at issue Mrs. Davies testified at hearings before the California State Assembly and California State Senate on pending medical marijuana legislation. She also testified at multiple city council and board of county supervisor meetings, advocating opening access to medical marijuana. Americans for Safe Access, an organization that supports the medical use of marijuana, hosted meetings on petitioner's premises every other week during the years at issue. To accommodate larger meetings petitioner leased additional adjacent space in 2008 which became known as "Crusaders Hall". Petitioner funded Mrs. Davies' and Mr. Landers' marijuana activist activities.

Mr. Davies held a daily prayer at 6 p.m. on petitioner's premises. He, Mrs. Davies, and other employees, including ordained minister Terry Lee Allen, Sr., were willing to listen to, comfort, and pray with individuals who sought their counsel. During the years at issue no one associated with petitioner, including its employees, officers, and directors, was a trained healthcare or caregiving professional or had a substantial amount of experience in the healthcare industry.

At trial Mr. and Mrs. Davies emphasized petitioner's community involvement. Petitioner was involved with local cancer and diabetes walks, hosted community barbecues, and held a holiday toy drive. Petitioner's employees were

[*6] not required to participate in these activities. Some employees would occasionally volunteer to participate, and on other occasions employees would be paid to participate during work hours. Mr. Davies also testified that petitioner was a not-for-profit corporation, which to him meant that if there was money remaining after petitioner paid wages and taxes, made necessary purchases, and paid other expenses it would be given away. However, Mr. Davies said that petitioner was usually "in the red" and that the owners usually had to contribute additional money.

Petitioner had 10 employees in 2006 and 2007 and 6 employees in 2008. Mr. Davies determined salaries. During the years at issue the shareholders' salaries far exceeded the salaries paid to any other employees. Mr. Cowen was paid $88,700, $152,900, and $144,000 during 2006, 2007, and 2008, respectively. Mr. Davies was paid $79,200, $160,900, and $146,200 during 2006, 2007, and 2008, respectively. In addition to their salaries, petitioner made payments for its shareholders' automobiles in the amounts of $31,459, $24,609, and $23,942 during 2006, 2007, and 2008, respectively. Petitioner's manager, its highest paid nonshareholder employee, was paid $36,000, $55,600, and $52,000 in 2006, 2007, and 2008, respectively. Mrs. Davies was paid $27,000, $66,480, and $74,000 during 2006, 2007, and 2008, respectively. Petitioner's other employees made an

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[*7] average of $24,494.17, $12,173, and $12,314.29 during 2006, 2007, and 2008, respectively.

Petitioner filed timely tax returns for the years at issue, claiming deductions for various expenses which respondent disallowed pursuant to section 280E in a notice of deficiency mailed to petitioner on November 29, 2011.

OPINION

The sole issue in this case is whether respondent properly disallowed petitioner's deductions pursuant to section 280E. Petitioner bears the burden of proving that respondent's determination of the deficiencies set forth in the notice of deficiency is incorrect. See Rule 142(a)(1); Welch v. Helvering, 290 U.S. 111, 115 (1933).

Section 162 generally allows a taxpayer to deduct ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 280E, however, is an exception to the general rule of section 162. It provides that

> [n]o deduction * * * 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.

[*8] The application of section 280E rests on the presence of three key elements: (1) trade or business; (2) trafficking; and (3) a controlled substance. For ease of discussion, we will address these elements in reverse order.

I. Controlled Substance

Drug Enforcement Administration regulations list marijuana as a schedule I controlled substance for purposes of the CSA. 21 C.F.R. sec. 1308.11(d)(22). Petitioner stipulated that it was in the business of distributing marijuana and that marijuana was a controlled substance within the meaning of schedule I of the CSA, prohibited by Federal law, during the years at issue.

Petitioner advances numerous arguments as to why marijuana should no longer be considered a schedule I controlled substance. We reject these arguments. Marijuana was a schedule I controlled substance during the years at issue. As recently stated by the Court of Appeals for the Ninth Circuit, to which an appeal in this case would lie: "[T]he only question Congress allows us to ask is whether marijuana is a controlled substance 'prohibited by Federal law.' * * * If Congress now thinks that the policy embodied in § 280E is unwise as applied to medical marijuana sold in conformance with state law, it can change the statute. We may not." Olive v. Commissioner, 792 F.3d 1146, 1150 (9th Cir. 2015), aff'g 139 T.C. 19 (2012).

[*9] II. Trafficking

Petitioner argues that its actions cannot be considered "trafficking" for purposes of section 280E because its activities were not illegal under California law. Petitioner claims that this conclusion is supported by memoranda issued by the Department of Justice (DOJ) on October 19, 2009, and August 29, 2013, and guidance issued by the Financial Crimes Enforcement Network (FinCEN) on February 14, 2014.

We have previously held the sale of medical marijuana pursuant to California law constitutes trafficking within the meaning of section 280E. Olive v. Commissioner, 139 T.C. at 38 ("[A] California medical marijuana dispensary's dispensing of medical marijuana pursuant to the * * * [CUA] was 'trafficking' within the meaning of section 280E."); CHAMP, 128 T.C. at 182. DOJ memoranda and FinCEN guidance released after the years at issue that represent exercises of prosecutorial discretion do not change the result in this case. Petitioner regularly bought and sold marijuana. This activity constitutes trafficking within the meaning of section 280E even when permitted by State law. See CHAMP, 128 T.C. at 182.

[*10] III. Trade or Business

We find that petitioner engaged in the sale of marijuana. In CHAMP we held that the taxpayer's caregiving services and provision of medical marijuana were separate trades or businesses for purposes of section 280E and that the taxpayer could deduct the expenses attributable to its caregiving services. Id. at 173-174. Petitioner argues that the taxpayer in CHAMP was a single entity involved in two distinct activities which have been misconstrued as two separate businesses. Petitioner claims that the Tax Court erred in CHAMP in finding that the taxpayer's primary business was caregiving because an entity may not be a caregiver under California law. Petitioner asserts that the taxpayer in CHAMP was merely an entity doing charitable work.

Petitioner's interpretation of CHAMP is incorrect. In CHAMP the taxpayer operated a community center for members with debilitating diseases, including AIDS and cancer. Id. at 174. The taxpayer'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." Id. The services the taxpayer provided included: five support groups that met weekly or biweekly; daily lunches for low-income members; hygiene supplies; one-on-one consultations with counselors to discuss benefits, health, housing, safety, and legal issues;

[*11] biweekly masseuse services; social events on Fridays and Saturdays; monthly field trips; online access; encouraging members to participate in political activities; and instructing members on various topics. Id. at 175-176. Members paid the taxpayer a membership fee for the right to receive extensive services and medical marijuana. Id. at 176. The membership fee was an amount the taxpayer's management estimated to be about equal to the cost of providing the foregoing services and the cost of the fixed amount of medical marijuana the taxpayer supplied to each of its members. Id.

CHAMP did not involve a determination as to whether the taxpayer qualified as a "caregiver" for purposes of California law, but instead determined that the taxpayer was involved in two distinct trades or businesses for purposes of the application of section 280E. We determined that the taxpayer was involved in two separate businesses--providing services and providing medical marijuana to its members. The fact that we labeled the services the taxpayer provided as "caregiving" is insignificant. We could have called them "social services" or simply "services" and our conclusion would have remained the same.

The crucial determination in CHAMP was that the taxpayer was engaged in two separate trades or businesses, and this is what allowed the taxpayer to deduct a portion of its expenses. In order "to be engaged in a trade or business for purposes

[*12] of section 162, [a taxpayer] must be involved in the activity with continuity and regularity and the taxpayer's primary purpose for engaging in the activity must be for income or profit." Olive v. Commissioner, 139 T.C. at 41. The parties stipulated that petitioner was in the business of distributing medical marijuana. Aside from the sale of medical marijuana, petitioner's only other source of income was the sale of books, T-shirts, and other items. On the basis of the evidence presented, we cannot determine what percentage of petitioner's income was from the sale of medical marijuana and what percentage was from the sale of other items. Because of the parties' stipulation, we find that the sale of medical marijuana was petitioner's primary source of income and that the sale of any other item was an activity incident to its business of distributing medical marijuana. See id. We find that petitioner was engaged in one business--the business of selling medical marijuana.

California law prohibits the distribution of marijuana for profit, and it was emphasized at trial and on brief that petitioner was not operated for profit. See Cal. Health & Safety Code sec. 11362.765. Whether petitioner was operated in accordance with California law's restrictions on profiting from the distribution of marijuana is not an issue before us, and it does not affect our finding that petitioner was engaged in the business of distributing marijuana for purposes of

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[*13] section 280E. There is no doubt that Mr. Davies incorporated petitioner to produce income. In fact, it was clear from Mr. Davies' testimony that he entered into the medical marijuana business in order to cure his family's financial difficulties. Mr. Davies and the other shareholders received wages well in excess of those paid to petitioner's other employees, and the payment of such wages would not have been possible if petitioner had not had income.

On the basis of the foregoing, we find that petitioner was involved in the trade or business of trafficking in a controlled substance within the meaning of the CSA that was prohibited by law during the years at issue. We hold that section 280E prohibits petitioner from deducting any amounts paid or incurred during the years at issue in connection with its trade or business that respondent disallowed.

We have considered all remaining arguments the parties made, including those in petitioner's briefing, and, to the extent not addressed, we find them to be irrelevant, moot or meritless.

To reflect the foregoing,

Decision will be entered for respondent.

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151 T.C. No. 11

UNITED STATES TAX COURT

PATIENTS MUTUAL ASSISTANCE COLLECTIVE CORPORATION d.b.a. HARBORSIDE HEALTH CENTER, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 29212-11, 30851-12, 14776-14.[1]

Filed November 29, 2018.

California medical-marijuana dispensary P deducted I.R.C. section 162 business expenses and adjusted for indirect COGS per the I.R.C. section 263A UNICAP rules for producers. R determined that P's sole trade or business was trafficking in a controlled substance and that I.R.C. section 280E prevented it from deducting business expenses. R also determined that P had to calculate COGS using the I.R.C. section 471 regulations for resellers and was liable for accuracy-related penalties. P argued that I.R.C. section 280E didn't apply to it, that it was a producer, and that a dismissed civil-forfeiture action precluded a deficiency action.

[1] We consolidated the cases at docket numbers 29212-11, 30851-12, and 14776-14 for trial, briefing, and opinion.

Held: The Government's dismissal with prejudice of a civil-forfeiture action against P does not bar deficiency determinations.

Held, further, I.R.C. section 280E prevents P from deducting ordinary and necessary business expenses.

Held, further, during the years at issue P was engaged in only one trade or business, which was trafficking in a controlled substance.

Held, further, P must adjust for COGS according to the I.R.C. section 471 regulations for resellers.

Henry G. Wykowski and Matthew A. Williams, for petitioner.

Nicholas J. Singer and Julie Ann Fields, for respondent.

HOLMES, Judge: Patients Mutual owns what may well be the largest marijuana dispensary in America. To the Commissioner that just makes it a giant drug trafficker, unentitled to the usual deductions that legitimate businesses can claim, unable even to capitalize its indirect costs into its inventory, and subject to penalties for taking contrary positions on its tax returns for the tax years ending July 31, 2007 through 2012. Patients Mutual wants to be treated like any other business because it follows California law, it does more than distribute marijuana, and the federal government already decided not to pursue a civil-forfeiture action against it.

FINDINGS OF FACT

I. California Medical-Marijuana Law

Under federal law marijuana is a Schedule I controlled substance. See Controlled Substances Act, Pub. L. No. 91-513, sec. 202, 84 Stat. at 1249 (codified as amended at 21 U.S.C. sec. 812 (2012)). This means that under federal law the manufacture, distribution, dispensation, or possession of marijuana--even medical marijuana recommended by a physician--is prohibited. See id. sec. 841(a); Californians Helping to Alleviate Med. Problems, Inc. v. Commissioner (CHAMP), 128 T.C. 173, 181 (2007) (citing United States v. Oakland Cannabis Buyers' Coop., 532 U.S. 483 (2001)).

Under California law, things are somewhat different. In 1996 California voters adopted Proposition 215--the California Compassionate Use Act of 1996 (CCUA)--to "ensure that seriously ill Californians have the right to obtain and use marijuana for medical purposes." See Cal. Health & Safety Code sec. 11362.5(b)(1)(A) (West 2007). The CCUA provides an exemption from California laws penalizing the possession and cultivation of marijuana for patients and their primary caregivers when the possession or cultivation is for the patient's personal medical purposes and recommended or approved by a physician. Id. sec. 11362.5(d). California later legalized collective or cooperative cultivation of

marijuana for medicinal purposes. Id. sec. 11362.775; see also People v. Colvin, 137 Cal. Rptr. 3d 856, 860 (Ct. App. 2012). These laws led to the formation of the first marijuana dispensaries.[2]

II. DeAngelo and Harborside

Steve DeAngelo saw these early dispensaries--which he described as being run by either well-meaning marijuana activists with no business experience or "thug operators"--and realized patients needed a better option. So in 2005 DeAngelo cofounded Patients Mutual Assistance Collective Corporation d.b.a. Harborside Health Center (Harborside) to be the "gold standard" in medical-marijuana dispensaries. His goal was to create a place where marijuana could be distributed responsibly, that was focused on patient care, and that provided benefits to both patients and the community. Harborside opened its doors in October 2006 and has grown into a booming business with more than 100,000 patient visits per year. It also generated a gusher of revenue during the years at issue:

[2] On November 8, 2016, California voters adopted Proposition 64, which made recreational marijuana use legal under California law. See Cal. Health & Safety Code sec. 11362.1 (West 2017).

Year	Nonmarijuana sales revenue	Marijuana sales revenue	Total revenue	Marijuana percentage
2007	$487	$5,448,635	$5,449,122	99.99
2008	3,990	10,916,914	10,920,904	99.96
2009	16,878	17,334,597	17,351,475	99.90
2010	42,492	22,047,372	22,089,864	99.81
2011	58,588	20,895,823	20,954,411	99.72
2012	320,651	25,199,997	25,520,648	98.74
Total	443,086	101,843,338	102,286,424	99.57

At all relevant times Harborside operated out of an approximately 7,500-square-foot space that had a reception area, healing room, purchasing office, processing room, clone room, and multipurpose room. The facility also had a large sales floor, offices, storage areas, restrooms, and a break room with a kitchen.

But operating a dispensary is no small task. DeAngelo had to make sure Harborside complied with California and local laws. This included getting proper permits, running as a nonprofit, and operating under a "closed-loop" system. Harborside interpreted the "closed-loop" requirement to mean that all of its marijuana must be provided by its patients; sold exclusively to its patients; handled only by its employees, all of whom were its patients; and not diverted into the illegal market. How Harborside achieved all of this is important, so we will start with how Harborside sourced and processed its inventory.

A. Sourcing and Processing

Harborside sold a wide variety of products, which we will divide into four main groups--clones, marijuana flowers, marijuana-containing products, and non-marijuana-containing products.

1. Clones

Clones are cuttings from a female cannabis plant that can be transplanted and used to cultivate marijuana. Harborside bought clones from clone nurseries, cared for them while they were in its store, repackaged them, and then sold them to its patients. It stored the clones in a clone room and sold them at a clone counter--the portion of the floor space dedicated to clone sales. During the years at issue Harborside had at least four employees who spent their time entirely in the purchase and sale of clones.

2. Marijuana Flowers

The Court learned at trial that it's not the leaves of the marijuana plant, but its flowers--or buds--that people can smoke.[3] Harborside purchased all of its marijuana flowers from its patient-growers. Some of these growers promised to sell what they cultivated back to Harborside, and Harborside gave them either

[3] The Court suspects, but makes no finding, that this may be why repurposed beer-marketing material--"This Bud's for you"--seems to be common where marijuana is sold.

seeds or clones to get started. Other growers, however, bought seeds and clones from Harborside. However they acquired their starter supplies, growers who were interested in selling to Harborside had to sign a cultivation agreement and were encouraged to take one of Harborside's free grow classes and follow its best-practices guides.

Once a grower had cultivated, harvested, trimmed, flushed, dried, and cured his marijuana buds, he would bring them to Harborside to sell. Harborside had a purchasing office to inspect and test the incoming marijuana. Harborside would reject marijuana if it wasn't properly cured, if it hadn't been sufficiently trimmed, if it had an incurable safety issue such as pathogenic mold, or if it didn't contain the right "cannabinoid profile." If, for example, Harborside was in need of a strain of marijuana that was rich in CBD,[4] it might reject a batch of marijuana that was rich in THC.[5] There were times Harborside rejected the "vast majority" of the bud that growers brought in, and a grower whose marijuana was rejected got no compensation (though he was free to sell it to another collective if he could).

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[4] CBD is the abbreviation for cannabidiol, a potent antiinflammatory compound.

[5] THC stands for tetrahydrocannabinol, the compound in marijuana believed to be responsible for providing a euphoric effect, or "high", as users call it.

On the other hand, if Harborside agreed to buy the marijuana, it would negotiate a price with the grower--typically enough to cover the grower's actual growing expenses and a reasonable amount for his time and labor. It stored the marijuana in a vault--a reinforced concrete room with a bank-vault door and biometric locks--and sent a sample of the marijuana out for testing by a third-party laboratory. If all went well, the marijuana would go to a processing room where it was reinspected, remanicured, retrimmed, and then weighed, packaged, and labeled. Harborside staff would put it on display on the sales floor or put it back in the vault until needed. Harborside had at least three employees dedicated to acquiring inventory, at least four devoted to managing inventory, and still others whose sole job was to process the bulk marijuana and ready it for resale.

3. Marijuana-Containing Products

Harborside's marijuana-containing products included edibles, beverages, extracts, concentrates, oils, topicals, and tinctures--marijuana-infused alcohol, vinegar, or glycerin. Harborside bought these items from other collectives, tested them, repackaged them if they came in bulk or needed child-proof packaging, relabeled them, and then sold them to its own patients. Harborside's human-resources director credibly estimated that about 55% to 60% of its employees'

total time was spent on buying and processing marijuana--both the buds and marijuana-containing products--and another 25% to 30% selling it.

