GALLIMAUFRY
THE STUFF THAT DOESN'T REALLY FIT ANYWHERE SPECIAL
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JANUARY 9, 2019

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

[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?

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.

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[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

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[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.

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[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).

(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.]

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

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[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"?

[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 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

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[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 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.

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[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

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[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.

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.

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]

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[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.

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

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

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[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

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[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.

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).

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[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 <u>solely</u> 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.

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

[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.

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.

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.

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.

To reflect the foregoing,

An appropriate order will be issued,

and decisions will be entered under Rule

155.

In the

United States Court of Appeals

For the Seventh Circuit

No. 17-3358

FRANCES L. ROGERS,

Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appeal from the United States Tax Court.
No. 15306-15 — **Kathleen Kerrigan**, *Judge*.

ARGUED OCTOBER 29, 2018 — DECIDED NOVEMBER 19, 2018

Before BAUER, EASTERBROOK, and SCUDDER, *Circuit Judges*.

SCUDDER, *Circuit Judge*. A married couple's choice to file a joint federal income tax return results in both individuals assuming full liability for any owed tax. Frances Rogers and her husband John did so for 2004. When the Internal Revenue Service subsequently found the return deficient, the Rogerses pushed back, ultimately took the IRS to trial, and lost. Frances Rogers, a former teacher with an MBA, doctorate, and law degree, attended the trial. Three years later, and facing a substantial tax deficiency and related penalties, Mrs. Rogers sought so-called innocent spouse relief under the Internal Revenue Code. The Tax Court rejected the claim, finding that Mrs. Rogers's meaningful participation in the trial precluded her from after-the-fact seeking to avoid responsibility for those liabilities.

The IRS brought its concerns with the 2004 tax return to the Rogerses' attention through the issuance of a notice of deficiency in December 2009. The notice informed them that they owed an additional $488,177 in income taxes and underreporting penalties of $138,732. Mrs. Rogers and her husband responded by challenging the Service's position in Tax Court.

In 2012 a trial ensued to resolve the disputed tax liability. John Rogers, a Harvard-educated tax lawyer, represented himself and his wife at trial. For her part, and although not testifying at trial or otherwise presenting oral argument, Frances Rogers attended the entire trial and sat at the table reserved for taxpayer petitioners.

In July 2014 the Tax Court ruled in the IRS's favor and ordered the Rogerses to pay an income tax deficiency of $207,942 and related penalties of $77,868. Congress has made that liability joint and several. See 26 U.S.C. § 6013(d). On appeal we affirmed the Tax Court's decision. See *Rogers v. Comm'r*, No. 15-3678, slip op. (7th Cir. Nov. 3, 2016). At no point during the proceedings in the Tax Court did Mrs. Rogers (or her husband as her counsel) raise an innocent spouse claim under 26 U.S.C. § 6015.

In June 2015—three years after the trial that ended with the adverse ruling—Mrs. Rogers petitioned the Tax Court for innocent spouse relief under 26 U.S.C. § 6015(b) and (f). But

Congress has chosen to permit such relief only if the petitioner has not "participated meaningfully in [the] prior proceeding"—here the 2012 trial. *Id*. at § 6015(g)(2). In this way, Congress has implemented a variation of *res judicata* applicable to claims for innocent spouse relief pursued after a prior proceeding has reached finality and resolved a taxpayer's liability.

While the Internal Revenue Code does not delineate what constitutes meaningful participation for purposes of innocent spouse relief, courts evaluate the totality of circumstances to measure the extent of a taxpayer's involvement and engagement in the prior proceeding. See *Haag v. Shulman*, 683 F.3d 26, 31 (1st Cir. 2012). Whether Mrs. Rogers meaningfully participated in the 2012 trial is a question of fact, which we review for clear error. See *Freda v. Comm'r*, 656 F.3d 570, 573 (7th Cir. 2011).

The Tax Court held that Mrs. Rogers failed to carry her burden of demonstrating she qualified for innocent spouse relief. The bottom line for the Tax Court was that Mrs. Rogers's contention that she lacked knowledge of business and financial matters, including complex tax matters, and otherwise did not understand what transpired during the 2012 trial lacked credibility. Section 6015(g)(2), the Tax Court reasoned, does not afford innocent spouse relief to individuals who feign ignorance or choose to remain willfully blind to their own tax predicament. Nor, the Tax Court underscored, did Congress intend to afford such relief to someone like Mrs. Rogers who had every opportunity to raise her claim during the 2012 trial.

On appeal Mrs. Rogers contends that a disclosure violation by the IRS should have precluded the Tax Court from considering the Commissioner's argument that she was barred from seeking innocent spouse relief. As Mrs. Rogers would have it, the IRS was bound under provisions in its Internal Revenue Manual to notify her before the 2012 trial of her right to request innocent spouse relief. That it failed to do so, she contends, means that the Tax Court should not have permitted the Service to invoke the meaningful participation bar in § 6015(g)(2).

We cannot agree. Even assuming that Mrs. Rogers could establish that she did not receive a particular disclosure, she has identified no authority that a disclosure shortcoming precluded the Service from taking the position that she was not entitled to innocent spouse relief. See *Matter of Carlson*, 126 F.3d 915, 922 (7th Cir. 1997) (explaining that the "[p]rocedures in the Internal Revenue Manual are intended to aid in the internal administration of the IRS; they do not confer rights on taxpayers"). This argument need not detain us further.

Mrs. Rogers's position on the merits fares no better. 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."

