GALLIMAUFRY
THE STUFF THAT DOESN'T REALLY FIT ANYWHERE SPECIAL
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1. Justifiably, the format of this lecture group has traditionally been to have presentations that deal with a specific topic.

2. That being said, however, this tends to result in cases and developments that can't be easily placed within a broader panorama being overlooked.

3. Over the last year or so, I've noticed a number of developments that are worthy of more than a passing look. And, in some of these situations, the lessons are not obvious.

4. So today, we will look at developments that are, generally speaking, unrelated. However, I think that they present important lessons.

5. The links shown next to each case at the beginning of each section will lead to the opinions.

A.
FOOL'S GOLD
THE FALSE PROMISE OF MAKING A FORTUNE IN MANUFACTURING AND SELLING CANNABIS.

Patients Mutual Assistance Collective Corporation, d.b.a., Harborside Health Center, 151 T.C. No. 11 (November 29, 2018) ("Harborside I") (http://slnews.us/010819grna)

Patients Mutual Assistance Collective Corporation, d.b.a., Harborside Health Center, T.C.M. 2018-208 (December 20, 2018) ("Harborside II") (http://slnews.us/010819grnb)

Alternative Health Care Advocates, 151 T.C. No. 13 (http://slnews.us/010819grnc)

A-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.

A-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. 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.

A-3. 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.

A-4. In *Californians Helping to Alleviate Med. Problems, Inc. (CHAMP)*, 128 T.C. 173 (2007), the Tax Court had held that we found that the taxpayer operated two separate trades or businesses--one that provided caregiving services and one that sold marijuana. The Court 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. 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.

A-5. 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.

A-6. 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." The Court therefore held that section 280E banned deductions for any of its business expenses.

A-7. 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 cannibis on a retail level? After all:

i. 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.

ii. 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.

iii. 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. *See Haborside I*, slip op. at 5-12.

A-8. 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.

A-9. 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.[1] The consultant advised that:

i. 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

ii. 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.

A-11. 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.

A-10. Now we get to *Harborside I*. A good portion of the Court's opinion deals with the issue of *res judicata* due to a civil forfeiture action brought against the taxpayer in 2012. The taxpayer prevailed in that action. The taxpayer argued that because the civil forfeiture action was dismissed with prejudice, the taxpayer, as a matter of law, the taxpayer was not a drug trafficker and could therefore not be subject to IRC § 280E. 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.

A-11. 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

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[1]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.

larger context of the Internal Revenue Code. Citing Shakespeare at least twice, the Court found the taxpayer's argument wanting.

A-12. 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.)

A-13. The Court distinguished *CHAMP* and *Olive*. 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.

A-14. 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.

A-15. 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.

A-16. 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.

A-17. 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.

A-18. 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.

Slip op. at 62.

A-19. 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.

A-20. 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.

A-21. 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.

A-22. 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].

A-23. Ouch.

A-24. 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.

Slip op. at 28-29.

A-23. Then, double-ouch, the Court applied the well known "tough nuces" rule:

> 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.

Slip op. at 29.

A-24. And now, triple-ouch. The Court imposed penalties under IRC § 6662.

A-25. 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.

A-26. 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.

A-27. It is here that there is a meaningful contrast with the taxpayer in *Harborside II*, a contrast that we should all be mindful of.

A-28. Note that, 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.

A-29. 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.

Slip op. at 5.

A-30. Next, the Court addressed the taxpayer's good faith.

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

ii. 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.

Slip op. at 6.

iii. 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." Slip op. at 7.

A-31. There is a larger message in these cases: One employing sharp practice will sometimes get sliced up.

A-32. And, of course, 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.

B.
DOES AN ATTORNEY WHO REPRESENTS A SPOUSE HAVE A FOOL FOR A CLIENT?

Rogers v. Commissioner, U.S. Court of Appeals for the 7th Cir. (No. 17-3358, November 19, 2018) (http://slnews.us/010819grnd)

B-1. Husband and Wife filed joint returns.

B-2. H, a Harvard-educated tax lawyer, represented himself and his wife at trial before the Tax Court.

B-3. W attended the entire trial and sat at the table reserved for taxpayer petitioners.

B-4. W had an M.B.A. and a J.D. and had completed multiple courses in taxation.

B-5. After an adverse ruling by the Tax Court requiring the couple to pay an income tax deficiency of $207,942 and related penalties of $77,868.