4. Non-Marijuana-Containing Products

Harborside also sold non-marijuana-containing products. These included branded gear such as shirts, hats, and pins; nonbranded gear such as socks and hemp bags; and a variety of other products including books, dabbing equipment,[6] rolling papers, and lighters. Harborside bought these items from outside vendors, stored them, and resold them to patients. Depending on the volume on hand, Harborside stored the non-marijuana-containing products on the sales floor and in one or more of its various storage rooms. A little less than 25% of the sales floor was used to display and sell these items and around 5% to 10% of Harborside's employees' time was dedicated to buying and selling these entirely legal products.

B. Sales and Pricing

Harborside took great care to avoid its marijuana's leaking into the black market. For example, no one could enter the sales floor without going through a "very rigorous identification process." This process required new patients to

[6] "Dabbing" means heating products that contain marijuana so as to create an intoxicating vapor. It may or may not have a connection to the strange fad among the young that seems to consist of pointing to the sky with one arm while putting one's face in the crook of the other arm while seeming to sneeze or sniff.

present valid photo IDs, have written recommendations from physicians licensed to practice in California, sign a collective cultivation agreement giving other Harborside patients the right to cultivate marijuana on their behalf, and agree to abide by Harborside's rules and regulations. Harborside also sold its marijuana at a premium above the black-market rate to discourage its patients from reselling it. The exact method used to determine the sale price is unclear from the record, but DeAngelo testified that Harborside looked "at [its] general overall picture and determined the margin that we needed to place on every bit of cannabis that came in."

C. Community Outreach

With premium prices, however, come significant profits. Harborside is a C corporation for federal tax purposes,[7] but to comply with California's nonprofit requirement,[8] its bylaws prohibited it from paying dividends or selling equity, and

[7] The IRS has determined that a marijuana dispensary generally cannot qualify as a tax-exempt organization under section 501(c)(3) because it is engaged in what federal law regards as a criminal enterprise and thus is not operated exclusively for charitable purposes. Rev. Rul. 75-384, 1975-2 C.B. 204; see also Priv. Ltr. Rul. 201224036 (June 15, 2012). (Unless we say otherwise, all section references are to the Internal Revenue Code in effect for the years at issue.)

[8] California laws decriminalizing medical marijuana specifically stated that they did not "authorize any individual or group to cultivate or distribute cannabis for profit." Cal. Health & Safety Code sec. 11362.765(a) (West 2007).

required it to use any excess revenue for the benefit of its patients or the community. To this end, Harborside provided its patients with a wide variety of services at no additional cost. It told patients during their orientation--and again with signs on the premises--that part of the purchase price of the marijuana would be used to pay for patient services and community outreach. But patients were not required to buy marijuana to use the services.

The services included one-on-one therapeutic sessions for reiki, hypnotherapy, naturopathy, acupuncture, and chiropractic consultations as well as group sessions for yoga, qigong, the Alexander technique, and tai chi. Harborside also offered grow classes, support groups, addiction treatment counseling, and a "sliding scale program" that gave discounts to patients with financial difficulties. All of the services were coordinated by Harborside's holistic-services director and took place in either Harborside's healing room or its multipurpose room. Harborside footed the bill and paid the service providers--all of whom were independent contractors. The total amounts paid were:

Year	Amount
2007	$30,290
2008	93,341
2009	119,884
2010	144,441
2011	141,926
2012	150,466

D. Administrative Functions

Harborside had other employees in support roles. The security department, for example, spent most of its time checking in both patients and vendors and then escorting vendors into the back of the building to meet with a purchasing manager. Harborside's human-resources director estimated that the security group spent 60% of its time checking in patients who came to buy marijuana, another 5% checking in people on site to receive a service, and the rest in assisting vendors. Harborside also had an administrative group, which included employees in its ombuds,[9] finance, human resources, and facilities departments as well as its executives.

[9] This is not a typo. It's Harborside's pun.

III. Forfeiture Action

All seemed well until July 2012, when the federal government filed a civil-forfeiture action in the U.S. District Court for the Northern District of California. The lawsuit alleged that the property which Harborside rents and on which it operates its business was subject to forfeiture because it was used to commit the distribution, cultivation, and possession of marijuana in violation of 21 U.S.C. sections 841(a)[10] and 856.[11] The action was dismissed with prejudice in May 2016 by stipulation of the parties.

IV. Tax Returns and Audit

The forfeiture action wasn't Harborside's only run-in with the federal government--it also caught the attention of the IRS. Recall that Harborside is a C corporation for federal tax purposes with tax years ending July 31. It filed Forms 1120, U.S. Corporation Income Tax Return, for 2007 to 2012 and later amended its 2007, 2008, and 2009 returns. These returns were selected for audits that led to

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[10] Title 21 U.S.C. section 841(a)(1) (2012) states that "it shall be unlawful for any person knowingly or intentionally * * * to manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense, a controlled substance."

[11] 21 U.S.C. section 856(a)(1) states that it shall be unlawful to "knowingly open, lease, rent, use, or maintain any place, whether permanently or temporarily, for the purpose of manufacturing, distributing, or using any controlled substance."

the issuance of three notices of deficiency--one for 2007 and 2008, one for 2009 and 2010, and one for 2011 and 2012. The notices denied most of Harborside's claimed deductions and costs of goods sold, and asserted tens of millions in deficiencies and accuracy-related penalties.

The IRS's primary reason for its adjustments was that "[n]o deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on a trade or business that consists of trafficking in controlled substances."

Harborside filed timely petitions for all years at issue. Its principal place of business was in California at all relevant times, so absent a stipulation by the parties these cases are appealable to the Ninth Circuit. See sec. 7482(b)(1)(B).

OPINION

I. Background

The CCUA did not decriminalize marijuana in California. See, e.g., People v. Harris, 52 Cal. Rptr. 3d 577, 582 (Ct. App. 2006) (marijuana remained a controlled substance under California law). It instead created an affirmative defense to charges of possessing or cultivating marijuana for persons who did so for personal, physician-approved use. Cal. Health & Safety Code sec. 11362.5(d);

People v. Wright, 146 P.3d 531, 533 (Cal. 2006). Primary caregivers of such persons could also raise the defense. Cal. Health & Safety Code sec. 11362.5(d).

In 2003 California enacted the Medical Marijuana Program Act (MMPA), also known as Senate Bill 420 and now codified at California Health and Safety Code sections 11362.7-11362.83. The MMPA extended the CCUA's affirmative defense to charges of transporting marijuana for patients and primary caregivers who "associate within the State of California in order collectively or cooperatively to cultivate marijuana for medical purposes."[12] Cal. Health & Safety Code sec. 11362.775; People v. Urziceanu, 33 Cal. Rptr. 3d 859, 883-84 (Ct. App. 2005). It also instructed California's attorney general to develop guidelines to "ensure the security and nondiversion of marijuana grown for medical use." Cal. Health & Safety Code sec. 11362.81(d). Those guidelines stated that medical-marijuana cooperatives should be formally organized, not operate for profit, maintain business licenses and permits, pay tax, verify each member's status as a patient, execute an agreement with each member regarding the use and distribution of

[12] The MMPA also set per-person quantity limits for harvested marijuana and marijuana plants, although the California Supreme Court invalidated these as impermissible amendments to the CCUA. People v. Kelley, 222 P.3d 186, 197-200, 213-14 (Cal. 2010). Patients and caregivers were thereafter allowed to possess, cultivate, or transport whatever amount of marijuana was "reasonably related to the patient's current medical needs." Id. at 188 (quoting People v. Trippet, 66 Cal. Rptr. 2d 559, 570 (Ct. App. 1997)).

marijuana, keep records of distribution, and neither buy marijuana from nor distribute marijuana to nonmembers. Qualified Patients Assoc. v. City of Anaheim, 115 Cal. Rptr. 3d 89, 97-98 (Ct. App. 2010); People v. Hochanadel, 98 Cal. Rptr. 3d 347, 356-58 (Ct. App. 2009); Cal. Att'y Gen., Guidelines for the Security and Non-Diversion of Marijuana Grown for Medical Use 8-10 (2008).

Federal law did not follow. The conflict between federal and state law went to the Supreme Court in 2005 when two California medical-marijuana users tried to enjoin the U.S. Attorney General and the Drug Enforcement Agency from enforcing federal marijuana law against them. See Gonzales v. Raich, 545 U.S. 1, 7 (2005). The Court upheld the federal prohibition on marijuana sale and possession with respect to medical-marijuana users, both under the Commerce Clause, U.S. Const. art. I, sec. 8, cl. 3, and the Supremacy Clause, U.S. Const. art. VI, cl. 2. Raich, 545 U.S. at 22, 29.

One might think the Supremacy Clause would have stifled the spread of state attempts at legalizing what remained illegal under federal law. But one would be wrong. And Congress complicated the situation by enacting a series of appropriations riders that prevent the Department of Justice (DOJ) from using any funds "to prevent * * * [States that permit medical-marijuana use] from implementing their own laws that authorize the use, distribution, possession, or

cultivation of medical marijuana." Consolidated Appropriations Act, 2017, Pub. L. No. 115-31, sec. 537, 131 Stat. at 228; see also Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, sec. 542, 129 Stat. at 2332-33 (2015); Consolidated and Further Continuing Appropriations Act, 2015, Pub. L. No. 113-235, sec. 538, 128 Stat. at 2217 (2014). When interpreting such a rider, the Ninth Circuit said that DOJ prosecutions of individuals who complied with state medical-marijuana laws interfered with the implementation of such laws and were therefore impermissible. United States v. McIntosh, 833 F.3d 1163, 1177-78 (9th

Cir. 2016).[13] So, medical marijuana is illegal under federal law, but the statutes criminalizing it may not be enforced--at least not by the DOJ.

But the IRS is part of the Department of the Treasury, and marijuana sellers must still contend with the Code. Here their major problem is section 280E, which prevents any trade or business that "consists of trafficking in controlled substances" from deducting any business expenses. Congress enacted this section in 1982 as a response to our decision in Edmondson v. Commissioner, T.C. Memo. 1981-623, where we allowed a cocaine dealer to deduct the ordinary and necessary expenses of his illicit trade. See S. Rept. No. 97-494, at 309 (1982), 1982

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[13] Note as well that these appropriations riders limit DOJ prosecutions of activity that would be legal under *medical*-marijuana laws. Thirty-three states now allow medical marijuana use: Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Florida, Hawaii, Illinois, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, Utah, Vermont, Washington, and West Virginia. Nat'l Conference of State Legislatures, State Medical Marijuana Laws, Tbl. 1 (last updated Nov. 8, 2018), http://www.ncsl.org/research/health/state-medical-marijuana-laws.aspx. So do the District of Columbia, Guam, and Puerto Rico. Id. Thirteen states permit medical use of some low-potency marijuana products: Alabama, Georgia, Iowa, Indiana, Kentucky, Mississippi, North Carolina, South Carolina, Tennessee, Texas, Virginia, Wisconsin, and Wyoming. Id. Tbl. 2.

Alaska, California, Colorado, Maine, Massachusetts, Michigan, Nevada, Oregon, Vermont, Washington, the District of Columbia, and the Northern Mariana Islands have repealed bans on recreational marijuana use. Id. Tbl. 1. No caselaw on how these appropriations riders will affect federal enforcement of federal law in these states has yet emerged.

U.S.C.C.A.N. 781, 1050. In 1986 new uniform capitalization (UNICAP) rules under section 263A raised the possibility that traffickers of controlled substances could capitalize indirect inventory costs that section 280E prevented them from deducting as expenses. See Tax Reform Act of 1986 (TRA), Pub. L. No. 99-514, sec. 803, 100 Stat. at 2350. But in 1988 Congress amended section 263A(a)(2) to say that taxpayers couldn't capitalize costs that were otherwise nondeductible. See Technical and Miscellaneous Revenue Act of 1988 (TAMRA), Pub. L. No. 100-647, sec. 1008(b)(1), 102 Stat. at 3437. It's within this confusing legal environment that Harborside operated.

Given this state of the law it's perhaps not surprising that Harborside isn't the first marijuana dispensary to appear in our Court. In our first major medical-marijuana case, we found that the taxpayer operated two separate trades or businesses--one that provided caregiving services and one that sold marijuana. CHAMP, 128 T.C. at 183-84. We therefore required the taxpayer to allocate its expenses between its two businesses according to the number of its employees and the portion of its facilities devoted to each. Id. at 185. We allowed it to deduct the expenses that it properly allocated to its caregiving business, but not those allocated to its marijuana-sales business. Id. at 173-74.

In our next medical-marijuana case, Olive v. Commissioner, 139 T.C. 19, 42 (2012), aff'd, 792 F.3d 1146 (9th Cir. 2015), we 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. Because that single trade or business was selling marijuana, we 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, id. at 32-36, 38 n.19. And in Canna Care, Inc. v. Commissioner, T.C. Memo. 2015-206, at *12, aff'd, 694 F. App'x 570 (9th Cir. 2017), we 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 nonmarijuana items such as books and socks "was an activity incident to its business of distributing medical marijuana." We therefore held that section 280E banned deductions for any of its business expenses. Id. at *13.

While Harborside raises some of the same issues we addressed in these cases, it also presents some new ones. Here we are asked to decide

- whether *res judicata* precludes the Commissioner from arguing Harborside was engaged in trafficking in a controlled substance;
- whether Harborside's business "consists of" trafficking in a controlled substance under section 280E;

- whether Harborside has more than one trade or business;
- what Harborside may include in its cost of goods sold; and
- whether Harborside is liable for accuracy-related penalties.

We will take each in turn.

II. Res Judicata

Harborside first argues that *res judicata* is a complete defense to its tax woes. Its position is that these cases and the 2012 civil-forfeiture action are all based on the same claim--that Harborside was trafficking in a controlled substance. It argues that the U.S. attorney's decision to dismiss the forfeiture action with prejudice means that as a matter of law Harborside was not a drug trafficker and cannot be subject to section 280E.

Res judicata--or claim preclusion--is an affirmative defense that bars suits on the same cause of action, and it does apply to tax litigation. See Russell v. Commissioner, 678 F.2d 782, 785-86 (9th Cir. 1982); Koprowski v. Commissioner, 138 T.C. 54, 59-60 (2012). The rule is easy to state:

> [W]hen a court of competent jurisdiction has entered a final judgment on the merits of a cause of action, the parties to the suit and their privies are thereafter bound "not only as to every matter which was offered and received to sustain or defeat the claim or demand, but as to any other admissible matter which might have been offered for that purpose."

Commissioner v. Sunnen, 333 U.S. 591, 597 (1948) (quoting Cromwell v. County of Sac, 94 U.S. 351, 352 (1876)). To successfully assert a *res judicata* claim, Harborside would have to clear these hurdles:

- an identity of claims between the actions;
- privity between the parties in the actions; and
- a final judgment on the merits in the civil-forfeiture action.

See Tahoe-Sierra Pres. Council, Inc. v. Tahoe Reg'l Planning Agency, 322 F.3d 1064, 1077 (9th Cir. 2003).

We think Harborside smashes right into the first. For there to be an identity of claims, two cases must "arise out of the same transactional nucleus of facts." Cent. Delta Water Agency v. United States, 306 F.3d 938, 952 (9th Cir. 2002) (quoting Fund for Animals v. Lujan, 962 F.2d 1391, 1398 (9th Cir. 1992)).[14] This almost always means that *res judicata* applies only when the second claim could have been asserted in the previous action. See Tahoe-Sierra Pres. Council, 322 F.3d at 1078; Sawyer Tr. of May 1992 v. Commissioner, 133 T.C. 60, 77-78

[14] Other questions that affect a decision about whether two claims share a single identity are whether: (1) "rights or interests established in the prior judgment would be destroyed or impaired by prosecution of the second action;" (2) "substantially the same evidence is presented in the two actions;" and (3) "the two suits involve infringement of the same right." Cent. Delta Water Agency, 306 F.3d at 952 n.11 (quoting Fund for Animals, 962 F.2d at 1398).

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(2009). Harborside's cases here are about its tax deficiencies, and the parties agree that the government could not have brought such actions as part of the civil-forfeiture case in district court.

Harborside insists, however, this doesn't matter and points to United States v. Liquidators of European Fed. Credit Bank, 630 F.3d 1139 (9th Cir. 2011). In Liquidators, the Ninth Circuit explained that in most cases the answer to the question of whether two cases share the "same transactional nucleus of facts" will be synonymous with the question of whether the contested claim in the second case could have been brought in the first. Id. at 1151. But it found an exception when it looked closely at forfeiture actions, and it held that *res judicata* barred a later criminal-forfeiture claim against the same property that had been the object of an earlier civil-forfeiture case. Id. at 1151-52. It reasoned that the two types of forfeiture actions always seek exactly the same result, arise from exactly the same facts, and offer the government two paths to reach the same goal. Id. at 1152 (which might have led one to think that the doctrine to apply was "election of remedy" rather than *res judicata*). But whether one looks at this puzzle as one of election of remedy or *res judicata* doesn't matter here. The forfeiture action in district court sought just that--the forfeiture of the property leased by Harborside--whereas these cases seek to impose a civil tax liability. And while the two actions

share some of the same facts, they are not--unlike civil and criminal forfeiture--different paths to the same goal. We will therefore decline to extend Liquidators beyond the "peculiarities of the forfeiture context." See United States v. Wanland, 830 F.3d 947, 957 (9th Cir. 2016). Instead we hold that these deficiency cases could not have been raised in the same case, and did not arise from the same transactional nucleus of fact. Identity of claims does not exist here and *res judicata* does not bar the Commissioner's deficiency actions. See Sawyer Tr., 133 T.C. at 78.

III. Section 280E

The Code allows a business to deduct all of its "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Sec. 162(a). But it also has exceptions, one of which is section 280E. See Olive, 792 F.3d at 1148 (noting that sections 261 through 280H list "Items Not Deductible"). Section 280E states:

> 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. [Emphasis added.]

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Medical marijuana is a Schedule I controlled substance, and dispensing it pursuant to the CCUA is "trafficking" within the meaning of section 280E. See CHAMP, 128 T.C. at 182-83; Beck v. Commissioner, T.C. Memo. 2015-149, at *15. But Harborside asks us to focus on the two words that we've italicized above: What does it mean for a business to *consist of* trafficking?

Harborside argues that "consists of" means an exhaustive list--or in other words that section 280E applies only to businesses that *exclusively* or *solely* traffic in controlled substances and not to those that also engage in other activities. The Commissioner argues that a single trade or business can have several activities and that section 280E applies to an entire trade or business if any one of its activities is trafficking in a controlled substance. Both parties say their interpretations match other Code sections' use of "consists of" and best fit section 280E's purpose.