The Tax Court stood on solid ground when rejecting Mrs. Rogers's position. See *Frierdich v. Comm'r*, 925 F.2d 180, 185 (7th Cir. 1991) (explaining that the Tax Court is not required to accept a taxpayer's testimony as absolute fact). Credibility matters. This principle applies with particular force where, as here, the taxpayer's testimony is self-serving and at odds with her education and experience.

The Tax Court also found that Mrs. Rogers's participation through her counsel, an experienced tax attorney, in the prior Tax Court proceedings indicated she participated meaningfully. Based on our review of the record, we cannot say any of these findings reflect clear error.

Accordingly, we AFFIRM.

TERRANCE JUDGE	*	IN THE
	*	
v.		MARYLAND TAX COURT
	*	
COMPTROLLER OF THE TREASURY	*	No. 17-IN-00-0724
	*	

MEMORANDUM AND ORDER

This case arises from Petitioner, Terrence Judge, being assessed by the Respondent, Comptroller of Maryland ("Comptroller"), for the unpaid withholding tax of LOCS of Beauty, LLC ("LLC"), for tax years 2012 and 2014. The asserted liability is premised on Petitioner being a partner in the LLC.

Ms. Cheeks was a hair stylist, whose services the Petitioner had used. The LLC was formed in 2010 to secure the purchase of the ongoing hair stylist business, where Ms. Cheeks had worked. Ms. Cheeks wanted to concentrate on the salon and Petitioner planned to "help her out" with the business aspects of the operation.

Petitioner and Ms. Cheeks executed a partnership agreement on May 19, 2010, in which they were designated as the only partners. (Respondent's Exhibit 103.) Ms. Cheeks and Petitioner allocated the partnership interest 60% and 40%, respectively. The agreement provided Ms. Cheeks would be both the Managing Partner and Tax Matters Partner. 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." Ms. Cheek's Capital Contribution was described as "...providing all Business services necessary to bring The Best little Hair house in Town to market, while Petitioner' s contribution was solely to "···provide Collateral."

As it had become apparent to Petitioner "that both [were] over our heads," Petitioner "completely withdrew" from the business in 2012. At that time, Petitioner had assumed previously incurred financial liabilities for the business. He had funded business expenses with an American Express card he secured for the business and withdrawals from the retirement account he had as a Federal government employee.

A dissolution agreement for the LLC was executed July 1, 2013. (Respondent's Exh. 104). It noted the partners "...desire to dissolve the partnership and liquidate its affairs." At Appendix A, the agreement apportioned obligations of the LLC, which were incurred before its execution. Petitioner "never went to the shop" and did not talk to Ms. Cheeks after the execution of the dissolution agreement, except for a single conversation three months before the February 7, 2018 Tax Court hearing.

Petitioner had a tax preparer prepare his tax returns. In Petitioner's 2012 and 2013 returns, a loss was reported for the LLC. (Petitioner's Exh. 1 & 2). Petitioner advised his tax preparer that as of June 2013 he "...was out of the partnership." In his 2014 return, the LLC is listed, but no loss is noted. (Respondent's Exh. 107).

In 2014 an Employer Withholding Reconciliation Report was filed for the LLC. (Respondent's Exh. 106). Counsel for the Comptroller conceded that Ms. Cheeks and not the Petitioner signed the Report.

Petitioner noted that while he was engaged in the business, Ms. Cheeks was diverting funds generated by the business to another LLC in which the Petitioner did not have an interest. He premised this suggestion upon him finding a second credit card processing terminal at the salon, which credited payments to the other LLC.

Petitioner does not contest the 2012 assessment, but suggests pursuant to the partnership agreement, he should only be liable for 40 percent of that assessment. He testified though that until he received a March 3, 2017 notice, he had "no clue" of an outstanding tax obligation, having "thought everything was taken care," commensurate with the dissolution agreement's execution.

The Comptroller premises Petitioner'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 added]. The Comptroller asserts this provision extends liability to not only a person who actually exercises "fiscal management," but to a person who simply has that authority.

A statutory construction analysis establishes the Comptroller's assertion of liability is too broad. Applying this analysis to the facts results in a finding that in 2014 the Petitioner did not exercise the requisite direct control of the LLC's fiscal management. In this regard, these facts convincingly establish Petitioner had no engagement with the LLC that year.[1]

Initially, a statutory analysis begins with a consideration of the plain language of the section 10-906 (d) (3) (i). *Hastings v. PNC Bank, NA*, 429 Md. 5, 36 (2012); *Frey v. Comptroller*, 422 Md. 111, 182-183 (2011). The term "exercise" is defined, in relevant part, as "...to make effective in action···" or "..to bring to bear..." and, the term "direct" is defined, in relevant part, as "···having no compromising or impairing element.." or "...marked by absence of an intervening agency, instrumentality, or influence..." *Merriam-Webster Collegiate Dictionary*, 10th Edition, 438 & 406, respectively, (1999). These terms of common parlance clearly establish, at the least, an actual engagement in fiscal management is required for liability to arise. "When a statute's plain language is unambiguous, we need only to apply the statute as written, and our efforts to ascertain the legislature's intent end there. [citations omitted]" *Hastings PNC Bank, NA, supra*. at 36; See also *Frey v. Comptroller, supra*. 182-183.