B-6. Only three years subsequent to the initial tax case, did W claim that she was entitled to innocent spouse relief. The Seventh Circuit summarized the Tax Court's ruling as follows:

> In reviewing her petition for innocent spouse relief, the Tax Court found substantial portions of her testimony to defy reality and lack credibility. The Tax Court did not its mince its words on this score:
>
> • "Despite having an M.B.A. and a J.D. and having completed multiple courses in taxation petitioner contends that she has 'no understanding' of items and transactions reported on their joint returns, which were the subject of the 2004 deficiency case."
>
> • "On her Form 8857 and in her testimony petitioner portrays herself as having a near complete lack of knowledge or sophistication

with respect to business and financial matters. For example, she states that before 2009 she 'was not capable of understanding a checking account or credit card statement' and that she still 'is unable to understand basic financial statements.'"

- "Petitioner's testimony about the extent of her ignorance is not credible."

- "We do not find it credible that she was unaware of the legal implications of being a named party in the 2004 deficiency case."

- "If, as she contends, she truly had 'no idea' about the matters being considered, then she could and should have consulted with her attorney to clarify any misunderstanding." Instead, "[s]he chose to do nothing."

Slip op. at 4-5.

B-7. Needless to say, the Court had no difficulty rejecting the innocent spouse claim.

B-8. Ok, we can laugh about the facts. The wife's education, presumed technical competence, and participation in the trial, clearly put her way outside of innocent spouse territory. But I'm not certain that if the facts had been just a little different, that the outcome could have been different.

B-9. How many cases have we seen whether H and W are represented by the same counsel? And, in those cases, how many involve potential innocent spouse defense claims? Having read numerous tax cases over the years, I am convinced that tax litigation counsel all too often blithely assume that there is such a unity of interest between the spouses that they can represent them both, thus ignoring the innocent spouse possibilities. Why shouldn't every case in which the tax liability emanates from the actions or inactions of one spouse be reviewed by counsel for the putative innocent spouse?

C.
"LLC" DOES NOT STAND FOR "LIMITED LIABILITY CORPORATION."

Judge v. Comptroller, M.T.C. No. 17-IN-OO-0724 (September 25, 2018) (http://slnews.us/010819grne)

C-1. At issue in this case were unpaid withholding tax penalties for 2012 and 2014. The Comptroller assessed liability against Judge for these two years based upon his being a partner in the business. The business was an LLC classified as a partnership for tax purposes.

C-2. Judge and Cheeks were the only two members of the LLC, sharing their interests on a 40 (Judge)–60 (Cheeks) basis.

C-3. Judge and Cheeks entered into an agreement that provided that Cheeks would be both Managing Partner and Tax Matters Parner.

C-4. The Tax Matters Partner was required to " . . . prepare, or cause to prepared, all tax returns and reports for the Partnership and make any related elections that the Partners deem advisable."

C-5. Ms. Cheek's Capital Contribution was described as ". . . providing all Business services necessary to bring [the business] to market, while Judge's s contribution was solely to " . . . provide Collateral."

C-6. Judge withdrew from the business in 2012 and a dissolution agreement was executed on July 1, 2013. That agreement apportioned obligations of the LLC, which were incurred before its execution. Thereafter, Judge had virtually not contact with either the business or Cheeks.

C-7. In 2014 an Employer Withholding Reconciliation Report was filed for the LLC. That report was signed by Cheeks not Judge.

C-8. Oddly, Judge did not contest the 2012 assessment, but "suggests pursuant to the partnership agreement, he should only be liable for 40 percent of that assessment."

C-9. The Comptroller premised its claim for Judge's liability for the 2014 withholding tax on Tax-General Article § 10-906 (d) (3)(i) which extends liability for income tax withholding of a LLC to " . . . any person who **exercises direct control** over its fiscal management . . ." [Emphasis in the original.]. The Comptroller asserted this provision extends liability to not only a person who actually exercises "fiscal management," but to a person who simply has that authority.

C-10. The Court found that:

> [I]n 2014 [Judge] did not exercise the requisite direct control of the LLC's fiscal management. In this regard, these facts convincingly establish [he] had no engagement with the LLC that year.