We've seen Harborside's argument before. In Olive, 139 T.C. at 39, the taxpayer made a nearly identical argument, which we cursorily rejected.[15] And, on appeal, the Ninth Circuit focused on the taxpayer's misuse of CHAMP. See Olive, 792 F.3d at 1149-50. We could stop there with a nod to *stare decisis*, but the parties argue the question at great length and, given the importance of these cases

[15] We note that this part of Harborside's brief repeats verbatim part of the taxpayer's brief in Olive.

to the industry, we will similarly explain our reasoning at greater length than we did when we first considered it.

A. Statutory Interpretation

Harborside begins with an appeal to the "ordinary, everyday usage" of the phrase. And we do agree that Harborside is right about the meaning of "consists of" in everyday use: For example, one says "The AFC East *consists of* the Bills, Patriots, Jets, and Dolphins," and anyone fluent in English would understand that to mean that those are both all, and the only, teams in that division. Harborside also has some excellent secondary sources behind it on this point. See, e.g., Antonin Scalia & Bryan A. Garner, Reading Law: The Interpretation of Legal Texts 132 (2012) (contrasting "includes", which sets off a nonexhaustive list, with "consists of" or "comprises", each of which generally introduces an exhaustive list); Black's Law Dictionary 279 (5th ed. 1979) (explaining that "consisting" "is not synonymous with 'including'" because "including", when used in connection with a number of specified objects, always connotes incompleteness). This might seem as though it should be the end of our analysis--after all, "[t]he ordinary-meaning rule is the most fundamental semantic rule of interpretation." Scalia & Garner, supra, at 69.

Another fundamental canon of construction, however, tells us to prefer textually permissible readings that don't render a statute ineffective.[16] Id. at 63 (citing Citizens Bank of Bryan v. First State Bank, 580 S.W.2d 344, 348 (Tex. 1979) ("[I]f the language is susceptible of two constructions, one of which will carry out and the other defeat * * * [the statute's] object, it should receive the former construction.")). Following the most common usage of "consists of," as Harborside suggests, would indeed make section 280E ineffective. If that section denies deductions only to businesses that *exclusively* traffic in controlled substances, then any street-level drug dealer could circumvent it by selling a single item that wasn't a controlled substance--like a pack of gum, or even drug paraphernalia such as a hypodermic needle or a glass pipe. This reading would edge us close to absurdity, which is another result our reading of a statute should avoid if possible. See id. at 234-35.

One might imagine--as a strictly theoretical matter--that a legislature might enact an absurdity, and our job as judges would be to enforce it. But the Commissioner reminds us that we shouldn't do so if there is an effective-and-not-absurd meaning that is also permissible. We must both avoid "a sterile literalism

[16] When canons of construction compete with one another, we must decide which is most appropriate under the circumstances. See Antonin Scalia & Bryan A. Garner, Reading Law: The Interpretation of Legal Texts 59 (2012).

which loses sight of the forest for the trees" and maintain "a proper scruple against imputing meanings for which the words give no warrant." N.Y. Tr. Co. v. Commissioner, 68 F.2d 19, 20 (2d Cir. 1933) (L. Hand, J.), aff'd sub nom. Helvering v. N.Y. Tr. Co., 292 U.S. 455 (1934); see also Scalia & Garner, supra, at 356.

But can "consists of" ever introduce a nonexhaustive list?

1. Dictionaries

Harborside says "no", and urges us to take a hint from the fourth edition of the American Heritage Dictionary. Harborside quotes a usage note in the entry for "include". See American Heritage Dictionary 887 (4th ed. 2006). The note explains that "include" connotes, but does not necessarily mean, that a list immediately following it is incomplete. Id. It also suggests that authors introducing exhaustive lists use "comprise" or "consist of" instead. Id. It doesn't say, however, that "consists of" necessarily introduces an exhaustive list. See id. And the dictionary's definition of "consist" is "[t]o be made up of or composed," "[t]o have a basis; reside or lie," or "[t]o be compatible." Id. at 392.

Harborside's other dictionary citation is similarly ambiguous. An old edition of Black's Law Dictionary defines "consisting" as "[b]eing composed or

made up of." Black's Law Dictionary 279 (5th ed. 1979).[17] It also explains that "consisting" is not synonymous with "including" because "including" always connotes incompleteness, and "consisting" doesn't. Id. The entry doesn't say that "consisting" and "including" are antonyms; that is, although "consisting" doesn't connote an incomplete list, it also doesn't connote an exhaustive list. Id. And even if "consisting" were the antonym of "including", that would mean only that it *connotes* completeness--not that it necessarily *means* completeness. Harborside doesn't mention it, but the same dictionary also defines "consist" as "[t]o stand together, to be composed of or made up of." Id.

Harborside even points us to an odd opinion that cites a precursor of the Oxford English Dictionary[18] that says "'[c]onsisting of' can have the meaning of 'to have its essential character in' or 'foundation in.'" Madison Teachers, Inc. v. Madison Metro. Sch. Dist., 541 N.W.2d 786, 801 (Wis. Ct. App. 1995) (Sundby, J., concurring in part and dissenting in part) (citing IIC A New English Dictionary

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[17] The seventh, eighth, and ninth editions of Black's Law Dictionary don't define "consisting" at all. See Black's Law Dictionary 303 (7th ed. 1999); Black's Law Dictionary 327 (8th ed. 2004); Black's Law Dictionary 350 (9th ed. 2009). The tenth edition defines "consisting of," but only for the specialized purposes of patent law. Black's Law Dictionary 373 (10th ed. 2014).

[18] See OED, History of the OED, http://public.oed.com/history-of-the-oed/ (last visited Nov. 2, 2018).

on Historical Principles 861-62 (1893)).[19] The takeaway here is that none of the dictionary definitions that Harborside provides preclude reading "consists of" as setting off a nonexhaustive list.

2. The Code

But this is a tax case, and before we go too far afield in dictionaries or literature, we should draw back to other sections of the law we have to apply to these cases. See, e.g., United States v. Olympic Radio & Television, Inc., 349 U.S. 232, 236 (1955) (interpreting phrase consistently within Code chapter and saying courts should give Code "as great an internal symmetry and consistency as its words permit"). But see Util. Air Regulatory Grp. v. EPA, 573 U.S. ___, ___, 134 S. Ct. 2427, 2441 (2014) ("the presumption of consistent usage 'readily yields' to context" (quoting Environmental Defense v. Duke Energy Corp., 549 U.S. 561, 574 (2007))). What does the Code itself tell us about how to read "consists of"?

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[19] See, e.g.,William Shakespeare, The Merchant of Venice act 3, sc. 3 ("The duke cannot deny the course of law: / For the commodity that strangers have / With us in Venice, if it be denied, / Will much impeach the justice of his state; / Since that the trade and profit of the city / Consisteth of all nations" -- Venice being open to foreign trade, or depending on foreign trade, but not literally trading with every nation in the world.)

There are some similar phrases. Section 401(a)(22) says that if more than 10% of the assets in an employee's defined-contribution plan account are stock in his closely held employer, section 409(e)'s voting-rights rules don't apply so long as "the trade or business of such employer consists of publishing on a regular basis a newspaper for general circulation." Section 451(i)(3)(B) provides an optional rule for determining in what year income is realized for "any stock or partnership interest in a corporation or partnership * * * whose principal trade or business consists of providing electric transmission services." And section 513(h)(1)(B) excludes from the definition of unrelated trade or business "any trade or business which consists of" exchanging or renting donor and member lists among nonprofits. We haven't found any cases construing what "consists of" means in any of these sections.

Harborside points out that in many Code sections Congress used the phrase "consists of" but then modified it--as it did in the electricity-related section above --to clarify that it doesn't mean "is composed entirely of." See, e.g., sec. 581 ("a substantial part of the business of which consists of"); sec. 181(e)(2)(E) (added by the Consolidated Appropriations Act, 2016, sec. 169(c), 129 Stat. at 3067 ("includes or consists of")). Harborside suggests that Congress could have similarly modified "consists of" in section 280E if it had intended to set off a

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nonexhaustive list there. The Commissioner, on the other hand, points to several Code sections where Congress used the phrase "consists of" but then modified it to clarify that it meant "is composed entirely of." See, e.g., sec. 444(d)(3)(B) ("consists only of"); sec. 416(g)(4)(H) ("consists solely of"). He suggests that Congress would have done the same for section 280E if it had meant to indicate an exhaustive list there.

Unmodified uses of "consists of" do sometimes seem to introduce exhaustive lists. See, e.g., sec. 108(e)(4)(B) ("family of an individual consists of the individual's spouse, the individual's children, grandchildren, and parents, and any spouse of the individual's children or grandchildren"). But in other places "consists of" would lead to an absurd result if it indicated an exhaustive list. The Commissioner points us to a glaring example: A "computer" eligible for accelerated depreciation "*consists of* a central processing unit containing extensive storage, logic, arithmetic, and control capabilities." Sec. 168(i)(2)(B)(ii)(II) (emphasis added). Here, Harborside's reading of "consists of" would mean that anything other than a central processing unit isn't a computer. Surely something wouldn't fail to be a computer because it had a monitor, a keyboard, a mouse, or a power cord. See Dunford v. Commissioner, T.C. Memo. 2013-189, at *30-*31 (referring to a laptop as a "computer" when determining depreciation eligibility).

These examples show, we think, that the Code uses "consists of" in more than one way. It sometimes sets off an exhaustive list, but it also sometimes introduces a nonexclusive list.

3. Caselaw

That leaves us with caselaw. Each party has precedent here, too. Harborside's chief example is one from Wisconsin which held that a statute preventing "a collective bargaining unit consisting of school district professional employees" from arbitrating certain issues didn't preclude arbitration by a unit that mainly had such employees but also had some other types of employees. Madison Teachers, Inc., 541 N.W.2d at 790-91, 793-94. That court said that a "decent respect for language makes it impossible to read 'consisting of' in the inclusive sense." Id. at 794. But it also explained that none of the 482 occurrences of the phrase "consisting of" in Wisconsin's statutes introduced nonexhaustive lists, and it pointed out that the Wisconsin legislature was careful to modify that phrase whenever it meant to use it inclusively. Id. Apparently Wisconsin's code enjoys a consistency missing from the Internal Revenue Code, which as we've seen uses "consists of" multiple ways. It's therefore hard for us--despite what we hope is our decent respect for language--to do as Harborside asks and interpret the phrase as mechanically as the Wisconsin Court of Appeals has.

The Commissioner, for his part, points us to a case that dealt with a section of the Code itself--a statute excluding for tax purposes from a tax-exempt organization's unrelated trade or business "any trade or business which consists of conducting bingo games." Julius M. Israel Lodge of B'nai B'rith No. 2113 v. Commissioner, T.C. Memo. 1995-439, 1995 WL 544877, at *3, aff'd, 98 F.3d 190 (5th Cir. 1996); see also sec. 513(f). But that case holds that "instant bingo" isn't "bingo" for section 513(f); it doesn't explicitly address what it means to "consist[] of conducting bingo games." See Julius M. Israel Lodge, 1995 WL 544877, at *7 (although it implicitly suggests the same entity can have two businesses in that situation, much as we did in CHAMP). It's therefore of limited use here. Caselaw doesn't settle the meaning of "consists of" any better than the Code itself does.

Dictionaries, the Code, and caselaw all show that "consists of" can introduce either an exhaustive list or a nonexhaustive list.[20] A nonexhaustive list

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[20] The Code is in good company. Shakespeare appears to use "consists of" both ways in a single exchange:

> Sir Toby Belch: * * * Does not our life consist of the four elements?
>
> Sir Andrew Aguecheek: Faith, so they say; but I think it rather consists of eating and drinking.
>
> Sir Toby Belch: Thou'rt a scholar; let us therefore eat and drink.

(continued...)

is the only option that doesn't render section 280E ineffective and absurd. We therefore read section 280E to deny business-expense deductions to any trade or business that involves trafficking in controlled substances, even if that trade or business also engages in other activities.

B. Purpose

We also note that Harborside has a subtler argument about the play between literal meaning and statutory purpose. It reminds us that dispensaries that are legal under state law didn't exist in 1982 and Congress even today won't let the DOJ prosecute them as if they were street-corner drug dealers. See Consolidated Appropriations Act, 2017 sec. 537; Consolidated Appropriations Act, 2016 sec. 542; Consolidated and Further Continuing Appropriations Act, 2015 sec. 538; see also McIntosh, 833 F.3d at 1177. These arguments aren't new, either--the Ninth Circuit disposed of them in Olive, 792 F.3d at 1150-51, so we mostly reiterate its reasoning here to acknowledge that Harborside has preserved it.

Although section 280E predates states' legalization of medical marijuana, "[t]hat Congress might not have imagined what some states would do in future years has no bearing on our analysis. It is common for statutes to apply to new

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[20](...continued)
William Shakespeare, Twelfth Night act 2, sc. 3. The four elements are an exhaustive list, but eating and drinking aren't all of life, even for Sir Andrew.

situations. And here, application of the statute is clear." Id. at 1150. The restriction on how the DOJ uses funds is irrelevant here because "the government is enforcing only a tax, which does not prevent people from using, distributing, possessing, or cultivating marijuana in California. Enforcing these laws might make it more costly to run a dispensary, but it does not change whether these activities are *authorized* in the state." Id. at 1150.

Finally, we note that several members of Congress asked the IRS to issue guidance saying that medical-marijuana dispensaries aren't subject to section 280E, and the IRS said it couldn't do that unless Congress amended the Code or the Controlled Substances Act. See IRS Information Letter 2011-0005. Members of Congress have subsequently introduced several bills that would exempt state-legal marijuana businesses from section 280E. Small Business Tax Equity Act of 2011, H.R. 1985, 112th Cong. (2011); Small Business Tax Equity Act of 2013, H.R. 2240, 113th Cong. (2013); Small Business Tax Equity Act of 2015, H.R. 1855, 114th Cong. (2015); Small Business Tax Equity Act of 2015, S. 987, 114th Cong. (2015); Small Business Tax Equity Act of 2017, H.R. 1810, 115th Cong. (2017); Small Business Tax Equity Act of 2017, S. 777, 115th Cong. (2017); Responsibly Addressing the Marijuana Policy Gap Act of 2017, H.R. 1824, 115th

Cong. (2017); Responsibly Addressing the Marijuana Policy Gap Act of 2017, S. 780, 115th Cong. (2017). None has been enacted.

We hold that section 280E prevents Harborside from deducting its business expenses.

IV. More Than One Trade or Business?

Harborside says that even if section 280E applies to its marijuana sales, it can still deduct its expenses for any separate, nontrafficking trades or businesses. That's correct. See CHAMP, 128 T.C. at 184-85; see also Olive, 792 F.3d at 1149. We therefore need to determine which--if any--of Harborside's activities are separate trades or businesses.

An activity is a trade or business if the taxpayer does it continuously and regularly with the intent of making a profit. See, e.g., Commissioner v. Groetzinger, 480 U.S. 23, 35 (1987); United States v. Am. Bar Endowment, 477 U.S. 105, 110 n.1 (1986). A single taxpayer can have more than one trade or business, CHAMP, 128 T.C. at 183, or multiple activities that nevertheless are only a single trade or business, see, e.g., Davis v. Commissioner, 29 T.C. 878, 891 (1958). 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. Morton v. United States, 98 Fed. Cl. 596, 600 (2011).

Whether two activities are two trades or businesses or only one is a question of fact. See, e.g., CHAMP, 128 T.C. at 183; Owens v. Commissioner, T.C. Memo. 2017-157, at *21. To answer it, we primarily consider the "degree of organizational and economic interrelationship of various undertakings, the business purpose which is (or might be) served by carrying on the various undertakings separately or together * * *, and the similarity of the various undertakings." Olive, 139 T.C. at 41; sec. 1.183-1(d), Income Tax Regs.

We've considered this issue with other California medical-marijuana dispensaries. In CHAMP, 128 T.C. at 175, 183, we found that the taxpayer had two distinct trades or businesses--caregiving services and medical-marijuana sales--even though its customers paid a single fee that entitled them to unlimited access to the services and a fixed amount of marijuana. We noted there that seven of the taxpayer's employees distributed marijuana, eighteen employees provided caregiving services, and no employees did both. Id. at 185. Moreover, dispensing marijuana occurred in only 10% of one of the taxpayer's three facilities. Id. at 176. We found the taxpayer's primary purpose was to provide caregiving services, and that those services were both "substantially different" from and "stood on * * * [their] own, separate and apart" from dispensing marijuana. Id. at 183.

In Olive, however, we held (and the Ninth Circuit agreed) that a taxpayer who sold medical marijuana and provided complimentary services--including movies, board games, yoga classes, massages, snacks, personal counseling, and advice on how to best consume marijuana--had a single trade or business. Olive, 139 T.C. at 38-42; Olive, 792 F.3d at 1148-50. The taxpayer in Olive charged only for marijuana, and set a price based on the amount and type of marijuana its patients bought; the cost of the other services was bundled into that price. Olive, 139 T.C. at 42; 792 F.3d at 1149. The same employees who sold marijuana also provided the services, and the taxpayer paid no additional wages, rent, or other significant costs connected exclusively with those services. Olive, 139 T.C. at 41. The taxpayer also had a single bookkeeper and accountant. Id. at 42. These facts led us to find that the services were "incident to" the sale of marijuana, and we noted that the two activities had a "close and inseparable organizational and economic relationship." Id. at 41. We held that they were "one and the same business." Id.

The most recent case where we had to figure out the number of a marijuana dispensary's trades or businesses is Canna Care, Inc. Like Harborside, the taxpayer there sold medical marijuana and other items, including books, T-shirts, and hats. Canna Care, Inc., at *4, *12. Unlike the taxpayer in Olive, the taxpayer

in Canna Care, Inc. had at least a little bit of income from nonmarijuana sales. Id. at *12. But we still found only a single trade or business--selling marijuana--and "the sale of any other item was an activity incident to" those sales. Id. But our analysis there was constrained: The parties had stipulated that the taxpayer "was in the business of distributing medical marijuana" and the record didn't enable us to determine what percentage of the taxpayer's income came from marijuana sales and what percentage came from other sources. See id.; see also Alterman v. Commissioner, T.C. Memo. 2018-83, at *27-*28 (refusing to allow business-expense deductions where the taxpayers failed to identify specific payments, provide record citations, or propose findings of fact sufficient for us to distinguish expenses associated with the sale of marijuana from those associated with the sale of nonmarijuana merchandise).