If the General Assembly wished to extend liability, as the Comptroller urges, it would have specifically done so, as it did in *Estates & Trusts Article* § 15-113 (1). That provision, in relevant part, extends joint and several liability to an entity that controls a trust company, if the trust company "**[m]ay** exercise trust or fiduciary

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[1] The only evidence Respondent presented to support Petitioner's 2014 involvement with the LLC is the LLC's listing in Petitioner's 2014 return. No loses or gains for the LLC were indicated in that return, as they were in the 2012 and 2013 returns. Hence, the Court concludes the listing was simply a placeholder with no significance. The Petitioner testifying he had advised his tax preparer that as of June 2013 he "was out of the partnership" supports this conclusion.

powers in the State.." [emphasis added]. Hence, the provision envisions liability when a person not only does exercise powers, but also may exercise those powers.

If "exercise" in Section 10-906 (d) (3) (i) had been modified with "may" the Comptroller's suggested interpretation would be convincing. But, it was not and the contrast between the two sections is entitled to weight in rejecting the Comptroller's asserted interpretation. See *Lyon v. Campbell*, 324 Md. 178, 185-186 & 189 (1991); *Rosecroft Trotting & Pacing Association, Inc. v. Prince George's County*, 298 Md. 580, 594 (1984); *Fox v. Comptroller*, 126 Md. App 279, 287-288 (1999)

In *Comptroller v. House*, 68 Md. App. 560 (1986) the Court considered statutory language parallel to the language of Section 10-906 (d) (3) (i). The undertaken analysis in the context of facts viewed relevant by the Court indicates the "exercise" of "direct control" requires actual engagement and not just the ability to engage, as the Comptroller suggests."

The then applicable statute before the Court was *Article 81* § 312(h)(4), which, in relevant part, rendered a corporate officer liable for withholding tax if that officer "···exercises direct control over the fiscal management of the corporation." In affirming the Tax Court's decision that Appellee, Dr. Homer House, exercised sufficient "direct control" to render him liable for the withholding tax, the Court noted that Dr. House "...(1) advised...[the corporations' president] of business opportunities, as well as potential business risks; (2) involved himself in the acquisition of a piece of equipment essential to ···[the corporation's] business; and, (3) played a significant role in attempting to extricate... [the corporation] from it's financial problems." *Id* .at 568.[2] It is apparent that Dr. House, unlike the Petitioner herein, was actually engaged in the corporation's affairs to the extent that he exercised the requisite "direct control over the fiscal management." [3]

The Comptroller, relying on *Fox v. Comptroller, supra.* at 289, argues an absurdity would arise if actual exercise of fiscal authority were required. That reliance is misplaced, as the absurdity suggested was the ability of corporate officers, in the context of their statutorily unrestricted liability for sales and use tax, to avoid that unrestricted personal liability by assigning tax payment responsibility to a third person. This potential absurdity is avoided in the context of a LLC as *Tax General* §10-906 (d) (3) (ii) imposes liability for unremitted withholding tax on "... any agent of the limited liability company or limited liability partnership who is

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[2] The Court earlier cited the following facts regarding Dr. House's engagement with the corporation:

1. He was a majority shareholder of the corporation;
2. He was listed in filings as the "Owner or Responsible Officer" of the corporation;
3. He offered advise to the Corporation's president regarding the viability of a contract and on several occasions of business opportunities;
4. He directed the president to fire an employee;
5. He raised the need for a computer and was involved in the purchase of that computer;
6. The annual corporate meetings were held at his house; and
7. As the corporation's finances deteriorated, he made loans to the company, had his wife manage check writing, became the sole authorized signatory of checks, and convened a meeting with his accountant and the president. *Id.* At 564-565

[3] The Court did reject "...the circuit court's construction of 'direct control' as meaning day to day control," noting that construction was "...inordinately narrow and contravenes the intent of art. 81, § 312(h)(4)." *Comptroller v. House, supra.* at 568. Regardless, the Petitioner's engagement in the LLC was always markedly less the Dr. House's engagement with the corporation and was non-existent during the time when the 2014 tax withholding obligation was incurred.

required to withhold and pay the income tax."[4] In addition, it is difficult to envision a circumstance when no member of a functioning LLC would exercise direct fiscal responsibility.

Fox is further inapplicable as it concerned a statutory provision that imposed absolute liability on a corporate officer, which Appellant Fox was determined to be, for sales and use tax "...without regard to their ability to control the fiscal management of the corporation." *Id.* At 289, See *Tax General Article* § 11-601 (d) (1). The Court continued in *dicta* to suggest even if fiscal control was required, Appellant Fox would be liable, as he was authorized to sign checks on three corporate accounts without any co-signatory and did so; managed a corporation-owned store; was responsible for collecting sales receipts from that store, including sales and use tax receipts, and depositing those receipts; and guaranteed or assumed personal liability for corporate debt. Hence, the Court's analysis, as did the previously cited analysis in *Comptroller v. House, supra.*, indicates an actual exercise of direct fiscal management is required for liability to arise for the subject 2014 assessment of the Petitioner.

The Comptroller cites two Tax Court decisions to support the contention that mere authority, without the actual exercise of that authority, is sufficient for liability to arise pursuant to Section 10-906 (d) (3)(i). *Roderick v. Comptroller*, 1981 WL 1991 (Md. Tax Ct. 1981) & *Christy v. Comptroller*, 1982 WL 1768 (Md. Tax Ct. 1982).