C-11. The Court went on to distinguish the liability of a member of an LLC under Tax-General Art. §10-906(d)(3)(ii) with the liability of a corporate officer under See Tax-General Art. § 11-601(d)(1). In the corporate context, the liability of an officer is made " . . . without regard to [the officer's] ability to control the fiscal management of the corporation." See slip op. at 7 citing *Fox v. Comptroller*, 126 Md. App 279, 289 (1999). It is worthy of some note that *Fox* was a sales tax case, not a withholding tax case.

C-12. The Court found that Judge was liable for the 2012 taxes since he had conceded that point. However, the Court relieved Judge of liability for interest for all periods prior to the time that he became aware that the taxes were unpaid.

C-13. This case is important for the following reasons:

i. Although it is dicta, the Court made the distinction between the liability of a corporate officer for unpaid withholding taxes and that of a member of an LLC. Had Judge not conceded liability for 2012, it is quite possible that he would not have been found liable for the unpaid withholding for that year as well.

ii. The Court also set forth the principle that if a person who is liable for the tax does not know of the unpaid tax, that individual should be relieved of liability for interest for all periods prior to the time that he or she knew of the fact of the non-payment.

C-14. From a planning perspective, there is an important lesson: If possible, clearly fix the locus of responsibility for tax compliance on that individual or those individuals who will actually be responsible for tax compliance.

C-15. From a litigation perspective when facing a liability claim, flesh out the facts as to the individual who is liable for each relevant period.

D.
YOU SCREAM, I SCREAM, WE ALL SCREAM FOR MARTIN'S ICE CREAM

Jeff M. Potter, T.C.M. 2018-153 (September 17, 2018) (http://slnews.us/010819f).

D-1. Potter, an individual, worked as a sales representative for Green Country. While directly in the employ of Green Country, as an independent contractor, he entered into an agreement that provided for a hefty termination payment should Green Country ever terminate his independent sales agency relationship. At some point, Potter incorporated Potter Sales and, essentially, assigned to Potter Sales the independent sales agency. From that point on, he was a full-time employee of Potter Sales and had a compensation agreement with that company.

D-2. In 2010, Old Castle, an independent third-party, purchased all of the assets of Green Country and Potter Sales. Potter, individually, was listed as a party to the purchase agreement.

D-3. Under the Old Castle purchase agreement, Old Castle specifically did not assume any obligation for any termination payments.

D-4. Potter received from $1,729,828.00 that he treated as a payment for personal goodwill. He also received $200,000.00 as a payment for a covenant not to compete. He initially treated this payment as a capital gain, but ultimately conceded that the payment was taxable as ordinary income that, I believe, was subject to self-employment tax.

D-5. The payments to Potter were made, not directly by the purchaser, Old Castle, but by a wire transfer from Green County to Potter Sales and thence, by another wire transfer, by Potter Sales to Potter.

D-6. Apparently the only actual assets of Green Country purchased by Old Caster were "office equipment, furniture, and vehicles used for sales purposes."

D-7. The opinion does not mention whether either the seller or the buyer filed a completed Form 8594 (Asset Acquisition Statement Under Section 1060).

D-8. The Court addressed two issues: (1) whether the termination payment was for the sale of Potter's goodwill and (2) if not, whether it is subject to self-employment tax.

D-9. The Court was careful to point out that, in *Martin Ice Cream*, 110 T.C. 189 (1998), "[t]he Court decided that the goodwill was not a corporate asset in Martin Ice Cream and did not address how the individual shareholder--Mr. Strassberg--should be taxed on the payments. . . . Thus, *Martin Ice Cream* is not controlling here" Slip op. at 12.

D-10. In a very short analysis, the Court found that "Although a party to the asset purchase agreement . . . . [and] did not sell any assets." Thus, the customer relationships that Potter fostered were with the seller's clients and were not his to sell. Slip op. at 13.

D-11. Accordingly:

> [T]he . . . termination payment was for [] Potter's right to service [the seller's] clients and receive ordinary income; it was not for the sale of [his personal] goodwill, because the client contacts were not his to sell."

D-12. As to the termination payment, the Court found that:

> [T]he termination payment was tied to the quantity and quality of [] Potter's work by being based on his previous year's commissions; no adjustments unrelated to his prior services were made in calculating the payment. Therefore, the termination payment is subject to self-employment tax.

Slip op. at 16.

D-13. I'm not at all certain where the *Potter* case leaves *Martin Ice Cream* case. Is there any such animal as personal goodwill? Is it so limited that, like some rare insect or reptile, it has now become extinct?