Harborside presented its case in greater detail. It argues that it had four activities, each of which was a separate trade or business:

- sales of marijuana and products containing marijuana;
- sales of products with no marijuana;
- therapeutic services; and
- brand development.

We consider each.

A. Selling Marijuana and Products Containing Marijuana

There's no question that selling marijuana and products containing marijuana was Harborside's primary purpose. Sixty percent of the members Harborside's security checked in were there to buy marijuana in one form or another. Marijuana and marijuana products took up around 75% of Harborside's sales floor. Harborside's employees spent 80-90% of their time purchasing, processing, and selling these products. And those sales generated at least 98.7% of Harborside's revenue during each of the years at issue. This was certainly a trade or business--specifically, the trade or business of trafficking in a controlled substance. See Olive, 139 T.C. at 38; CHAMP, 128 T.C. at 182-83.

B. Selling Products That Didn't Contain Marijuana

Harborside's sale of items that didn't contain marijuana--such as branded clothing, hemp bags, books about marijuana, and marijuana paraphernalia such as rolling papers, pipes, and lighters--generated the remaining 0.5% of its revenue. The same Harborside employees who bought, processed, and sold marijuana also sold these items, but selling them took up only 5-10% of their time. The nonmarijuana items occupied only 25% of the sales floor where Harborside sold marijuana, and that sales floor was accessible only to patrons who had already presented their credentials to security--which means that no one who couldn't buy

marijuana could buy these nonmarijuana items. And the record shows no separate entity, management, books, or capital for the nonmarijuana sales. This leads us to find that the sale of non-marijuana-containing products had a "close and inseparable organizational and economic relationship" with, and was "incident to," Harborside's primary business of selling marijuana. See Olive, 139 T.C. at 41; see also Tobin v. Commissioner, T.C. Memo. 1999-328, 1999 WL 773964, at *5-*6 (farm and garden one activity because same employees, equipment, management, and books). There's also an obvious business purpose for selling items that facilitate and encourage marijuana use alongside actual marijuana. We also find that the sale of items that are about marijuana, are branded with Harborside's logo, or enable use of marijuana is not "substantially different" from the sale of marijuana itself. See CHAMP, 128 T.C. at 183.

Harborside nevertheless argues that its sale of anything other than marijuana is a separate trade or business. It cites an analogy the Ninth Circuit used in Olive, 792 F.3d at 1150, to explain why a store that charged for marijuana and gave away incidental services had only a single trade or business. In that analogy, a hypothetical bookstore that sold books and gave away coffee to attract customers ("Bookstore A") had only one trade or business, whereas a hypothetical bookstore

that sold books and also sold coffee ("Bookstore B") had two trades or businesses. Id.

We think Harborside misses the analogy's point: It shows that a service a taxpayer doesn't charge for, but which attracts customers, isn't a separate trade or business. It doesn't mean that selling two things is necessarily two separate trades or businesses. Bookstore B is there to provide contrast to Bookstore A, which is what the court compared to the taxpayer in Olive. Id.

Finally, the analogy--though a good fit for Olive, which was selling marijuana and giving away snacks and soft drinks--doesn't suit Harborside. A better analogy would be to a bookstore that derives 0.5% of its revenue from selling stationery, bookmarks, and T-shirts with pictures of books on them ("Bookstore C"). To be completely analogous to Harborside, Bookstore C would sell these items using the same employees, sales floor, management, ledgers, and business entity it used to sell books. That hypothetical bookstore would, we think, be a single trade or business under the Ninth Circuit's reasoning. And Harborside's sale of non-marijuana-containing items is, we find, not a separate trade or business.

C. Therapeutic Services

Recognizing that an activity needs a profit motive to be a separate trade or business, Harborside argues that a portion of each marijuana sale was actually a purchase of its free holistic services.[21] This is what it told its patrons, too.

Harborside says this makes it like CHAMP. But in CHAMP, 128 T.C. at 175-76, members paid a set fee for unlimited access to extensive services and also received a fixed amount of marijuana--the services' price wasn't "bundled" into the amount paid for marijuana, to use Harborside's terminology. And we found that the services in CHAMP were the taxpayer's primary purpose, took up most of its employees' time, and used almost all of its three facilities. Id. at 174-76, 183, 185.

Harborside is more like the dispensary in Olive, 792 F.3d at 1148, where patrons paid according to the amount and type of marijuana they wanted and in return gained access to incidental services. Harborside tries to distinguish itself by pointing out that it offered many more services than the much smaller taxpayer in Olive did.[22] But the services were still incidental; Harborside's security spent only

[21] Harborside argues that "the price for these services was rolled into the price of the cannabis."

[22] In Olive, 792 F.3d at 1148, the taxpayer's combined reported income and
(continued...)

5% of its time checking in people for the services, while spending 60% of its time checking in people who were there to buy marijuana. And independent contractors, rather than Harborside's own employees, provided those services. During the years at issue Harborside paid those contractors a total of only about $680,000--less than 1% of its sales revenue from marijuana.

The relationship between Harborside's marijuana business and holistic services closely fits Olive's "Bookstore A" analogy. See id. at 1150. Just as a bookstore that gives away coffee is still only a bookstore, a marijuana dispensary that gives away services is still only a marijuana dispensary. See id. The fact that Harborside used a tiny bit of its marijuana-sales revenue to pay for those services doesn't change anything--after all, Bookstore A necessarily pays for its coffee with book sales. And we also find that there were business reasons to offer these services alongside marijuana sales: It justified premium pricing and helped Harborside meet the community-benefit standards California law required. We therefore find that Harborside's holistic services were not a separate trade or business.

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[22](...continued)
claimed expenses for each year we considered were under $500,000. In contrast, Harborside had $5 million-$25 million in total revenue during each of the years at issue.

D. Branding

Harborside's final argument on this subject is that its brand-development activity was a separate trade or business. Because this did not generate any revenue until after the years at issue, the Commissioner compares it to preoperational expenditures that have to be capitalized instead of deducted. Harborside insists it is a trade or business eligible for section 162 deductions because from day 1 it performed them with an independent profit motive. To show a profit motive without any revenue, Harborside says its branding activities were part of a "unified business enterprise" with its activities that did make money during the years at issue.

A separate entity purposely operating at a loss is still a trade or business eligible for deductions if it and entities related to it together form a unified business enterprise that itself has a profit motive. See Campbell v. Commissioner, 868 F.2d 833, 836-37 (6th Cir. 1989) (partnership leasing airplane to sister corporation at loss had profit motive because common owners benefited), aff'g in part, rev'g in part T.C. Memo. 1986-569; Kuhn v. Commissioner, T.C. Memo. 1992-460, 1992 WL 193604, at *5 (partnership's below-market lease of land to sister corporation had profit motive because corporation benefited); Morton, 98 Fed. Cl. at 602 (S corporation that owned airplane was part of unified business

enterprise with shareholder's other businesses and therefore had a profit motive). In other words, the unified-business-enterprise doctrine Harborside relies on says that separate but related entities can share a single profit motive; it doesn't say that a single entity's unprofitable activities are a separate trade or business. Rather than show that Harborside's branding was separate from its marijuana sales, the unified-business-enterprise doctrine instead suggests that it was part of a single overall trade or business.

There's also no actual evidence to suggest that Harborside's brand development was in any way a separate trade or business. As far as we can tell, Harborside did its branding using the same entity, management, capital structure, employees, and facilities as its marijuana sales. See Tobin, 1999 WL 773964, at *5-*6. And rather than being "substantially different" from the underlying sale of marijuana, Harborside's brand development was necessarily entwined with it. See CHAMP, 128 T.C. at 183. Harborside's branding, therefore, had a "close and inseparable organizational and economic relationship" with, and was "one and the same business" as, its marijuana sales. See Olive, 139 T.C. at 41. It was not a separate trade or business.

Harborside dedicated the lion's share of its resources to selling marijuana and marijuana products. Those sales accounted for over 99.5% of its revenue. Its

other activities were neither economically separate nor substantially different. We therefore hold that Harborside had a single trade or business--the sale of marijuana. That's trafficking in a controlled substance under federal law, so Harborside cannot deduct any of its related expenses. See sec. 280E; see also Olive, 139 T.C. at 38; CHAMP, 128 T.C. at 182-83.

V. Cost of Goods Sold

The fact that Harborside can't deduct any of its business expenses doesn't mean it owes tax on its gross receipts. All taxpayers--even drug traffickers--pay tax only on gross income, which is gross receipts minus the cost of goods sold (COGS). See, e.g., New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934); CHAMP, 128 T.C. at 178 n.4; secs. 1.61-3(a), 1.162-1(a), Income Tax Regs. Congress understood that when it enacted section 280E. See S. Rept. No. 97-494, supra at 309, 1982 U.S.C.C.A.N. at 1050. We've understood it ourselves. See Olive, 139 T.C. at 32-36.

But what is the distinction between a business-expense deduction and an adjustment for COGS? Deductions are subtractions from gross income that taxpayers make when they calculate their taxable income. Sec. 63(a). Deductions are statutory, and Congress can grant or deny them as it chooses--the standard refrain is that they're a matter of Congress's "legislative grace." INDOPCO, Inc.

v. Commissioner, 503 U.S. 79, 84 (1992); New Colonial Ice Co., 292 U.S. at 440; Olive, 139 T.C. at 32. We've already seen an example of Congress's withholding that grace from those whose works it rejects--it grants most taxpayers a deduction for ordinary and necessary business expenses in section 162, but then uses section 280E to deny those deductions to drug traffickers. See Canna Care, Inc., at *7.

COGS is the costs of acquiring inventory, through either purchase or production. See, e.g., Reading v. Commissioner, 70 T.C. 730, 733 (1978) (COGS is "expenditures necessary to acquire, construct or extract a physical product which is to be sold"), aff'd, 614 F.2d 159 (8th Cir. 1980); secs. 1.61-3(a), 1.162-1(a), Income Tax Regs. As we've said, all taxpayers, regardless of the business they're in, use COGS to offset their gross receipts when they calculate gross income. See, e.g., Olive, 139 T.C. at 20 n.2.

The big difference between deductions and COGS adjustments is timing. See INDOPCO, 503 U.S. at 83-84; Wasco Real Props. I, LLC v. Commissioner, T.C. Memo. 2016-224, at *19. Taxpayers can usually claim at least part of a deductible expense for the year they incur it. See, e.g., INDOPCO, 503 U.S. at 83-84; Wasco Real Properties I, LLC, at *19. But when accounting for COGS they have to capitalize an item's cost in the year of acquisition or production and either amortize it or wait until the year the item's sold to make the corresponding

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adjustment to gross income.[23] See, e.g., INDOPCO, 503 U.S. at 83-84; Wasco Real Props. I, LLC, at *19.

A. How Should Harborside Account for its COGS?

The Code tells taxpayers what to include in COGS. See, e.g., secs. 263, 263A, 471. But there's more than one set of rules, and the issue here is which set applies to Harborside. The Commissioner thinks Harborside needs to follow the rules under section 471, but Harborside insists it's subject to the rules of section 263A. We consider each.

1. Section 471

Section 471 was in place when Congress enacted section 280E. It empowers the Commissioner to write regulations that govern how taxpayers account for inventories. See sec. 471. This the Commissioner did--with separate regulations for resellers and producers. See secs. 1.471-3(b) and (c), 1.471-11, Income Tax Regs.

[23] A simple example illustrates the difference. If in year 1 a taxpayer incurs a deductible expense of $100, he can reduce his taxable income for year 1 by $100. If in year 1 he instead buys 100 units of inventory for $100 and manages to sell 10 of those units per year, he has to take a $10 COGS adjustment in year 1, a $10 adjustment in year 2, and so on, through year 10, when he runs out of inventory. In each case, the taxpayer reduces the amount of income he's taxed on by a total of $100. The difference is that he recovers the entire deductible expense in year 1, but recovers his inventory cost as he sells the inventory, which in this example means he doesn't get the full $100 back until year 10.

The regulations tell resellers to use as their COGS the price they pay for inventory plus any "transportation or other necessary charges incurred in acquiring possession of the goods." Sec. 1.471-3(b), Income Tax Regs. The regulations for producers are more complex. Producers must include in COGS both the direct and indirect costs of creating their inventory. See secs. 1.471-3(c), 1.471-11, Income Tax Regs. The regulations tell producers to capitalize the "cost of raw materials," "expenditures for direct labor," and "indirect production costs incident to and necessary for the production of the particular article, including * * * an appropriate portion of management expenses." Sec. 1.471-3(c), Income Tax Regs. Direct and indirect production costs are further explained in section 1.471-11(b), Income Tax Regs.

In their current forms, section 471 and its regulations also direct taxpayers to section 263A for additional rules.

2. Section 263A

Congress enacted section 263A in 1986. TRA sec. 803. That section instructs both producers and resellers to include "indirect" inventory costs in their COGS. Sec. 263A(a)(2)(B), (b); sec. 1.263A-1(a)(3), (c)(1), (e), Income Tax Regs. It also broadens the definition of indirect costs for both types of taxpayers. Compare sec. 1.263A-1(e)(3), Income Tax Regs., with sec. 1.471-11, Income Tax

Regs. Congress thought this would treat taxpayers more fairly. S. Rept. No. 99-313, at 140 (1986), 1986-3 C.B. (Vol. 3) 1, 140. It also thought this would do a better job of matching COGS adjustments to the years in which taxpayers realized the related income. Id.; see also Office of the Sec'y, Dep't of the Treasury, 1 Tax Reform for Fairness, Simplicity, and Economic Growth: Treasury Department Report to the President 126-28 (1984).

These sections are also about timing. A business that could immediately deduct indirect costs under section 471 now has to treat those costs as capital expenditures and wait until it realizes related income to adjust for them. In a sense Congress is taking away some current deductions but allowing them in later years, renamed COGS. It is legislative grace deferred, but not denied.

Most business don't like this. They'd rather have a deduction now than increased COGS later. See, e.g., Frontier Custom Builders, Inc. v. Commissioner, T.C. Memo. 2013-231, at *14 (homebuilder argued it was a seller, not a producer, in attempt to avoid capitalization), aff'd, 626 F. App'x 89 (5th Cir. 2015). But drug traffickers have a different attitude. Although section 280E prevents them from deducting expenses, they are still entitled to COGS adjustments. Olive, 139 T.C. at 32-36. By renaming COGS what had been deductions, Congress made it possible for traffickers to adjust for expenses that they couldn't previously claim.

They have to make those adjustments in the later year when the inventory is sold, but later is better than never.

Except that maybe it's still never. In 1988 Congress amended section 263A(a)(2), adding flush language that says: "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." TAMRA sec. 1008(b)(1). The regulations show that "cost" here means expenses that would otherwise be deductible. See sec. 1.263A-1(c)(2), Income Tax Regs. In their explanation of how section 263A(a)(2)'s flush language works, the regulations point out that if a business meal is entirely attributable to the acquisition or production of inventory, the taxpayer capitalizes only 80% of it because section 274(n), at that time, limited business meal deductions to 80% of their "cost" (which the section itself calls an "expense", see sec. 274(n)); the taxpayer doesn't get to capitalize the whole meal and escape the 80% limitation on the deduction, sec. 1.263A-1(c)(2)(i), Income Tax Regs. So if something wasn't deductible before Congress enacted section 263A, taxpayers cannot use that section to capitalize it. Section 263A makes taxpayers defer the benefit of what used to be deductions--it doesn't shower that as grace on those previously damned.

3. Harborside's Argument

Can Congress get away with this? Harborside argues that limiting its COGS to "only the actual cost used to purchase inventory" violates the Sixteenth Amendment. Its theory is that section 263A represents the most accurate tax-accounting method for calculating COGS and that not letting marijuana dispensaries use it forces them to pay tax on more than their gross income. In other words, Harborside thinks section 263A somehow defines COGS for constitutional purposes.

That's wrong. The Sixteenth Amendment's meaning didn't change when Congress enacted section 263A. See U.S. Const. art. V (providing only method for changing constitution). Section 471 wasn't found unconstitutional during the many decades when it was the only means of calculating COGS, and it wouldn't be unconstitutional now if Congress repealed section 263A. The Constitution does limit Congress to taxing only gross income, and courts have consistently held--including in cases Harborside cites--that gross income is gross receipts minus *direct* costs. See Reading, 70 T.C. at 733 (COGS are direct investment in item sold); Pittsburgh Milk Co. v. Commissioner, 26 T.C. 707, 715 (1956) (gross income on sales is income for Sixteenth Amendment); Anderson Oldsmobile, Inc. v. Hofferbert, 102 F. Supp. 902, 905 (D. Md. 1952) (IRS can tax only amount

realized on sale minus basis), aff'd, 197 F.2d 504 (4th Cir. 1952). Harborside, like all taxpayers, can still adjust for its direct costs--or, to use its terminology, "the actual cost used to purchase inventory." It therefore pays tax only on the amount it realizes on sales, which is what the Constitution requires.

Harborside compares itself to the taxpayer in Anderson Oldsmobile, but that case doesn't help it. There the taxpayer paid more for its inventory than since-repealed federal price controls allowed, and the Commissioner tried to limit the taxpayer's COGS to the highest legal price. Id. at 903. The court held that because Congress can tax only gross income, the taxpayer was entitled to a COGS adjustment for the actual amount it paid for its inventory even though that amount was illegally high. Id. at 903, 905, 909.

As Harborside correctly points out, Anderson Oldsmobile says that statutes can't let the Commissioner tax more than gross income. Id. at 905. But that's not what's happening here. Unlike Anderson Oldsmobile, where the Commissioner wanted to use a statute to deny the taxpayer a COGS adjustment for part of its direct cost of purchasing inventory, these cases find the Commissioner saying only that Harborside can't use section 263A to capitalize indirect costs that it wouldn't otherwise be able to deduct. Harborside still gets to do exactly what the taxpayer

in Anderson Oldsmobile did: calculate its gross income by subtracting the direct cost of its inventory from its gross receipts. See id. at 905.

What Anderson Oldsmobile really holds is that taxpayers can adjust for COGS whether or not their direct costs are legal. See id. at 903; see also Pittsburgh Milk Co., 26 T.C. at 717 (taxpayer who sold milk below legal price used actual price when calculating income). This tells us what we already know: Harborside would get COGS adjustments for its direct inventory costs no matter what--even if it was trafficking cocaine or any other controlled substance not legal under California law. The only things Harborside doesn't get are indirect inventory costs granted as deductions and then deferred under section 263A.