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[4] In discussing the legislative history of the applicable section, the Court cited Senate Bill 642 of the 1992 Session, which specifically struck a provision imposing liability on "...any agent of the corporation who has to collect or pay the sales and use tax. "

Both cases concerned the statutory provision establishing the corporate officer's withholding tax liability for "...exercising direct control over the fiscal management of the corporation." *Article 81* § 312(h)(4). The Court does not find these administrative decisions instructive, as they were issued before the *House* and *Fox* decisions cited above. Regardless, the facts relied upon by the Tax Court in both cases present a more intense engagement by the Petitioner in the business affairs than the engagement of the Petitioner in the case at bar.

In *Christy v. Comptroller, supra.*, the Tax Court noted the Petitioner "...signed payroll checks and.. [allocated] a $10,000 contribution to bills and expenses **during the period in question..**" [emphasis added]; was the only officer capable of " direct[ing] finances ; co-signed the withholding tax application as 'responsible officer' ; and wrote the amount required to be "...withheld and remitted on the face of checks. *Id.* at 5-6. In *Roderick v. Comptroller*, supra., the Tax Court noted the Petitioner was president of the corporation; owned 60% of the stocks; could cosign checks and "...received a salary during **the subject period.**" [5] [emphasis added] While the Tax Court noted the facts... "[led it] ...to include that Petitioner exercised or was capable of exercising sufficient fiscal control to render him personally liable..." the reference to being "capable" appears as surplusage since the articulated facts evidenced an actual exercise of fiscal control. [6]

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[5] In both cases, the Tax Court appears to have limited its liability analysis to the specific period when the liability was incurred, as does the Court in this liability analysis.

Petitioner complained that before he received a March 3, 2017 notice of assessment, he was not aware of an outstanding tax obligation. He "thought everything was taken care," commensurate with the dissolution agreement's execution. As the Petitioner appeared *pro se* and is not an attorney, the Court views this complaint as a request for an abatement of the interest and penalty up until the March 3, 2017 notice.

The Petitioner's assertion regarding his awareness of the outstanding tax obligation is credible. It was reasonable for him to presume that all pending obligations were addressed with the dissolution agreement. This is borne out as there is no apportionment of liability at Appendix A of the agreement for the withholding tax as there is for other obligations. In addition, Ms. Cheeks, as the designated Tax Matters Partner, was responsible for remitting withheld tax. Hence, the Court must now consider whether this factual predicate establishes sufficient reasonable cause for the requested abatement of interest and penalty. See *Frey v. Comptroller*, 422 Md. 111(2011).

The Court does find there is sufficient reasonable cause to waive penalty accrued before March 3, 2017, as the facts indicate the Petitioner was not aware of the obligation until that date. Insofar as interest, the Court finds convincing the Comptroller's suggestion a more rigorous standard is to be applied than for a penalty waiver, as interest is to compensate for the State's loss of income and not to

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[6] The Comptroller presented a convincing and thorough argument that the dissolution agreement did not extricate Petitioner from the partnership. But, the Court does not address this argument, as the Court's statutory construction analysis is dispositive.

punish. Since Petitioner did not elect to pay the uncontested tax liability upon becoming aware of that liability, the Court does not find sufficient cause to waive interest.

Accordingly, it is this 25th day of September, 2018, by the Maryland Tax Court **ORDERED** that Petitioner is fully liable for withholding tax for 2012[7], but not for 2014; is not liable for any penalty incurred before March 3, 2017, but is fully liable for interest; and is liable for penalty incurred after March 3, 2017. [8]

CC: Terrance Judge
Brian L. Oliner, Esq.

CERTIFIED TRUE COPY
TEST: John T. Hearn, Clerk

NOTICE: You have the right of appeal from the above Order to the Circuit Court of any County or Baltimore City, wherein the property or subject of the assessment may be situated. The Petition for Judicial Review **MUST** be filed in the proper Court within thirty (30) days from the date of the above Order of the Maryland Tax Court. Please refer to Rule 7-200 et seq. of the Maryland Rules of Court, which can be found in most public libraries.

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7 Petitioner's argument that his liability is limited to forty percent, as that is his interest as defined in the partnership agreement, is rejected, as the partnership agreement cannot take precedence over the statutorily established liability. See *Fox v. Comptroller, supra*. at 288-289

8 Issues raised not specifically addressed by the Court were deemed de minimis.

T.C. Memo. 2018-153

UNITED STATES TAX COURT

JEFF M. POTTER AND MARSHA R. POTTER, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

POTTER SALES, INC., Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 4972-14, 5754-14. Filed September 17, 2018.

Steven P. Flowers, for petitioners.

William F. Castor, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

PARIS, Judge: These cases have been consolidated for trial, briefing, and opinion. Respondent determined deficiencies and accuracy-related penalties under section 6662(a) relating to the Federal income tax of Jeff M. Potter and Marsha R.

[*2] Potter and Potter Sales, Inc. (Potter Sales).[1] For the Potters, respondent determined deficiencies of $6,674 and $4,728 and accuracy-related penalties of $81,629.40 and $945.60 for 2010 and 2011, respectively. For Potter Sales, respondent determined deficiencies of $81,260 and $598 and accuracy-related penalties of $16,252 and $119.60 for 2010 and 2011, respectively.

After concessions,[2] the issues for decision are: (1) whether the termination payment Green Country Soils, Inc. (Green Country), paid to Mr. Potter in 2010 was capital gain or ordinary income; (2) if the termination payment was ordinary income, whether it is subject to self-employment tax; (3) which taxpayer--Mr. Potter, individually, or Potter Sales--entered into the cowboy mounted shooting activity (activity) for the years in issue; (4) if the activity was Mr. Potter's, whether the activity was entered into for profit for the years in issue; and

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

[2]Petitioners concede that: (1) Mr. and Mrs. Potter received a constructive dividend of $20,172 in 2010, see infra pp. 5-6 and note 7; (2) the $200,000 Mr. Potter received in 2010 for a covenant not to compete with Oldcastle Lawn & Garden, Inc. (Oldcastle), was ordinary income; and (3) Potter Sales is liable for unreported gross receipts of $7,950 for 2010. The parties also made several concessions in the stipulation of facts regarding Potter Sales' expenses reported on the Forms 1120, U.S. Corporation Income Tax Return, and these concessions will be binding in the Rule 155 computations.

[*3] (5) whether petitioners are liable for accuracy-related penalties for the years in issue.[3]

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The first stipulation of facts and facts drawn from the stipulated exhibits are incorporated herein by this reference. Mr. and Mrs. Potter resided in Oklahoma and Potter Sales had its principal place of business in Oklahoma when they timely filed their petitions.

I. Working With the Family Business

Mr. Potter began working with Green Country in the early 1990s. Mr. Potter's younger brother was Green Country's president and majority shareholder. In 1995 Mr. Potter--in his individual capacity--entered into a written independent sales representative compensation agreement (compensation agreement) with Green Country. Under the compensation agreement Mr. Potter was treated as an independent contractor and received a commission on all sales of Green Country

[3]Respondent also determined that the Potters were liable for alternative minimum tax for 2011. This determination was computational and will not be discussed further.

[*4] products to any person or entity whose account he either served or obtained.[4] The compensation agreement also provided that if either party terminated the agreement Mr. Potter would be entitled to an amount equal to 1-1/2 times his commissions for the previous year. He also had the option to declare the compensation agreement terminated if Green Country was ever sold or transferred. The compensation agreement provided that Mr. Potter could not assign or transfer his obligations under the agreement without Green Country's written consent.

Mr. Potter incorporated Potter Sales in 1998. At all relevant times he was its sole shareholder and president. He was also a full-time employee of Potter Sales. From its incorporation until 2010, Mr. Potter performed his duties under the compensation agreement as Potter Sales.[5] All commissions earned were then paid to Potter Sales. From at least 2005 and through the years in issue, it, in turn, paid a salary to Mr. Potter and issued him Forms W-2, Wage and Tax Statement. During that time Potter Sales' only client was Green Country, and Mr. Potter

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[4]Green Country bagged and sold potting and top soils, manures, peat, mulches, and rocks.

[5]There is no evidence in the record of Green Country's written consent to Mr. Potter's performance of his duties under the compensation agreement through Potter Sales.

[*5] routinely worked longer than 12 hours a day selling Green Country's products. At no time was Mr. Potter a shareholder or officer of Green Country.

In 2010 Oldcastle, a garden soil competitor, approached Green Country regarding selling its assets and existing sales contracts in an attempt to move into Green Country's marketing areas. Soon thereafter Green Country and Potter Sales entered into an asset purchase agreement (purchase agreement) with Oldcastle. Green Country's number one sales representative, Mr. Potter, in his individual capacity, is also listed as a party to the purchase agreement. Oldcastle acquired all of Green Country's and Potter Sales' assets. The assets Oldcastle acquired from Potter Sales were office equipment, furniture, and vehicles used for sales purposes. Neither Potter Sales nor Mr. Potter received any compensation for those items under the purchase agreement. The purchase agreement with Oldcastle specifically excluded the assumption of certain liabilities, including any termination payments.

The Green Country compensation agreement terminated upon Oldcastle's purchase of Green Country. Mr. Potter and Green Country agreed that Mr. Potter was entitled to a termination payment equal to 1-1/2 times his commissions from the previous year, totaling $1,729,828.40. On October 15, 2010, Green Country completed a wire transfer of $1,929,828.40 to Potter Sales' bank account--the

[*6] termination payment plus payment for the covenant not to compete of $200,000 due to Mr. Potter under the purchase agreement.[6] Potter Sales recorded the $1,929,828.40 as a liability to Mr. Potter in its general ledger. On November 2, 2010, Potter Sales completed a wire transfer of $1,750,000 to Mr. Potter.[7] Potter Sales recorded the transfer as a debit to its "Notes Payable - Jeff Potter" account.

II. Want To Be a Cowboy?

With a bit of free time on his hands, a history of working long hours, and the desire to continue working, Mr. Potter began looking for something to fill his days. Several years before the Oldcastle sale he had been introduced to the activity, which is a timed event where an individual rides a horse through a

[6]There is no explanation in the record as to why Green Country paid the $200,000 due to Mr. Potter under the purchase agreement when the covenant not to compete was entered into between Mr. Potter and Oldcastle. Although originally reported as the sale of a capital asset on the Schedule D, Capital Gains and Losses, attached to their 2010 Form 1040, U.S. Individual Income Tax Return, petitioners conceded the $200,000 was ordinary income, see supra note 2, so the Court will not concern itself with the issue.

[7]The Potters conceded that the difference between the termination payment of $1,729,828 and the $1,750,000 Potter Sales transferred--$20,172--was a constructive dividend in 2010. See supra note 2.

[*7] designated course while shooting a firearm at targets.[8] The activity is governed by two organizations--the Cowboy Mounted Shooting Association (CMSA), formed in the mid-1990s, and the Mounted Shooters of America (MSA), formed in 2000.