The section 263A capitalization rules don't apply to drug traffickers. Unlike most businesses, drug traffickers can't capitalize indirect expenses beyond what's listed in the section 471 regulations. Section 263A expressly prohibits capitalizing expenses that wouldn't otherwise be deductible, and drug traffickers don't get deductions. Because federal law labels Harborside a drug trafficker, it must calculate its COGS according to section 471.

B. Is Harborside a Producer or a Reseller?

Because the section 471 regulations have different rules for resellers and producers, how Harborside calculates its COGS depends on which type of

taxpayer it is. Harborside was without question a reseller of the marijuana edibles and non-marijuana-containing products it bought from third parties and sold at its facility. But the situation is more complex for the marijuana bud it sold. Harborside insists it produced this marijuana and can include in its COGS the indirect inventory costs that section 1.471-3(c), Income Tax Regs., describes. The Commissioner says Harborside is a reseller and, under section 1.471-3(b), Income Tax Regs., it can include only its inventory price and transportation costs.

1. What Does "Produce" Mean?

To sort this out we first need to know what "produce" means. The Commissioner, citing a Court of Claims case, says that under section 471 "production" means "manufacturing". See Heaven Hill Distilleries, Inc. v. United States, 476 F.2d 1327, 1335 (Ct. Cl. 1973). He then cites a line of cases saying that "manufacturing" requires a change to the essential character of the merchandise. Marcor, Inc. v. Commissioner, 89 T.C. 181, 193 (1987); see also Anheuser-Busch Brewing Ass'n v. United States, 207 U.S. 556, 562 (1908); In re I. Rheinstrom & Sons Co., 207 F. 119 (E.D. Ky. 1913), aff'd sub nom. Cent. Tr. Co. v. George Lueders & Co., 221 F. 829 (6th Cir. 1915); People ex rel. New England Dressed Meat & Wool Co. v. Roberts, 155 N.Y. 408, 412 (1898); People v. Knickerbocker Ice Co., 1 N.E. 669 (N.Y. 1885). His argument, then, is that

"production" means "change". Look at the dates of most of these cases, though--they predate the Sixteenth Amendment.

Harborside at least points us to something more recent, the Ninth Circuit case, Suzy's Zoo v. Commissioner, 273 F.3d 875 (9th Cir. 2001), aff'g 114 T.C. 1 (2000). That case, however, isn't about section 471. It's about section 263A(g)(1)'s definition of "produce"--which says that term "includes construct, build, install, manufacture, develop, or improve"--and section 1.263A-2(a)(1)(i), Income Tax Regs., which says that "produce includes the following: construct, build, install, manufacture, develop, improve, create, raise, or *grow*." Suzy's Zoo, 273 F.3d at 878 (emphasis added).

Although Suzy's Zoo is about section 263A, it's useful for construing section 471's regulations which, like section 263A's regulations, provide different methods of accounting for inventory that's "purchased" or "produced" but don't define those terms. See sec. 1.471-3(b) and (c), Income Tax Regs. We think "produce" should mean the same thing in section 471 as it does in section 263A. We also think we should follow the Ninth Circuit's reasoning in a case appealable to that court. See Golsen, 54 T.C. at 757.

In Suzy's Zoo, the taxpayer, a greeting-card company, designed images and sent them to a contract printer who did color separations, made proofs, and printed

them using its own materials. A trucking company then picked up the prints and took them to a finisher. The finisher cut and folded the prints into greeting cards and returned them to the taxpayer. The printer and the finisher each bore the risk of loss while they had the materials. Suzy's Zoo, 273 F.3d at 877.

We held--and the Ninth Circuit affirmed--that the taxpayer was a "producer" because it retained title to the items throughout the contract-production process. Id. at 877, 880. Citing regulations under section 263A, the court said: "The only requirement for being a 'producer' * * * is that the taxpayer be 'considered an owner of the property produced,'" that "ownership is 'based on all of the facts and circumstances,'" and that "[a] taxpayer may be considered an owner of property produced, even though the taxpayer does not have legal title to the property." Id. at 880 (citing section 1.263A-2(a)(1)(ii)(A), Income Tax Regs.). A taxpayer can be a "producer", moreover, even if it uses contract manufacturers to do the actual production. Id. at 878 (citing section 263A(g)(2)). The Ninth Circuit explained that achieving section 263A's purpose of treating all taxpayers fairly required a broad construction of "produce". Id. at 879; see also Von-Lusk v. Commissioner, 104 T.C. 207, 215 (1995); S. Rept. No. 99-313, supra at 140, 1986-3 C.B. (Vol. 3) at 140. We've said this before ourselves, not coincidentally in a case holding that

"production" for section 263A doesn't require a physical change. See Von-Lusk, 104 T.C. at 217.

"Produce" is therefore broader than "manufacture". That's also evident from the Code and regulations. We saw that already in section 263A(g)(1) and section 1.263A-2(a)(1)(i), Income Tax Regs. See supra pp. 58-59. The section 471 regulations also show that "production" and "manufacturing" are distinct, if related, concepts. Section 1.471-11, Income Tax Regs., discusses "production" costs, but refers in several places to costs "incident to and necessary for production or manufacturing," a construction implying that the two terms are not identical, even if they are closely related and receive identical tax treatment.[24] For purposes of section 471, production turns on ownership--ownership as determined by facts and circumstances, not formal title.

2. Did Harborside Own What Its Growers Grew?

In finding that Suzy's Zoo was a producer, the Ninth Circuit emphasized the "degree of control * * * [the taxpayer] exercise[d] over the manufacturing

[24] The heading of section 1.471-11, Income Tax Regs., is "Inventories of Manufacturers," but this doesn't change our analysis of its text. Statutory titles and headings are useful when interpreting ambiguous words or phrases, but "they cannot undo or limit that which the text makes plain." Bhd. of R.R. Trainmen v. Baltimore & Ohio R.R. Co., 331 U.S. 519, 528-29 (1947); see also Dixon v. Commissioner, 132 T.C. 55, 81 (2009).

process." Suzy's Zoo, 273 F.3d at 880. Harborside says it also exercised a high degree of control over the growers it purchased marijuana from. It points out that it bought marijuana only from its members, and even then only if the members used Harborside's clones (which they either bought or received for free), took Harborside's growing class, followed Harborside's best practices, and met Harborside's quality-control standards.

But there was more to Suzy's Zoo. There the taxpayer acquired ownership when it first designed the characters because that was the most important step and the one that required the most skill and expertise. Suzy's Zoo, 114 T.C. at 8. Suzy's Zoo's contractors couldn't sell, copy, or use those characters without breaching Suzy's Zoo's license. Id. Suzy's Zoo retained the "exclusive right to sell the finished product," id. at 9, and it accepted all the finished products it ordered, see Suzy's Zoo, 273 F.3d at 877.

Harborside, unlike Suzy's Zoo, see id.; Suzy's Zoo, 114 T.C. at 8-10, didn't create the clones, maintain tight control over them, order specific quantities, prevent sales to third parties, or take possession of everything produced. Harborside bought clones from nurseries and either sold them to growers with no strings attached or gave clones to growers expecting that they'd sell bud back to Harborside. Nothing prevented either type of grower from selling to another

collective, and DeAngelo thought it would be futile to try to use the courts to stop them.[25] Harborside had complete discretion over whether to purchase what bud growers brought in, paid growers only if it purchased their bud, and at times rejected the "vast majority" of its growers' bud. And Harborside thought growers could do whatever they wanted with the rejected bud.

This was not the type of contract-manufacturing arrangement we saw in Suzy's Zoo, 273 F.3d at 877, where a designer hired others to make its products but owned those products at all stages of their creation. Harborside 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. Harborside 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.[26]

This leaves only the issue of whether Harborside owes accuracy-related penalties under section 6662(a). We will address this issue in a separate opinion.

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[25] DeAngelo said he never sued anyone for breach of contract because "the possibility o[f] prevailing on contract disputes in something that involves a controlled substance is slim and would be expensive."

[26] Harborside did have a "processing room." See supra p. 8. But the "processing" that went on there--reinspection, packaging, and labeling--fall within the category of "purchasing, handling, and storage" that resellers do without losing their character as resellers. See sec. 1.263A-3(c), Income Tax Regs.

From the Desk of
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T.C. Memo. 2018-208

UNITED STATES TAX COURT

PATIENTS MUTUAL ASSISTANCE COLLECTIVE CORPORATION d.b.a. HARBORSIDE HEALTH CENTER, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 29212-11, 30851-12, 14776-14.[1]

Filed December 20, 2018.

Henry G. Wykowski and Christopher A. Wood, for petitioner.

Nicholas J. Singer and Julie Ann Fields, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

HOLMES, Judge: In Patients Mutual Assistance Collective Corp. v. Commissioner (Patients Mutual I), 151 T.C. ___ (Nov. 29, 2018), we concluded

[1] We consolidated docket numbers 29212-11, 30851-12, and 14776-14 for trial, briefing, and opinion. This opinion addresses only Harborside's liability for penalties.

[*2] that section 280E[2] required the disallowance of deductions for Harborside Health Center's (Harborside) ordinary and necessary business expenses and that section 263A(a)(2) precluded Harborside's capitalizing those expenses. Patients Mutual I left undecided the more contentious question of whether Harborside is liable for accuracy-related penalties under section 6662(a).

OPINION

We begin with the law. Section 6662(a) and (b)(1) and (2) imposes a 20% penalty on the portion of an underpayment attributable to any substantial understatement of income tax or negligence or disregard of rules or regulations. Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Code, and disregard includes any careless, reckless, or intentional disregard. Sec. 6662(c). An understatement of a corporation's income tax is substantial if it exceeds the lesser of $10 million or "10 percent of the tax required to be shown on the return for the taxable year (or, if greater, $10,000)." Sec. 6662(d)(1)(B).

Harborside can avoid these penalties by showing that it acted with reasonable cause and in good faith. Sec. 6664(c)(1); sec. 1.6664-4(a), Income Tax

[2] Unless we say otherwise, all section references are to the Internal Revenue Code in effect for the years at issue and all Rule references are to the Tax Court Rules of Practice and Procedure.

[*3] Regs. To decide whether a taxpayer acted with reasonable cause and in good faith, we look at all relevant facts and circumstances, such as the "taxpayer's effort to assess the taxpayer's proper tax liability" and his "experience, knowledge, and education." Sec. 1.6664-4(b)(1), Income Tax Regs.

FINDINGS OF FACT

And that brings us to the contention here: What do the facts show?

The key facts for the remaining penalty issue are that Harborside is a C corporation for federal tax purposes and has a tax year ending July 31. It filed Forms 1120, U.S. Corporation Income Tax Return, for 2007 to 2012 and later amended its 2007 and 2008 returns. These returns led to three notices of deficiency--one for 2007 and 2008, one for 2009 and 2010, and one for 2011 and 2012.

Although the Commissioner asserted the accuracy-related penalties for both negligence and substantial understatement in the notices of deficiency, by the time he filed his pretrial memorandum he was relying only on Harborside's substantial understatements. And we agree with him that he has met his burden of production for the penalties, because in Patients Mutual I we found an understatement (which does not exceed $10 million for any year) that was well over 10% of the tax required to be shown and over $10,000 for each of the six years at issue.

[*4] Harborside argues, however, that it showed that its return positions were reasonable and taken in good faith. It specifically argues that they were reasonable because from 2007 until 2012 the only relevant case was Californians Helping to Alleviate Med. Problems, Inc. v. Commissioner (CHAMP), 128 T.C. 173, 181 (2007), where we did hold that medical-marijuana dispensaries were "trafficking" under section 280E, but allowed a dispensary to deduct its non-drug-trafficking-related expenses. CHAMP was the first of our marijuana-dispensary cases, and the Commissioner conceded any penalty. CHAMP, 128 T.C. at 173, 185-86.

In CHAMP, however, we did not analyze the main argument that Harborside relied on in Patients Mutual I--that the phrase "consists of" in section 280E must mean something like "consists entirely of." And there the caselaw sat until 2012, when we issued Olive. Olive v. Commissioner, 139 T.C. 19, 36-42 (2012), aff'd, 792 F.3d 1146 (9th Cir. 2015), disallowed deductions only after highlighting major factual differences with CHAMP; allowed estimated COGS adjustments under the Cohan rule, see Cohan v. Commissioner, 39 F.2d 540, 543-44 (2d Cir. 1930); and was on appeal until 2015. In Olive we did discuss the meaning of the phrase "consists of" in section 280E, but treated it rather summarily, presumably because the taxpayer's *only* revenue was from marijuana

[*5] sales. Olive, 139 T.C. at 22, 42. In these cases, Harborside elaborated on the argument very considerably--and almost persuasively--in what we find was a reasonable hope for a more elaborate judicial analysis of that position for a business with some, albeit comparatively tiny, revenue from nonmarijuana sales.

In any event, Olive did not become final and unappealable until years after Harborside filed the last of the returns at issue in these cases. And Harborside also points out that, apart from CHAMP and Olive, there was very limited guidance available to marijuana dispensaries. Harborside correctly points out that the IRS has never promulgated regulations for section 280E and didn't issue any guidance on marijuana businesses' capitalization of inventory costs until 2015. See Chief Counsel Advice 201504011 (Jan. 23, 2015).

This leads us to the conclusion that Harborside'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 Patients Mutual I, the meaning of "consists of" as used in section 280E is subject to more than one reasonable interpretation. See Patients Mutual 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.

[*6] As to Harborside's good faith: We released Olive shortly after Harborside's 2012 tax year ended, and Harborside began allocating a percentage of its operating expenses to a "non-deductible" category starting that year and did not even wait for Olive to be affirmed on appeal. And although Harborside wasn't primarily a caregiver like the taxpayer in CHAMP, its non-drug-trafficking activities were less negligible than those in Olive, putting it factually somewhere between those cases.

It is true that we did sustain a portion of the accuracy-related penalty in Olive, but that was because the taxpayer had not kept good books and records. 139 T.C. at 44. We carefully observed that "[t]he application of section 280E to the expenses of a medical marijuana dispensary had not yet been decided when petitioner filed his Federal income tax returns for 2004 and 2005. The accuracy-related penalty does not apply, therefore, to the portion of each underpayment that would not have resulted had petitioner been allowed to deduct his substantiated expenses." Id. 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.

[*7] 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. After trying the case and looking at the records and testimony that Harborside presented, we find no bad faith in its taking the reporting positions that it did.

We've previously declined to impose accuracy-related penalties when there was no clear authority to guide taxpayers. See Petersen v. Commissioner, 148 T.C. 463, 481 (2017); Williams v. Commissioner, 123 T.C. 144, 153 (2004); see also Foster v. Commissioner, 756 F.2d 1430, 1439 (9th Cir. 1985), aff'g in part, vacating in part 80 T.C. 34 (1983). We will do so again here.

We therefore find that Harborside acted with reasonable cause and in good faith when taking its tax positions for the years at issue. Harborside isn't liable for penalties.

Decisions will be entered under Rule 155.

From the Desk of
Stuart Levine
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151 T.C. No. 13

UNITED STATES TAX COURT

ALTERNATIVE HEALTH CARE ADVOCATES, ET AL.,[1] Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 16123-14, 30186-14, 8813-15, 8850-15, 8852-15, 12321-15.

Filed December 20, 2018.

In these consolidated cases C, a corporation, operates a medical marijuana dispensary in California. Other Ps were individual shareholders of S, an S corporation that was organized to handle daily operations for C including paying employee wages and salaries. C deducted I.R.C. sec. 162 business expenses and later adjusted COGS to include indirect expenses per I.R.C. sec. 263A. R determined that both C's and S's sole trade or business was trafficking in a controlled substance and that I.R.C. sec. 280E precluded C's and S's deducting business expenses. In light of that determination, R further

[1] Cases of the following petitioners are consolidated herewith: Donald Duncan a.k.a. Don D. Duncan a.k.a. Don Duncan, docket No. 30186-14; Jeremy S. Kwit, docket Nos. 8813-15 and 12321-15; and Grant Rozmarin, docket Nos. 8850-15 and 8852-15.

determined that Ps had underreported their flowthrough income from S. R also determined that C is not entitled to COGS in an amount greater than what R already allowed and that C is liable for I.R.C. sec. 6662(a) accuracy-related penalties.

Held: I.R.C. sec. 280E precludes C from deducting I.R.C. sec. 162 business expenses.

Held, further, I.R.C. sec. 280E precludes S from deducting I.R.C. sec. 162 business expenses.

Held, further, Ps underreported their flowthrough income from S.

Held, further, C is not entitled to a COGS greater than what respondent has allowed.

Held, further, C is liable for I.R.C. sec. 6662(a) accuracy-related penalties.

Henry G. Wykowski, Christopher J. Wood, and Matthew A. Williams, for petitioners.

Audra M. Dineen and Ina Susan Weiner, for respondent.

PUGH, Judge: Respondent determined deficiencies, additions to tax, and penalties as follows:[2]

[2] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended and in effect for the years at issue. Rule

(continued...)

Alternative Health Care Advocates, docket No. 16123-14

Year	Deficiency	Addition to tax sec. 6651(a)(1)	Penalty sec. 6662(a)
2009	$384,665	$38,447	$76,933
2010	367,316	91,829	73,463

Donald Duncan, docket No. 30186-14

Year	Deficiency	Addition to tax sec. 6651(a)(1)
2009	$245,151	$61,023
2010	247,891	37,062
2011	163,118	38,530
2012	308,174	46,175

[2](...continued)
references are to the Tax Court Rules of Practice and Procedure. All monetary amounts are rounded to the nearest dollar.

The notices of deficiency were sent on the following dates: Petitioner Alternative Health Care Advocates (Alternative) on April 14, 2014; petitioner Donald Duncan on October 8, 2014; petitioner Jeremy Kwit on Jan. 7, 2015, for the 2012 tax year and on April 6, 2015, for the 2011 tax year; and petitioner Grant Rozmarin on Jan. 7, 2015.