In late 2009 Mr. Potter began taking lessons for the activity. He had previously purchased a horse, Dakota, for pleasure riding. After some training Dakota proved quite adept at learning the activity. During the years in issue Mr. Potter entered CMSA events. Potter Sales paid the events' entry fees and other expenses related to the activity. CMSA paid prize money won at the events directly to Mr. Potter and issued him Forms 1099-MISC, Miscellaneous Income, for such payments during the years in issue. All prize money won was deposited into Potter Sales' bank account.

In 2010, after Mr. Potter and Dakota successfully competed in the CMSA world competition, Potter Sales purchased a Chevrolet Silverado pickup truck for $48,205.46, a large horse trailer with living quarters for $104,500, and a tractor for

[8]The rider's firearm is loaded with primer and black powder that will shoot approximately 20 feet and make contact with the targets, i.e., balloons. The embers of the powder burst the balloons.

[*8] $9,250 to be used in the activity.[9] Each of these assets was recorded on Potter Sales' books as a capital asset subject to depreciation and reported on the depreciation schedule attached to its 2010 Form 1120.

III. The Income Tax Returns, the Agreement to Assess, and the Notices of Deficiency

On their 2010 Form 1040 the Potters reported the termination payment of $1,729,828 as the sale of goodwill and the covenant not to compete payment of $200,000 as capital gain. They also attached a Schedule C, Profit or Loss From Business, for the activity to their 2010 return. They reported the CMSA events prize money as gross receipts, claimed cost of goods sold equal to the gross receipts, and reported a net profit of zero on the basis that Mr. Potter was paid the prize money as Potter Sales' nominee. They reported the 2011 CMSA prize money in the same manner. Potter Sales reported the CMSA prize money as gross receipts for 2010 and 2011. It also claimed deductions for expenses related to the activity. Potter Sales did not include the termination payment or the covenant not to compete payment on its 2010 Form 1120 in any manner. The Potters and Potter Sales had the same certified public accountant (CPA) prepare the returns for both

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[9]By 2014 Mr. Potter was a successful competitor and had won several national titles in the activity, including the MSA nonpro world title and the amateur American Paint Horse Association world title, and finished second in the CMSA world competition.

[*9] years in issue. Mr. Potter discussed the termination payment and the activity on several occasions with his CPA. Additionally, petitioners gave their CPA all the information necessary for him to prepare their Federal income tax returns. At the time of trial their CPA had been a licensed CPA for 35 years, and he had prepared the Potters' income tax returns for approximately that long. He has also prepared Potter Sales' income tax returns since its incorporation.

On May 13, 2013, during a review of the Green Country sale, the Potters' previous legal representative signed Form 870, Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment, agreeing to an assessment of tax of $401,473 for 2010. Form 4549-A, Income Tax Discrepancy Adjustments, dated May 8, 2013, lists the termination and the covenant not to compete payments as the adjustments. Those payments were changed from capital gain to ordinary income subject to self-employment tax. There is no penalty listed on the Form 870 or the accompanying Form 4549-A. Form 870 includes the following statement: "I understand that by signing this waiver, I will not be able to contest these years in the United States Tax Court unless additional deficiencies are determined for these years." The tax assessed has been paid.

[*10] On December 3, 2013, respondent issued the Potters a notice of deficiency determining deficiencies of $6,674 and $4,728 and accuracy-related penalties of $81,629.40 and $945.60 for 2010 and 2011, respectively. Respondent's position is that the accuracy-related penalty reflected on the notice of deficiency for 2010 relates back to the assessment on the Form 870. Respondent also issued Potter Sales a notice of deficiency dated December 3, 2013, determining deficiencies of $81,260 and $598 and accuracy-related penalties of $16,252 and $119.60 for 2010 and 2011, respectively.

IV. Respondent's Motion To Reopen the Record

On January 12, 2018, respondent filed a motion to reopen the record to submit additional evidence. Attached to the motion is the declaration of Laura L. Vidal, who was the immediate supervisor of the revenue agent who conducted the examination of the Potters' and Potter Sales' returns. Also attached to the motion are two Civil Penalty Approval Forms (penalty approval form)--one for the Potters and one for Potter Sales--that Ms. Vidal signed.

OPINION

I. Burden of Proof

Generally, the Commissioner's determination of a deficiency is presumed correct, and the taxpayer bears the burden of proving it incorrect. See Rule

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[*11] 142(a); Welch v. Helvering, 290 U.S. 111, 115 (1933). Moreover, deductions are a matter of legislative grace, and the taxpayer bears the burden of proving his entitlement to any deductions claimed. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934).

Under certain circumstances the burden of proof as to factual matters regarding the determination of a deficiency may shift to the Commissioner pursuant to section 7491(a). Petitioners did not argue for a burden shift under section 7491(a), and the record does not establish that the prerequisites for a burden shift have been met; therefore, the burden of proof remains theirs.

II. The Termination Payment

The Potters agreed to an assessment of $401,473 for 2010, which included tax on the termination payment as ordinary income subject to self-employment tax. A taxpayer's consent to assessment and collection on a Form 870 merely frees the Commissioner from the obligation to issue a notice of deficiency before assessment. Elco Constr. Co. v. Commissioner, T.C. Memo. 1965-259, 24 T.C.M. (CCH) 1406, 1410 (1965). Respondent's subsequent issuance of the notice of deficiency determining an additional deficiency for 2010 and petitioners' filing a timely petition give the Court jurisdiction over the entire year, including the

[*12] amount which the Potters agreed to have assessed on the Form 870. See sec. 6214(a); Bowman v. Commissioner, 17 T.C. 681 (1951). The Court must answer two questions about the termination payment: (1) whether it was for the sale of Mr. Potter's goodwill and (2) if not, whether it is subject to self-employment tax.

A. Goodwill?

The questions of whether goodwill existed and was transferred are questions of fact. Butler v. Commissioner, 46 T.C. 280, 287 (1966). Petitioners scream for Martin Ice Cream Co. v. Commissioner (Martin Ice Cream), 110 T.C. 189 (1998), to rule the day because what Mr. Potter "sold" were his relationships with the various buyers of Green Country's products. In Martin Ice Cream, 110 T.C. at 207-208, the Court held that the benefits of the relationships with supermarket chains that a shareholder, Arnold Strassberg, cultivated were not the corporation's assets; Mr. Strassberg was the owner and seller of those assets. Thus, the corporation--Martin Ice Cream Co.--was not liable for tax due on payments for the shareholder's assets. The 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. See Kennedy v. Commissioner, T.C. Memo. 2010-206, 100 T.C.M. (CCH) 268, 274-275 (2010). Thus, Martin Ice Cream is not controlling here.

[*13] What is controlling is the fact that Mr. Potter did not sell a trade or business. See Baker v. Commissioner, 118 T.C. 452 (2002) (holding that the taxpayer did not sell a trade or business to which goodwill could attach), aff'd, 338 F.3d 789 (7th Cir. 2003). "To qualify as the sale of goodwill, the taxpayer must demonstrate that he sold 'the business or a part of it, to which the goodwill attaches.'" Id. at 465 (quoting Schelble v. Commissioner, 130 F.3d 1388, 1394 (10th Cir. 1997), aff'g T.C. Memo. 1996-269). Although a party to the asset purchase agreement between Oldcastle and Green Country, Mr. Potter did not sell any assets to Oldcastle or to Green Country. The word "sale" means "a transfer of property for a fixed price in money or its equivalent". Schelble v. Commissioner, 130 F.3d at 1394 (quoting Iowa v. McFarland, 110 U.S. 471, 478 (1884)); see also Commissioner v. Brown, 380 U.S. 563, 571 (1965). Potter Sales' office furniture, computers, and vehicles were included in the assets Oldcastle acquired when it purchased Green Country's assets, but it paid nothing for them.[10] Additionally, Potter Sales had only one client, Green Country. The relationships that Mr. Potter fostered were with Green Country's clients; the client contacts were not his to sell. See Foxe v. Commissioner, 53 T.C. 21, 26 (1969) (finding that an insurance

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[10]Nor did Mr. Potter "exchange" property for another property that was materially different in either kind or extent. See sec. 1.1001-1(a), Income Tax Regs.

[*14] salesman's personal contacts with customers did not amount to goodwill because the insurance company owned the customer contacts). Therefore, the 2010 termination payment was for Mr. Potter's right to service Green Country's clients and receive ordinary income; it was not for the sale of Mr. Potter's goodwill, because the client contacts were not his to sell.

B. Self-Employment Income?

Mr. Potter entered the compensation agreement with Green Country as an independent contractor, and it expressly stated that the parties agreed that he was an independent contractor. Sometime soon after that he incorporated Potter Sales, and Green Country began paying all of his commissions to the corporation. Mr. Potter was a salaried employee of Potter Sales. Although express written agreement was required before Mr. Potter could assign or transfer his obligations under the compensation agreement, no such written agreement between Mr. Potter and Green Country assigning or transferring his obligations to Potter Sales was entered into evidence. But Green Country paid Potter Sales the commissions Mr. Potter earned for at least 12 years. The compensation agreement provided that Mr. Potter was entitled to the termination payment if Green Country terminated his employment without cause, if he terminated his relationship with Green Country, or if the controlling interest of Green Country was sold or transferred. The basis

[*15] for the termination payment was Mr. Potter's commissions from the previous year. The parties stipulated that the termination payment was Mr. Potter's and not Potter Sales'.

Section 1401 imposes a tax upon each individual's "self-employment income". Section 1402(b) defines "self-employment income" as "net earnings from self-employment" with certain exceptions not relevant here. Section 1402(a) defines "net earnings from self-employment" as "gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business". For income to be taxable as self-employment income, "there must be a nexus between the income received and a trade or business that is, or was, actually carried on." Newberry v. Commissioner, 76 T.C. 441, 444 (1981). For there to be a "nexus" and the income to be subject to self-employment tax, the income must arise from some actual--past, present, or future--income-producing activity of the taxpayer. Id. at 446. Additionally, gross income derived from a taxpayer's trade or business may be subject to self-employment tax even when it is attributable in whole or in part to services rendered in a prior taxable year. Sec. 1.1402(a)-1(c), Income Tax Regs. "[S]elf-employment income is determined by the source of the income, not the taxpayer's status at the time the income is realized." Schelble v.

[*16] Commissioner, 130 F.3d at 1392 (alteration in original) (quoting Shumaker v. Commissioner, 648 F.2d 1198, 1200 (9th Cir. 1981), aff'g in part, rev'g in part T.C. Memo. 1979-71).