Jeremy S. Kwit, docket Nos. 8813-15 and 12321-15

		Additions to tax			
Year	Deficiency	Sec. 6651(a)(1)	Sec. 6651(a)(2)	Sec. 6654(a)	Penalty sec. 6662(a)
2011	$7,920	$826	- - -	- - -	- - -
2012	39,693	8,931	$4,168	$712	$7,939

Grant Rozmarin, docket Nos. 8850-15 and 8852-15

		Additions to tax			
Year	Deficiency	Sec. 6651(a)(1)	Sec. 6651(a)(2)	Sec. 6654(a)	Penalty sec. 6662(a)
2011	$10,213	$2,298	$1,685	$202	$2,043
2012	19,846	2,084	2,084	356	3,969

After concessions,[3] the issues for decision are: (1) whether respondent properly disallowed deductions for Alternative's expenses pursuant to section 280E; (2) whether Mr. Duncan, Mr. Kwit, and Mr. Rozmarin underreported their flowthrough income from their S corporation, Wellness Management Group, Inc. (Wellness), because section 280E also applied to disallow Wellness' deductions; (3) whether Alternative is entitled to deduct cost of goods sold (COGS) in amounts greater than those respondent allowed; and (4) whether Alternative is liable for a section 6662(a) accuracy-related penalty for 2009 or 2010.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. Alternative was a California corporation with its primary place of business in West Hollywood,

[3] On December 6, 2016, the parties filed a Stipulation of Settled Issues in which the following concessions were made: (1) Alternative is liable for a sec. 6651(a)(1) addition to tax for its 2009 and 2010 taxable years to the extent there is an underpayment for each year; (2) Mr. Duncan is liable for a sec. 6651(a)(1) addition to tax for the taxable years 2009 through 2012 to the extent there is an underpayment for each year; (3) Mr. Kwit is liable for a sec. 6651(a)(1) addition to tax for the 2011 and 2012 taxable years to the extent there is an underpayment for each year; (4) Mr. Kwit is not liable for the sec. 6651(a)(2) addition to tax, adjustment for other taxes, sec. 6654(a) addition to tax, or the sec. 6662(a) accuracy-related penalty for the 2012 taxable year; (5) Mr. Rozmarin is liable for the sec. 6651(a)(1) addition to tax for the 2011 and 2012 taxable years and the sec. 6654(a) addition to tax for the 2011 and 2012 taxable years to the extent there is an underpayment for each tax year; and (6) Mr. Rozmarin is not liable for the sec. 6651(a)(2) addition to tax, adjustment for other taxes, or the sec. 6662(a) accuracy-related penalties for the 2011 and 2012 taxable years.

California, when its petition was timely filed. Mr. Duncan and Mr. Rozmarin resided in California, and Mr. Kwit resided in Oregon, when their petitions were timely filed.

I. Background on Petitioners and Wellness

A. Donald Duncan

Mr. Duncan--a graduate of the University of North Texas and former business student at Vista Community College--is a businessman and consultant experienced in the formation and operation of medical marijuana dispensaries in California.[4] In 1999 Mr. Duncan founded Berkeley Patients Group, a medical marijuana dispensary located in Berkeley, California. In 2006 Mr. Duncan assisted with opening California Patients Group, a medical marijuana dispensary in Los Angeles, and served as a consultant for medical marijuana facilities in Palm Springs, Malibu, and other locations throughout California. Mr. Duncan's consulting activities included advising dispensary operators on best practices for screening members, securing the facility, and ensuring proper screening of

[4] The provision of medical marijuana to patients in the State of California is permitted by the Compassionate Use Act of 1996. See Cal. Health & Safety Code sec. 11362.5 (West 1996). Pursuant to California Senate Bill No. 420 (Medical Marijuana Program Act of 2003), individuals or groups are prohibited from cultivating or distributing marijuana for profit. See Cal. Health & Safety Code, sec. 11362.765; Canna Care, Inc. v. Commissioner, T.C. Memo. 2015-206, aff'd, 694 F. App'x 570 (9th Cir. 2017).

medical marijuana. Mr. Duncan is also a cofounder and member of the board of directors of Americans for Safe Access, a patient advocacy organization.

B. Alternative

While operating Berkeley Patients Group, Mr. Duncan and his colleagues identified an opportunity for growth in a new market, observing that members of Berkeley Patients Group were traveling long distances from southern California to obtain medical marijuana. Therefore, in 2004 Mr. Duncan opened a second location in Los Angeles, initially naming the new dispensary Los Angeles Patients and Caregivers Group. In 2008 Mr. Duncan organized Alternative--a California corporation[5]--to operate this medical marijuana dispensary. Alternative is a California nonprofit mutual benefit corporation with members, rather than shareholders, that is treated as a C corporation for Federal tax purposes.

Mr. Duncan served as Alternative's president, and Richard Kearns served as its secretary. Mr. Kwit was a patient-member of the dispensary and served as a cultivator and consultant. Mr. Rozmarin served as a manager of the dispensary

[5] Alternative originally was named LAPC [Los Angeles Patients & Caregivers] Foundations, Inc. On September 8, 2010, Amended and Restated Articles of Incorporation were filed with the California secretary of state, changing the name of the corporation to Alternative.

and was responsible for handling administrative and staffing matters, performing human resource functions, and procuring and processing marijuana.

C. Wellness

In 2008 Mr. Duncan also organized a second entity, Wellness--a California corporation that elected S corporation status for Federal tax purposes--to handle daily operations for Alternative.[6] At the time Alternative was organized, Mr. Duncan was uncertain what dispensaries could do legally under California State law aside from growing and providing medical marijuana to patients. So Wellness was organized to perform functions for the medical marijuana dispensary such as hiring employees and paying expenses, including advertising, wages, and rent. While Mr. Duncan anticipated that Wellness might offer its management and operations services to other medical marijuana dispensaries, Wellness performed services solely for Alternative during the tax years at issue.

Wellness was owned by four shareholders: Mr. Duncan owned 80%; Mr. Kwit owned 10%; Mr. Rozmarin owned 5%; and Cori Escalante--a manager of the dispensary--owned 5%. Wellness maintained an office separate from Alternative

[6] Wellness originally was named Los Angeles Patients & Caregivers Group, Inc. On August 19, 2010, a Certificate of Amendment of Articles of Incorporation was filed with the California secretary of state, changing the name of the corporation to Wellness and listing Mr. Duncan as its president and Mr. Rozmarin as its secretary.

but also used the dispensary's address as a mailing address during the taxable years at issue.

II. Operations of the Dispensary

During the taxable years at issue Alternative intended to distribute medical marijuana to its patient-members in accordance with California law. The dispensary employed (through Wellness) administrators, security personnel, marijuana processors, salespersons, and receptionists. The following is a detailed description of the dispensary's business operations and processes.

A. Patient Intake Process

Upon patients' arrival at Alternative's dispensary, security personnel would check their credentials, including proper identification and a doctor's letter recommending use of medical marijuana. Patients then entered the dispensary facility and were greeted by a receptionist who would determine whether the patients were current members of the collective or were new patients. New patients were required to present their doctor's letter and identification for verification, and dispensary staff would call their doctor to verify the recommendation. Dispensary staff also would check the California Department of Consumer Affairs online directory to confirm that the doctor was licensed to practice medicine in the State of California. Dispensary staff would conduct an

intake interview to explain the rules of the facility and complete necessary paperwork. Patient-members then were able to enter the sales floor of the dispensary. Patient-members who purchased marijuana used cash or credit cards and were charged sales tax on their purchases.

B. Acquisition of Marijuana

Pursuant to guidelines published by the California State attorney general in August 2008, collective and cooperative associations engaged in acquiring and distributing medical marijuana conducted their sales in a closed circuit. Guidelines for the Security and Non-Diversion of Marijuana Grown for Medical Use (August 2008). The closed-circuit process ensured that medical marijuana was only purchased from or sold to members of the collective. Id. Alternative, in compliance with these guidelines, acquired various forms of medical marijuana from its patient-members. Alternative's medical marijuana offerings included hash, kief, cuttings (or clones), edibles, tinctures, and oils. Alternative also offered forms of marijuana that could be applied topically.

Before acquiring the medical marijuana from a patient-member, a manager of the dispensary conducted a quality inspection to ensure the overall appearance, smell, and desirability of the product. Cash payments were issued to patient-members upon successful completion of the inspection.

C. Processing of Marijuana Products

Alternative acquired marijuana from its members in various preparations or forms. Hash is a concentrated resin of the cannabis plant, and kief is a nonconcentrated resin of the cannabis plant. A cutting, or clone, is the cannabis plant itself that patient-members can take home, grow, and bring back to the dispensary. Edible preparations are foods--typically made with oil and butter--that contain marijuana. Tinctures, or alcohol tinctures, are a form of marijuana that can be taken under the tongue. Finally, oils are extracted from the cannabis plant and can be taken orally or smoked. The edibles, tinctures, oils, and forms of marijuana meant for topical applications were purchased in a condition ready for resale, but other products required some additional preparation and maintenance.

The dispensary employed (through Wellness) processors whose responsibilities included preparing the acquired marijuana products for sale. Marijuana was typically divided into quarter-pound increments for processing. Processors would break up and package marijuana in smaller increments (typically bags of one gram or 3-1/2 grams). In some instances processors were required to dry marijuana that arrived damp, to prevent mold or mildew. Sometimes processors would have to prepare cannabis flowers--the portion of the cannabis plant used as medicine--for resale by trimming and removing undesirable leaves

and stems from the cannabis plant. Additionally, dispensary employees were responsible for maintaining the clones (live cannabis plants) in a humid environment pending resale. Dispensary staff worked to ensure roots were kept moist and monitored the clones daily for pest infestations.

Most of the dispensary's floor space was used to acquire, process, or sell marijuana. Similarly, employee time was spent mostly on acquiring, processing, or selling marijuana. Security personnel spent 15% of their time processing marijuana products and 75% of their time selling marijuana; receptionists spent 10% of their time processing marijuana and 80% selling marijuana;[7] customer service representatives spent 10% of their time processing marijuana and 80% of their time selling marijuana; processors spent all of their time processing marijuana products; and managers spent 40% of their time acquiring marijuana and 30% to 40% selling marijuana.

D. Sale of Nonmarijuana Items

While medical marijuana accounted for most of Alternative's sales, it also offered nonmarijuana items. Specifically, Alternative sold books, T-shirts and

[7] At trial Susana de la Rionda--the general manager of the dispensary--estimated that receptionists spent between 42% and 49% of their time on marijuana sales but otherwise estimated that most employee time was spent on marijuana-related activities.

hats, rolling papers, pipes, grinders, incense, lighters, ashtrays, and cleaning supplies for pipes and bongs. These items did not take up much floor space. Mr. Duncan estimated the following percentage breakdown of employee time related to the sale of nonmarijuana products: 10% for security personnel; 10% for receptionists;[8] 10% for customer service representatives; and 15% for managers.

E. Finances

Alternative paid patient-members for the marijuana products that they provided and made all sales tax payments. But Wellness paid Alternative's other expenses, such as advertising, wages, and rent, and was reimbursed by Alternative for the expenses it paid. At times, however, those expenses were paid directly by Alternative.

Alternative maintained two bank accounts with JP Morgan Chase Bank and held a credit card machine merchant account and related deposit account with Bank of America. Several bank accounts were held by Alternative (under its prior name, Los Angeles Patients & Caregivers Group): credit card machine merchant accounts with Bank of America, American Express, and Discover, and a bank

[8] Ms. de la Rionda recalled at trial that receptionists spent between 21% and 28% of their time on the sale of nonmarijuana products.

account with Wells Fargo.[9] Mr. Duncan, Mr. Rozmarin, and Ms. Escalante each were authorized signors on the Wells Fargo account. Wellness maintained bank accounts with JP Morgan Chase and Wells Fargo.

Alternative and Wellness both used QuickBooks software to manage their finances and shared the computer in which financial information was entered.[10] Employees who were responsible for entering sales and expense information into QuickBooks categorized certain entries as taxable or nontaxable and classified certain products in a "hemp store" category. While the dispensary's procedure was to include marijuana products in the nontaxable sales category and nonmarijuana products in the hemp store or taxable sales category, a change to its bookkeeping procedure may have resulted in improper categorization. Sales entries for marijuana and nonmarijuana products were combined into single entries classified as "Donations" in QuickBooks; no distinction was made between the two product categories on the dispensary's financial records.

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[9] The Wells Fargo account was held in the name "Los Angeles Patients &."

[10] In 2010 the shared computer crashed, rendering inaccessible Alternative's and Wellness' QuickBooks data. Alternative and Wellness had several problems with the shared computer following the initial crash in 2010. Financial documents for Alternative and Wellness were reconstructed in preparation for respondent's audit.

III. Income Tax Returns

A. Alternative

Alternative filed Forms 1120, U.S. Corporation Income Tax Return, for the 2009 and 2010 taxable years. Alternative's Forms 1120 were prepared by its accountant, F. Michael Watson. Mr. Watson was referred to Mr. Duncan by an individual who ran a medical marijuana dispensary in Los Angeles. Alternative prepared financial statements for the taxable years at issue. Mr. Watson used only Alternative's financial statements to prepare the Forms 1120; Alternative did not provide Mr. Watson with any other documents to complete its income tax returns.

Alternative's 2009 Form 1120 lists "Medicine Sales" as its business activity. Alternative reported $2,780,952 of gross receipts from the sale of medical marijuana on its 2009 Form 1120. Alternative subtracted from gross receipts $1,622,925 of COGS--an amount respondent allowed in its entirety. Additionally, Alternative claimed deductions totaling $1,101,772 for 2009, consisting of $700 of rent, $11,098 of taxes and licenses, $698 of depreciation, $9,064 of advertising, and $1,080,212 of other deductions (including $896,975 for contract services and $34,723 for outside services).

Alternative's 2010 Form 1120 lists "Medicine Sales" as its business activity. Alternative reported $2,803,521 of gross receipts from the sale of

medical marijuana on its 2010 Form 1120. Alternative subtracted from gross receipts $1,712,020 of COGS--an amount respondent allowed in its entirety. Additionally, Alternative claimed deductions totaling $1,066,183 for 2010, consisting of $2,816 of charitable contributions, $59 of advertising, and $1,063,308 of other deductions (including $961,985 for contract services).

B. Wellness

Wellness filed Forms 1120S, U.S. Income Tax Return for an S Corporation, for the 2009, 2010, 2011, and 2012 taxable years, listing "Management" as its principal business activity. On its 2009 Form 1120S, Wellness reported gross receipts of $922,936 and claimed deductions totaling $890,890.[11] Wellness' deductions consisted of $227,916 of compensation of officers, $318,534 of salaries and wages, $64,713 of rent, $47,432 of taxes and licenses, $22,761 of advertising, and $209,534 of other deductions.

On its 2010 Form 1120S, Wellness reported gross receipts of $961,985 and claimed deductions totaling $911,791. Wellness' deductions consisted of $222,122 of compensation of officers, $343,552 of salaries and wages, $69,123 of

[11] The parties did not explain why Alternative's deductions for contract services and outside services did not equal Wellness' gross receipts for 2009.

rent, $48,322 of taxes and licenses, $15,422 of advertising, and $213,250 of other deductions.

On its 2011 Form 1120S, Wellness reported $582,655 of gross receipts and claimed deductions totaling $757,092. Wellness' deductions consisted of $222,122 of compensation of officers, $274,711 of salaries and wages, $1,583 of repairs and maintenance, $95,025 of rent, $5,494 of taxes and licenses, $2,221 of depreciation, $12,589 of advertising, and $143,347 of other deductions.

Finally, on its 2012 Form 1120S, Wellness reported $1,127,170 of gross receipts and claimed deductions totaling $1,116,701. Wellness' deductions consisted of $524,727 of salaries and wages, $2,420 of repairs and maintenance, $94,430 of rent, $209,128 of taxes and licenses, $15,882 of advertising, and $270,114 of other deductions.

C. Donald Duncan

Mr. Duncan filed Forms 1040, U.S. Individual Income Tax Return, for the 2009, 2010, 2011, and 2012 taxable years. Mr. Duncan attached Schedules E, Supplemental Income and Loss, to his Forms 1040 for the 2009 and 2010 taxable years. Mr. Duncan reported $8,349 of nonpassive income related to his interest in Wellness on his 2009 Schedule E. Additionally, Mr. Duncan reported $31,529 of nonpassive income related to his interest in Wellness on his 2010 Schedule E. Mr.

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Duncan did not report Schedule E income or losses on either his 2011 or his 2012 Form 1040.

D. Jeremy Kwit

Mr. Kwit filed Forms 1040 for the 2011 and 2012 taxable years.[12] Mr. Kwit did not report any income or loss with respect to his interest in Wellness on his 2011 Form 1040. Mr. Kwit attached a Schedule E to his 2012 Form 1040, reporting $1,739 of nonpassive income related to his interest in Wellness.

E. Grant Rozmarin

Mr. Rozmarin did not file Forms 1040 before the notices of deficiency were issued to him for the 2011 and 2012 taxable years.

OPINION

I. Burden of Proof

The taxpayer generally has the burden of proving that the Commissioner's determinations in a notice of deficiency are incorrect. Rule 142(a); Welch v. Helvering, 290 U.S. 111, 115 (1933). The burden of proof may shift from the taxpayer to the Commissioner in certain circumstances under section 7491(a).

[12] Mr. Kwit's 2012 Form 1040 was filed after the notice of deficiency was issued for the 2012 taxable year.

Petitioners have not claimed or shown that they meet the requirements of section 7491(a) to shift the burden of proof to respondent as to any relevant factual issue.

II. Deductions--Alternative

Deductions are a matter of legislative grace, and a taxpayer must prove its entitlement to deductions. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934). Taxpayers must maintain sufficient records to substantiate any deductions claimed. Sec. 6001.

Section 162(a) generally permits a taxpayer to deduct ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 261, however, provides that "[i]n computing taxable income, no deduction shall in any case be allowed in respect of the items specified in this part." "[T]his part" includes section 280E, Expenditures in Connection With the Illegal Sale of Drugs. See Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner (CHAMP), 128 T.C. 173, 180 (2007). Section 280E provides:

> 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.

Section 280E, therefore, bars the deduction of expenses by (1) a trade or business that is (2) trafficking in (3) a controlled substance. See Canna Care, Inc. v. Commissioner, T.C. Memo. 2015-206, at *8, aff'd, 694 F. App'x 570 (9th Cir. 2017). We address the existence of these elements in reverse order.

A. Controlled Substance

Petitioners acknowledge that marijuana is a controlled substance within the meaning of schedules I and II of the Controlled Substances Act. See Controlled Substances Act, Pub. L. No. 91-513, sec. 202, 84 Stat. at 1249 (1970) (codified as amended at 21 U.S.C. sec. 812 (2012)). Marijuana is a schedule I controlled substance in the context of section 280E even when the marijuana is medical marijuana recommended by a physician. See, e.g., United States v. Oakland Cannabis Buyers' Coop., 532 U.S. 483 (2001); Olive v. Commissioner, 139 T.C. 19 (2012), aff'd, 792 F.3d 1146 (9th Cir. 2015); CHAMP, 128 T.C. at 181; Sundel v. Commissioner, T.C. Memo. 1998-78, aff'd without published opinion, 201 F.3d 428 (1st Cir. 1999). We, therefore, find that the controlled substance element of section 280E is satisfied.

B. Trafficking

Section 280E does not define "trafficking" in controlled substances. In CHAMP, 128 T.C. at 182, we defined "trafficking" as the act of engaging in a commercial activity--that is, to buy and sell regularly. In Olive v. Commissioner, 139 T.C. at 38, we held that "dispensing * * * medical marijuana pursuant to * * * [California law] was 'trafficking' within the meaning of section 280E." In the Controlled Substances Act, "[t]he term 'dispense' means to deliver a controlled substance to an ultimate user". 21 U.S.C. sec. 802(10); see id. sec. 841(a)(1) (prohibiting the manufacture, distribution, dispensation, or possession of marijuana).

Section 7208, which criminalizes certain offenses relating to stamps, is the only section in the Internal Revenue Code that explicitly defines the term "trafficking". Section 7208(4)(B) defines "trafficking" as "[k]nowingly or willfully buy[ing], sell[ing], offer[ing] for sale, or giv[ing] away * * * washed or restored stamp[s] to any person for use". While the Internal Revenue Code is silent with respect to trafficking in controlled substances, congressional findings and declarations on controlled substances, see 21 U.S.C. sec. 801(2), describe it as "[t]he illegal importation, manufacture, distribution, and possession and improper use of controlled substances". Further, the Federal statute criminalizing

trafficking in counterfeit goods or services provides that "the term 'traffic' means to transport, transfer, or otherwise dispose of, to another, for purposes of commercial advantage or private financial gain, or to make, import, export, obtain control of, or possess, with intent to so transport, transfer, or otherwise dispose of". 18 U.S.C. sec. 2320(f)(5) (2012).

Petitioners do not dispute that Alternative was selling marijuana. While petitioners acknowledge that marijuana is a controlled substance, they claim that section 280E does not preclude dispensaries operating legally under State law from deducting expenses related to the sale of medical marijuana. Petitioners assert that section 280E should not apply because Alternative's activities did not "consist of" drug trafficking. Petitioners first argue that, under a plain reading of the statute, "Alternative's varied commercial activities place it squarely outside the reach of [section] 280E." Petitioners assert that because Alternative's activities did not consist solely of trafficking in medical marijuana, its expenses should be deductible. Petitioners further argue that under a "purpose-based judicial interpretation", section 280E does not apply to Alternative because Congress never intended that State-legal marijuana dispensaries be barred from deducting business expenses.

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We have held previously that section 280E applies to medical marijuana dispensaries even though they are operating in compliance with the laws of their jurisdictions. See Patients Mutual Assistance Collective Corp. v. Commissioner (Patients Mutual), 151 T.C. ___ (Nov. 29, 2018); Olive v. Commissioner, 139 T.C. at 38; CHAMP, 128 T.C. at 182-183; Canna Care, Inc. v. Commissioner, T.C. Memo. 2015-206. Further, in Olive v. Commissioner, 139 T.C. at 38, we explicitly rejected the same arguments the taxpayers made in that case with respect to the "consists of" language in section 280E:[13]

> Petitioner argues that he may deduct the Vapor Room's expenses notwithstanding section 280E because, he claims, the Vapor Room's business did not consist of the illegal trafficking in a controlled substance. He argues that the illegal trafficking in controlled substances is the only activity covered by section 280E. We disagree that section 280E is that narrow and does not apply here. We therefore reject petitioner's contention that section 280E does not apply here because the Vapor Room was a legitimate operation under California law. We have previously held that a California medical marijuana dispensary's dispensing of medical marijuana pursuant to the CCUA was "trafficking" within the meaning of section 280E. That holding applies here with full force. [Citations omitted]

Our decision was affirmed by the Court of Appeals for the Ninth Circuit, to which an appeal of these cases would lie. See Golsen v. Commissioner, 54 T.C. 742 (1970), aff'd, 445 F.2d 985 (10th Cir. 1971). The Court of Appeals concluded that

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[13] The taxpayer in Olive was represented by the same counsel representing petitioners in the present case.

the taxpayer's only "business" was selling medical marijuana because the caregiving services were not a separate business. Olive v. Commissioner, 792 F.3d at 1149-1150. In response to the taxpayer's arguments related to congressional intent and public policy, the court concluded that "[i]f Congress now thinks that the policy embodied in * * * [section] 280E is unwise as applied to medical marijuana sold in conformance with state law, it can change the statute. We may not." Id. at 1150. Petitioners fail to distinguish these cases from Olive.

We, therefore, find that Alternative was engaged in "trafficking" in a controlled substance within the meaning of section 280E.

C. Trade or Business

Petitioners do not dispute that Alternative is in the trade or business of selling marijuana but argue that Alternative also operates a separate trade or business consisting of the sale of nonmarijuana items. Petitioners assert that Alternative is entitled to allocate its expenses between its "trafficking" and "non-trafficking" businesses.

For an activity to qualify as a trade or business for purposes of the Internal Revenue Code, "the taxpayer must be involved in the activity with continuity and regularity and * * * the taxpayer's primary purpose for engaging in the activity must be for income or profit." Commissioner v. Groetzinger, 480 U.S. 23, 35

(1987). A single taxpayer can have more than one trade or business, and multiple activities may nevertheless constitute a single trade or business. Patients Mutual, 151 T.C. at ___ (slip op. at 37). Compare CHAMP, 128 T.C. at 183 (holding that the taxpayer--which operated a community center for members with debilitating diseases and charged a membership fee that covered only a fixed amount of marijuana--was engaged in two separate trades or businesses and, therefore, was entitled to an allocation of expenses), with Olive v. Commissioner, 139 T.C. at 39-42 (holding that the taxpayer--which operated a community-center whose sole source of revenue was from the sale of marijuana--had a single trade or business and was precluded from deducting expenses pursuant to section 280E), and Canna Care v. Commissioner, at *12-*13 (holding that--where the taxpayer was in the business of distributing medical marijuana and its only other source of income was its sale of books, T-shirts, and other nonmarijuana items--the sale of nonmarijuana items "was an activity incident to" the taxpayer's sole business of selling marijuana and the taxpayer was precluded from deducting expenses pursuant to section 280E). Further, the activities of separate entities can be treated as a single trade or business if they are part of a "unified business enterprise" with a single profit motive. Patients Mutual, 151 T.C. at ___ (slip op. at 37) (quoting Morton v. United States, 98 Fed. Cl. 596, 600 (2011)).

Petitioners direct us to two methods by which we can allocate expenses between trafficking and nontrafficking activities: the percentage of employee time dedicated to each activity and the percentage of floor space devoted to each activity. Petitioners cite the trial testimony of Mr. Duncan and Ms. de la Rionda to support their proposed allocation methods.

The percentages Mr. Duncan assigned at trial to marijuana and nonmarijuana activities seemed improvised, but the import of his testimony and that of Ms. de la Rionda is that Alternative's primary activity was operating a marijuana dispensary and the nonmarijuana activities were only ancillary--not occupying much time or space. Their allocation of floor space and employee activities both show that the receipt and sale of marijuana was the dominant activity and that the sale of nonmarijuana products had "a close and inseparable organizational and economic relationship" with--and was "incident to"--Alternative's primary business of selling marijuana. Patients Mutual, 151 T.C. at ___ (slip op. at 41-42) (quoting Olive v. Commissioner, 139 T.C. at 41).

We, therefore, hold that pursuant to section 280E Alternative is not entitled to its claimed deductions for the taxable years at issue.

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III. Deductions--Wellness

We next must determine whether Mr. Duncan, Mr. Kwit, and Mr. Rozmarin had unreported income with respect to their ownership interests in Wellness.

Section 1366(a)(1) provides that shareholders of an S corporation shall take into account their pro rata shares of the S corporation's income, loss, deductions, and credits for the S corporation's taxable year ending with or in the shareholder's taxable year. See CNT Inv'rs, LLC v. Commissioner, 144 T.C. 161, 178 n.23 (2015). An S corporation's shareholders must take into account the S corporation's income regardless of whether any income is distributed. See Enis v. Commissioner, T.C. Memo. 2017-222, at *15; Dunne v. Commissioner, T.C. Memo. 2008-63, at *20; Chen v. Commissioner, T.C. Memo. 2006-160, at *14. Therefore, as shareholders of Wellness--an S corporation during the taxable years at issue--Mr. Duncan, Mr. Kwit, and Mr. Rozmarin each must include his pro rata shares of Wellness' income, loss, deductions, and credits on their income tax returns.

Petitioners argue that in computing Mr. Duncan, Mr. Kwit, and Mr. Rozmarin's pro rata shares of Wellness' income, respondent wrongly applied section 280E to disallow Wellness' claimed deductions. Specifically, petitioners argue that because Wellness is a management company that does not engage in the

sale and purchase of marijuana, section 280E does not apply. Petitioners cite Davis v. Commissioner, 29 T.C. 878 (1958), and Roselle v. Commissioner, T.C. Memo. 1981-394, to support their argument that a management services company can engage in a separate line of business from the entity it manages.

Because Alternative and Wellness are legally separate entities, we must analyze whether Wellness' own business activities also constituted "trafficking in controlled substances" as contemplated by section 280E. Petitioners argue that, as a management services company, Wellness did not itself engage in the purchase and sale of marijuana. But the 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. And, to the extent Wellness engaged in nontrafficking activities, the record before us does not allow us to allocate expenses between marijuana-related and non-marijuana-related activities.

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.

IV. Cost of Goods Sold

Next, we must determine whether Alternative is entitled to a COGS amount greater than respondent allowed for the taxable years at issue.

A taxpayer engaged in manufacturing or merchandising can subtract COGS from gross receipts to arrive at gross income. See secs. 1.61-3(a), 1.162-1(a), Income Tax Regs.; see also Feinberg v. Commissioner, T.C. Memo. 2017-211, at *10; Rodriguez v. Commissioner, T.C. Memo. 2009-22, 2009 WL 211430, at *3. COGS is not a deduction but an offset to gross receipts for the purpose of calculating gross income. See Feinberg v. Commissioner, at *11; Kazhukauskas v. Commissioner, T.C. Memo. 2012-191, 2012 WL 2848694, at *9. A taxpayer is required to maintain sufficient reliable records to allow the Commissioner to verify the taxpayer's income and expenditures. See sec. 6001; Olive v. Commissioner, 139 T.C. at 33. COGS is generally determined under section 471 and the accompanying regulations. See secs. 1.471-3, 1.471-11, Income Tax Regs. Producers must include in COGS both the direct and indirect costs of creating their inventory. See secs. 1.471-3(c), 1.471-11, Income Tax Regs. Section 471 and its regulations also direct taxpayers to section 263A for additional rules. That section instructs both producers and resellers to include "indirect" inventory costs in COGS. Sec. 263A(a)(2)(B), (b); sec. 1.263A-1(a)(3), (c)(1), (e), Income Tax Regs. It also broadens the definition of indirect costs for both types of taxpayers. Compare sec. 1.263A-1(e)(3), Income Tax Regs., with sec. 1.471-11, Income Tax Regs.

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Petitioners first argue that, under section 263A, Alternative is entitled to include both direct and indirect costs of its inventory in computing COGS. Petitioners do not specify what additional expenses should be allowed beyond the COGS offsets that respondent already allowed; rather they ask the Court to consider Mr. Duncan's testimony regarding the square footage of the dispensary and a general overhead estimate as well as Ms. de la Rionda's estimates regarding employee time and related costs.

Section 263A puts into COGS only expenses otherwise deductible. See Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, sec. 1008(b)(1), 102 Stat. at 3437 ("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."). Here, the expenses petitioners have reported are not deductible. Petitioners are correct that Congress cannot take away COGS, but that is not what section 263A does. It adds otherwise deductible expenses to COGS. Because by operation of section 280E these indirect expenses are not deductible, they cannot be added to COGS. Patients Mutual, 151 T.C. at ___ (slip op. at 19).

Petitioners further argue that Alternative is a "producer" for purposes of sections 263A and 471 and is therefore entitled to include its "production" costs in

inventory. We find that Alternative is not a "producer" for purposes of section 263A or 471. Under section 263A and its accompanying regulations, "[t]he term 'produce' includes construct, build, install, manufacture, develop, * * * improve", "create, raise, or grow." Sec. 263A(g)(1); sec. 1.263A-2(a)(1), Income Tax Regs. Under the section 471 regulations, "[c]osts are considered to be production costs to the extent that they are incident to and necessary for production or manufacturing operations or processes." Sec. 1.471-11(b)(1), Income Tax Regs.

Petitioners have not shown that Alternative was a "producer" of the marijuana products it purchased from its patient-members. Certain of Alternative's product offerings required some additional preparation and maintenance. But we are unable to conclude that the dispensary grew, created, or improved its marijuana products to the extent required by section 263A or 471 when the only evidence before us is that the dispensary inspected, packaged, trimmed, dried, and maintained the stock. Patients Mutual, 151 T.C. at ___ (slip op. at 60-62). Further, even were we to allow Alternative to include such costs, petitioners have not offered a reasonable basis upon which to compute the additional amounts of COGS.

We also reject Alternative's argument that, under Suzy's Zoo v. Commissioner, 114 T.C. 1 (2000), aff'd, 273 F.3d 875 (9th Cir. 2001), it was a

"producer" as it was the owner of the marijuana produced by its patient-members. A taxpayer is considered a "producer" if it is an owner of the property produced under Federal income tax principles. Sec. 1.263A-2(a)(1)(ii)(A), Income Tax Regs. An ownership determination is made on the basis of "all of the facts and circumstances, including the various benefits and burdens of ownership vested with the taxpayer." Id. Mr. Duncan testified that the dispensary had oral agreements with its patient-members to grow the marijuana and create marijuana products. But no other evidence supports petitioners' claim that Alternative owned the marijuana products produced by its patient-members until Alternative paid them for their products. Further, even if patient-members had to sell to Alternative, employees had complete discretion over whether to purchase the marijuana products from the patient-members and compensated the patient-members only if their marijuana was purchased. See Patients Mutual, 151 T.C. at ___ (slip op. at 62).

Petitioners have not established that Alternative's relationship with its patient-members was the type of contract-manufacturing arrangement the Court of Appeals recognized in Suzy's Zoo v. Commissioner, 273 F.3d at 877. We conclude instead that Alternative was a reseller of the marijuana products it purchased.

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We, therefore, hold that petitioners are limited to the COGS respondent has already allowed for the taxable years at issue.

V. Section 6662(a) Penalty[14]

Finally, we must determine whether Alternative is liable for the section 6662(a) accuracy-related penalty for the 2009 and 2010 taxable years. Section 6662(a) and (b)(1) and (2) imposes a penalty equal to 20% of the portion of an underpayment of tax required to be shown on the return that is attributable to "negligence or disregard of rules or regulations" and/or a "substantial understatement of income tax." Negligence includes "any failure to make a reasonable attempt to comply with the provisions of this title". Sec. 6662(c). We have defined negligence as the failure to exercise due care or the failure to do what a reasonable person would do under the circumstances. See Allen v. Commissioner, 92 T.C. 1, 12 (1989), aff'd, 925 F.2d 348 (9th Cir. 1991); Neely v. Commissioner, 85 T.C. 934, 947 (1985). With respect to corporations, an understatement of income tax is "substantial" if it exceeds the greater of 10% of

[14] As we have stated above, Mr. Duncan, Mr. Kwit, and Mr. Rozmarin have conceded their liability for additions to tax to the extent we find that underpayments exist for the relevant taxable years. As we have determined that petitioners underreported their income with respect to their ownership interests in Wellness, Mr. Duncan, Mr. Kwit, and Mr. Rozmarin are liable for these additions to tax.

the tax required to be shown on the return or $10,000 (or if it exceeds $10,000,000). Sec. 6662(d)(1).

An understatement may be reduced if the taxpayer had substantial authority for its return position. Sec. 6662(d)(2)(B); see Campbell v. Commissioner, 134 T.C. 20, 30 (2010), aff'd, 658 F.3d 1255 (11th Cir. 2011); sec. 1.6662-4(a), Income Tax Regs. "Substantial authority is an objective standard based on an analysis of the law and its application to the relevant facts." See Campbell v. Commissioner, 134 T.C. at 30 (citing Myers v. Commissioner, T.C. Memo. 1994-529). And substantial authority exists only if the weight of the authorities supporting the return position is substantial in relation to the weight of authorities supporting contrary treatment. See id. (citing O'Malley v. Commissioner, T.C. Memo. 2007-79).

An understatement also may be reduced if the taxpayer adequately disclosed the position and had a reasonable basis for the position. Sec. 6662(d)(2)(B); see Campbell v. Commissioner, 134 T.C. at 30; sec. 1.6662-4(a), Income Tax Regs. Disclosure generally must be made on Form 8275, Disclosure Statement, unless otherwise permitted by an applicable revenue procedure. Sec. 1.6662-4(f), Income Tax Regs.; see Campbell v. Commissioner, 134 T.C. at 31. And reasonable basis is a relatively high standard of reporting; taxpayers must have a position that is

more than merely arguable. Sec. 1.6662-3(b)(3), Income Tax Regs.; see Campbell v. Commissioner, 134 T.C. at 31.

Petitioners did not argue that Alternative had substantial authority for its position or that they disclosed the section 280E issue and had a reasonable basis. Respondent, therefore, asserts that petitioners waived this argument. We agree and hold that Alternative had substantial understatements of income tax for the years at issue.[15]

A taxpayer may avoid a section 6662(a) penalty if it can show reasonable cause for the resulting underpayment and that it acted in good faith. Sec. 6664(c). The decision as to whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. See sec. 1.6664-4(b)(1), Income Tax Regs. Generally, the most

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[15] The burden of production as to the penalty remains on Alternative because sec. 7491(c) does not apply to corporations. See NT, Inc. v. Commissioner, 126 T.C. 191, 195 (2006). In addition, in Dynamo Holdings Ltd. P'ship v. Commissioner, 150 T.C. ___, ___ (slip op. at 13) (May 7, 2018), we held that the Commissioner does not have the burden of production as to supervisory approval under sec. 6751(b) for a penalty determined against a corporation in a notice of deficiency. Respondent has filed a motion to reopen the record and admit evidence pertaining to his compliance with sec. 6751(b)(1) here. As we held in Dynamo that the Commissioner has no burden of production with respect to sec. 6751(b), and Alternative did not argue that respondent failed to comply with that provision, we will deny as moot respondent's motion to reopen the record.

important factor is the extent of the taxpayer's efforts to assess the proper tax liability. Id.; see Halby v. Commissioner, T.C. Memo. 2009-204. Reliance on professional advice may constitute reasonable cause and good faith if the taxpayer proves, by a preponderance of the evidence, that it "meets each requirement of the following three-prong test: (1) [t]he advisor was a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer provided necessary and accurate information to the advisor, and (3) the taxpayer actually relied in good faith on the adviser's judgment." Neonatology Assocs., P.A. v. Commissioner, 115 T.C. 43, 99 (2000), aff'd, 299 F.3d 221 (3d Cir. 2002); see Hudson v. Commissioner, T.C. Memo. 2017-221.

Petitioners argue that, given the unsettled caselaw and confusion surrounding section 280E (in their view) at the time the tax returns were prepared and filed, it would be unfair to impose an accuracy-related penalty. Petitioners note that during the years at issue, the only relevant case was CHAMP, and that the Court in CHAMP allowed the taxpayer to deduct a large percentage of its expenses despite its provision of medical marijuana. As we outlined above, the factual circumstances that enabled the Court in CHAMP to allocate expenses between the taxpayer's businesses are absent from the case before us. The only directly relevant authority available was directly against petitioners' tax treatment.

Alternative failed to state anywhere on its returns that it was involved in the distribution of marijuana or that section 280E was at issue in any way. Alternative stated on its return only that its business activity was "Medicine Sales". And Alternative offered insufficient evidence that it sought advice regarding proper tax treatment for its transactions. While Alternative hired an accountant believed to have experience with marijuana dispensaries, Alternative provided no evidence that it relied on the accountant for advice on whether section 280E applied. Indeed, the record shows that Alternative only provided its accountant financial statements to prepare its returns. And merely hiring a professional to prepare an income tax return--without giving him necessary information or relying on his advice--does not absolve a taxpayer from liability of a penalty. See, e.g., Povolny Grp., Inc. v. Commissioner, T.C. Memo. 2018-37, at *27-*28; Bronson v. Commissioner, T.C. Memo. 2012-17, 2012 WL 129803, at *12-*13, aff'd, 591 F. App'x 625 (9th Cir. 2015).

We, therefore, hold that Alternative is liable for the section 6662(a) accuracy-related penalty for the taxable years at issue.

We have considered all of the arguments made by the parties and, to the extent they are not addressed above, we find them to be moot, irrelevant, or without merit.

From the Desk of
Stuart Levine
sltax@taxation-business.com

To reflect the foregoing,

An appropriate order will be issued, and decisions will be entered under Rule 155.

Office of Chief Counsel
Internal Revenue Service

Memorandum

From the Desk of
Stuart Levine
sltax@taxation-business.com

Number: **201504011**
Release Date: 1/23/2015

CC:ITA:6 – LFNolanII
POSTS-125750-13

UILC: 280E.00-00, 61.00-00, 263A.00-00, 446.00-00, 446.01-00, 471.00-00

date: December 10, 2014

to: Matthew A. Houtsma
Associate Area Counsel (Small Business/Self-Employed)
CC:SB:5:Den:2

from: W. Thomas McElroy, Jr.
Senior Technician Reviewer
Office of Associate Chief Counsel (Income Tax & Accounting)
CC:ITA:6

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subject: Taxpayers Trafficking in a Schedule I or Schedule II Controlled Substance -- Capitalization of Inventoriable Costs

This advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

(1) How does a taxpayer trafficking in a Schedule I or Schedule II controlled substance determine cost of goods sold ("COGS") for the purposes of §280E of the Internal Revenue Code ("Code")?

(2) May Examination or Appeals require a taxpayer trafficking in a Schedule I or Schedule II controlled substance to change to an inventory method for that controlled substance when the taxpayer currently deducts otherwise inventoriable costs from gross income?

CONCLUSION

(1) A taxpayer trafficking in a Schedule I or Schedule II controlled substance determines COGS using the applicable inventory-costing regulations under §471 as they existed when §280E was enacted.

(2) Yes, unless the taxpayer is properly using a non-inventory method to account for the Schedule I or Schedule II controlled substance pursuant to the Code, Regulations, or other published guidance.

BACKGROUND

In the Comprehensive Drug Abuse Prevention and Control Act of 1970, 21 U.S.C. §801–971 (1970), ("Controlled Substances Act" or "CSA"), Congress created a regime to curtail the unlawful manufacture, distribution, and abuse of dangerous drugs ("controlled substances"). Congress assigned each controlled substance to one of five lists (Schedule I through Schedule V). *See* §812 of the CSA. Schedule I includes: (a) opiates; (b) opium derivatives (e.g., heroin; morphine); and (c) hallucinogenic substances (e.g., LSD; marihuana (a/k/a marijuana); mescaline; peyote).

Though a medical marijuana business is illegal under federal law, it remains obligated to pay federal income tax on its taxable income because §61(a) does not differentiate between income derived from legal sources and income derived from illegal sources. *See, e.g., James v. United States*, 366 U.S. 213, 218 (1961). Under the Sixteenth Amendment of the United States Constitution ("Sixteenth Amendment"), Congress is authorized to lay and collect taxes on income. In a series of cases, the United States 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. *See, e.g., Doyle v Mitchell Bros. Co.*, 247 U.S. 179, 185 *(*"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.'"*); New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934) ("The power to tax income 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 therefor can any particular deduction be allowed.").

Section 61(a) defines "gross income" broadly using 15 examples of items that are includible in gross income. Consistent with the Sixteenth Amendment, §61(a)(3) provides that gross income includes net gains derived from dealings in property, which includes controlled substances produced or acquired for resale. "Gains derived from dealings in property" means gross receipts less COGS, which is the term given to the adjusted basis of merchandise sold during the taxable year. Section 1.61-3(a) of the Income Tax Regulations. *See also* §§1001(a); 1011(a); 1012(a). As the Tax Court explained in *Reading v. Commissioner*, 70 T.C. 730, 733 (1978), "[t]he 'cost of goods sold' 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." 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. In general, the taxpayer first determines gross income by subtracting COGS from gross receipts, and then determines taxable income by

subtracting all ordinary and necessary business expenses (*e.g.*, §162(a)) from gross income.

In 1981, the Tax Court allowed an illegal business to recover the cost of the controlled substances (*i.e.*, amphetamines; cocaine; marijuana) obtained on consignment and also to claim certain business deductions (a portion of the rent he paid on his apartment which was his sole place of business, the cost of a small scale, packaging expenses, telephone expenses, and automobile expenses). *See Jeffrey Edmondson v. Commissioner*, T.C. Memo. 1981-623.

In 1982, Congress enacted §280E, which reverses the holding in *Edmondson* as it relates to deductions other than the cost of the controlled substances. Section 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.

Under 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.

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 C.B. 661.

When enacting §280E, Congress exercised its authority to withhold the legislative grace mentioned in *New Colonial Ice Co.*, *supra*. It is important to understand that §280E even disallows a deduction for expenses that are not illegal per se (*e.g.*, salaries; rent; telephone). Thus, §280E has a greater reach than §162(c), which disallows a deduction for specified illegal payments (*e.g.*, bribes; kickbacks).

When §280E was enacted, taxpayers using an inventory method were subject to the inventory-costing regulations under §471. Specifically, resellers were subject to §1.471-3(b), and producers were subject to §§1.471-3(c) and 1.471-11 (“full-absorption regulations”).

Four years after enacting §280E, Congress enacted the Tax Reform Act of 1986, which added the uniform capitalization rules of §263A to the Code. Under §263A(a), resellers and producers of merchandise are required to treat as inventoriable costs the direct costs of property purchased or produced, respectively, and a proper share of those indirect costs that are allocable (in whole or in part) to that property. Flush language at the end of §263A(a)(2) provides, "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."

The flush language at the end of §263A(a)(2) was added by §1008(b)(1) of the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA")[1] (P.L. 100-647), *reprinted in* 1988 U.S.C.C.A.N. 4621, 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.

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

The Tax Court has tried a few cases involving taxpayers that sell medical marijuana. In the seminal case in this area, the Tax Court held that the taxpayer trafficked in medical marijuana, which is a Schedule I controlled substance, and that §280E disallows all deductions attributable to that trade or business. The Tax Court also held, however, that §280E does not disallow the deductions attributable to the taxpayer's separate and lawful trade or business. *Californians Helping to Alleviate Medical Problems, Inc., v. Commissioner*, 128 T.C. 173 (2007) ("*CHAMP*"). In *CHAMP*, the government conceded that §280E does not prohibit a taxpayer from claiming COGS. *Id.* at 178, n. 4. In other cases involving nonmedical marijuana or other Schedule I controlled substances, the Tax Court recognized that §280E does not disallow adjustments to gross receipts for COGS. *See, e.g., Peyton v. Commissioner*, T.C. Memo. 2003-146; *Franklin v. Commissioner*, T.C. Memo. 1993-184; *McHan v. Commissioner*, T.C. Memo. 2006-84.

Applied literally, §280E severely penalizes taxpayers that traffic in a Schedule I or Schedule II controlled substance but don't use an inventory method for the controlled substance. When required to use an inventory method, a taxpayer also is required to use an accrual method for purchases and sales of merchandise. *See* §§1.471-1; 1.446-

[1] TAMRA began as the Technical Corrections Act of 1988 (S. 2238) and the Miscellaneous Revenue Bill of 1988 (H.R. 4333).

1(c)(2)(i). *But see* §1.61-4(b).[2] Thus, the taxpayer will 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 receipts. On the other hand, when not required to use an inventory method, a taxpayer might be permitted to use the cash method. *See, e.g.,* §446(c)(1). *See also* Rev. Proc. 2001-10, 2001-1 C.B. 272; Rev. Proc. 2002-28, 2002-1 C.B. 815. Under the modified cash method as described in Rev. Proc. 2001-10 and Rev. Proc. 2002-28, a reseller may account for merchandise as "inventories" or as "materials and supplies that are not incidental." *See* §1.162-3 (a)(1). When a unit of merchandise is sold, the reseller will account for that cost as a deduction from gross income in the taxable year that the unit is sold or the payment is received, whichever is later. Similarly, a cash-method producer or farmer will deduct production expenses from gross income in the taxable year paid and, thus, will have no basis in the merchandise that it eventually sells. In the case of a cash-method reseller, producer, or farmer, the obligation to pay an income tax on gains derived from the sale of a controlled substance creates a tension between the accepted interpretation of "income" under the Sixteenth Amendment and §280E, which disallows all deductions of a trade or business trafficking in a Schedule I or Schedule II controlled substance.

ANALYSIS

ISSUE 1: How does a taxpayer trafficking in a Schedule I or Schedule II controlled substance determine COGS for the purposes of §280E?

To resolve this issue, we will consider: (1) when and how an item becomes an inventoriable cost; (2) what Congress intended to include within the meaning of inventoriable costs when they enacted §280E; and (3) whether Congress changed their definition when they enacted §263A.

To be deductible by a business enterprise, a business expense (*e.g.*, salaries; rent) must be "ordinary and necessary" within the meaning of §162 and must satisfy the timing requirements of §461. Once these requirements are satisfied, the amount of that expense is deducted in the current taxable year, unless another provision of the Code or regulations requires this deduction to be deferred to a subsequent taxable year, capitalized to an asset, or disallowed entirely. *See, e.g.*, §§267(a)(2); 471(a); 263A(a); 280E. For example, in the case of a producer of property, inventory-costing rules typically require the capitalization of costs that are "incident to and necessary for production or manufacturing operations or processes" (*e.g.*, §1.471-11(b)(1)) or costs that "can be identified or associated with particular units or groups of units of specific property produced" (*e.g.*, §1.263A-1(e)(2)). Thus, when one of these inventory-costing regulations applies, a producer must capitalize, as an inventoriable cost, what otherwise

[2] The rule that applies to farmers is different from the rule that applies to producers and resellers. A farmer using an overall accrual method also must use an inventory method because of its use of an accrual method.

would have been a deduction under §162 and must keep that cost in inventories until the taxable year that the producer sells the merchandise. At that point, the producer includes those costs in COGS and accounts for COGS as an adjustment to gross receipts.

As noted above, the legislative history of section 280E states that "[t]o 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." When §280E was enacted in 1982, "inventoriable cost" meant a cost that was capitalized to inventories under §471 (as those regulations existed before the enactment of §263A). The specific regulations are §1.471-3(b) in the case of a reseller of property and §§1.471-3(c) and 1.471-11 in the case of a producer of property. Thus, a marijuana reseller using an inventory method would have capitalized 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. 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), Category 1 indirect costs (§1.471-11(c)(2)(i)), and possibly Category 3 indirect costs (§1.471-11(c)(2)(iii)).

Section 263A increased the types of costs that are inventoriable compared to the rules under §471, but did not revolutionize inventory costing. A reseller still is required to treat the acquisition costs of property as inventoriable. Now, a reseller also is required to capitalize purchasing, handling, and storage expenses. In addition, both resellers and producers are required to capitalize a portion of their service costs, such as the costs associated with their payroll, legal, personnel functions. Thus, under §263A, resellers and producers of property are required to treat some deductions as inventoriable costs.

Section 263A is a timing provision. It does not change the character of any expense from "nondeductible" to "deductible," or vice versa. For a taxpayer to be permitted to treat an expense as an inventoriable cost, that expense must not run afoul of the flush language at the end of §263A(a)(2) — "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." *See* §1.263A-1(c)(2)(i).

Read together, §280E and the flush language at the end of §263A(a)(2) prevent a taxpayer trafficking in a Schedule I or Schedule II controlled substance from obtaining a tax benefit by capitalizing disallowed deductions. Congress did not repeal or amend §280E when it enacted §263A. Furthermore, nothing in the legislative history of §263A suggests that Congress intended to permit a taxpayer to circumvent §280E by treating a disallowed deduction as an inventoriable cost or as any other type of capitalized cost. In fact, the legislative history of §263A(a)(2) states that "a cost is subject to capitalization . . . only to the extent it would otherwise be taken into account in computing taxable income for any taxable year." If a taxpayer subject to §280E were allowed to capitalize "additional §263A costs," as defined for new taxpayers in §1.263A-

1(d)(3),[3] §263A would cease being a provision that affects merely timing and would become a provision that transforms non-deductible expenses into capitalizable costs. Thus, we have concluded that a taxpayer trafficking in a Schedule I or Schedule II controlled substance is entitled to determine inventoriable costs using the applicable inventory-costing regulations under §471 as they existed when §280E was enacted.

ISSUE 2: May Examination or Appeals require a taxpayer trafficking in a Schedule I or Schedule II controlled substance to change to an inventory method for that controlled substance when the taxpayer deducts otherwise inventoriable costs from gross income?

A cash-method producer of a Schedule I or Schedule II controlled substance, such as marijuana, typically will deduct all production costs in the taxable year paid and, thus, will not have any adjusted basis in the product that it produces. When §280E is applied in the case of a producer trafficking in a Schedule I or Schedule II controlled substance, and all deductions from gross income are disallowed, the producer's taxable income for each taxable year will be significantly higher than what it would have been if the producer had used a permissible inventory method and recouped its production costs through COGS. Furthermore, the producer will not be able to take those disallowed production costs into account in any future taxable year. Thus, in this scenario, the overall cash method does not clearly reflect income because of the operation of §280E.[4] Stated differently, even a producer trafficking in a Schedule I or Schedule II controlled substance is subject to tax on "gains derived from dealings in property," not on gross receipts. Section 61(a)(3). This rule regarding "gains derived from dealings in property" applies equally to a reseller trafficking in a Schedule I or Schedule II controlled substance.

In our view, Examination and Appeals have the authority under §446(b) to require a taxpayer to change from a method of accounting that does not clearly reflect income to a method that does clearly reflect income regardless of whether that change results in a positive or negative §481(a) adjustment.[5] When a producer or reseller of a Schedule I

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[3] Section 1.263A-1(d)(3) provides, in part, "For new taxpayers, additional section 263A costs are defined as the costs, other than interest, that the taxpayer must capitalize under section 263A, but which the taxpayer would not have been required to capitalize if the taxpayer had been in existence prior to the effective date of section 263A."

[4] In addition, the overall cash method might not clearly reflect income because of §1.61-4(b) or §1.471-1.

[5] Section 446(b) provides that if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income. The Commissioner has broad discretion to determine whether a taxpayer's method of accounting clearly reflects income, and the Commissioner's determination must be upheld unless it is clearly unlawful. *See Thor*

or Schedule II controlled substance uses a method of accounting that causes a tax result contrary to the Sixteenth Amendment, to §61(a)(3), and to the legislative history of §280E, the proper exercise of the above-mentioned authority is warranted. Section 446(b). *See also* Rev. Proc. 2002-18. *See also* IRM 4.11.6.7.1 (05-13-2005). Consequently, if a producer or reseller of a Schedule I or Schedule II controlled substance is deducting from gross income the types of costs that would be inventoriable if that taxpayer were properly using an inventory method under § 471, it is an appropriate exercise of authority for Examination or Appeals to require that taxpayer to use an inventory method, to use the applicable inventory-costing regime (as discussed under Issue (1) of this memo), and to change from the overall cash method to an overall accrual method.[6] 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.

Please call Leo F. Nolan II or Amy Wei at (202) 317-7007 (not a toll-free number) if you have any questions.

Power Tool Co. v. Commissioner, 439 U.S. 522 (1979); *RCA Corp. v. United States*, 664 F.2d 881 (2d Cir. 1981), *cert. denied*, 457 U.S. 1133 (1982).

[6] The §481(a) adjustment required to implement this method change does not include any amount attributable to non-inventoriable costs disallowed under §280E in any taxable year.