Green Country and Mr. Potter agreed that he was an independent contractor. Additionally, petitioners and respondent stipulated that the termination payment was Mr. Potter's money, not Potter Sales'. The termination payment was calculated by multiplying Mr. Potter's previous year's commissions by 1-1/2. Thus if Mr. Potter had earned no commissions in the previous year, the termination payment would have been zero. The termination payment was tied to the quantity and quality of Mr. 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. See Schelble v. Commissioner, 130 F.3d at 1393. Therefore, the termination payment is subject to self-employment tax.[11]

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[11]The Court notes that this decision follows the U.S. Court of Appeals for the Tenth Circuit--the Circuit in which, absent an agreement between the parties otherwise, these cases are appealable, see sec. 7482(b)--and does not rely on Jackson v. Commissioner, 108 T.C. 130, 140 (1997), which held that "[i]n the interest of promoting uniformity, consistency, and fairness in the disposition of this issue with respect to former insurance agents who receive termination payments under similar contractual agreements, we follow the decision" in Milligan v. Commissioner, 38 F.3d 1094 (9th Cir. 1994), rev'g T.C. Memo. 1992-655. The U.S. Court of Appeals for the Ninth Circuit had reversed the Tax Court, holding that the termination payment due an insurance salesman did not derive

(continued...)

[*17] III. Whose Activity, Anyway?

In the notice of deficiency respondent also determined that the activity was not entered into for profit under section 183. Respondent disallowed all of the claimed deductions associated with the activity and included the prize money won for each year as income to the Potters. The parties then stipulated that all of the deductions had been properly substantiated and that if the Court found that the activity was for profit then Potter Sales properly claimed the deductions. Through their stipulation the parties have recrafted the question to be who performed the activity--Mr. Potter in his individual capacity or Potter Sales as a corporation--because section 183 does not apply to C corporations. See sec. 183(a) ("In the case of an activity engaged in by an individual or an S corporation, if such activity

[11](...continued)
from the quality and quantity of his work and was therefore not subject to self-employment tax. Both Jackson and Milligan were about termination payments made to insurance salesmen--and had fact patterns similar to those of many other cases concerning termination payments to insurance salesmen--and the holding in Jackson sought to bring uniformity to that subset of termination payment cases. That "uniformity, consistency, and fairness" does not mean that every case about termination payments must be decided under the holding in Jackson. See Kennedy v. Commissioner, T.C. Memo. 2010-206 (finding that payments received in connection with the sale of an employee benefits consulting business were not capital gain but ordinary income subject to self-employment tax). The U.S. Court of Appeals for the Tenth Circuit has also contrasted other termination payment cases from Milligan. See Schelble v. Commissioner, 130 F.3d 1388 (10th Cir. 1997), aff'g T.C. Memo. 1996-269; Golsen v. Commissioner, 54 T.C. 742, 757 (1970), aff'd, 445 F.2d 985 (10th Cir. 1971).

[*18] is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section." (Emphasis added.)); sec. 1.183-1(a), Income Tax Regs. (stating that no inference may be drawn from section 183 and its regulations as to whether a C corporation is engaged in an activity for profit); see also Knutsen-Rowell, Inc. v. Commissioner, T.C. Memo. 2011-65 (finding section 183 inapplicable to corporate doll business); Misko v. Commissioner, T.C. Memo. 2005-166 (stating that section 183 does not apply to C corporations).

No evidence was entered into the record questioning Potter Sales' corporate validity. Indeed, respondent has conceded that the deductions related to the activity belong to Potter Sales. There is nothing to preclude Potter Sales from operating multiple trades or businesses or changing from one trade or business to another. That is exactly what happened here; Potter Sales stopped selling potting soil and began operating the activity as its trade or business. The fact that Mr. Potter was the named rider in the competitions does not preclude the activity from being that of Potter Sales. The Court finds that Mr. Potter received any prize winnings as Potter Sales' nominee. Potter Sales performed the activity as a trade or business; section 183 does not apply.

[*19] IV. Accuracy-Related Penalty

Section 6662(a) and (b)(1) and (2) authorizes a 20% penalty on the portion of an underpayment attributable to: (1) negligence or disregard of rules or regulations or (2) a substantial understatement of income tax. Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code, and "disregard of rules or regulations" includes any careless, reckless, or intentional disregard. Sec. 6662(c). Negligence is determined by testing a taxpayer's conduct against that of a reasonable, prudent person. Zmuda v. Commissioner, 731 F.2d 1417, 1422 (9th Cir. 1984), aff'g 79 T.C. 714 (1982). For individual taxpayers there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of 10% of the tax required to be shown on the return for the taxable year or $5,000. Sec. 6662(d)(1)(A). For corporations there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the lesser of 10% of the tax required to be shown on the return for the taxable year (or, if greater, $10,000) or $10 million. Sec. 6662(d)(1)(B).

Under section 7491(c) the Commissioner bears the burden of production regarding penalties related to individual taxpayers. Higbee v. Commissioner, 116

[*20] T.C. 438, 446 (2001). That burden of production includes evidence that the penalties were "personally approved (in writing) by the immediate supervisor of the individual making such determination." Sec. 6751(b)(1); Chai v. Commissioner, 851 F.3d 190, 221 (2d Cir. 2017), aff'g in part, rev'g in part T.C. Memo. 2015-42; Graev v. Commissioner, 149 T.C. ___, ___ (slip op. at 14) (Dec. 20, 2017), supplementing and overruling in part 147 T.C. 460 (2016). Once the Commissioner has met the burden of production, the taxpayer has the burden of proving that the penalties are inappropriate because of reasonable cause or, in the case of a substantial understatement of income tax, substantial authority. See Rule 142(a); Hall v. Commissioner, 729 F.2d 632, 635 (9th Cir. 1984), aff'g T.C. Memo. 1982-337; Higbee v. Commissioner, 116 T.C. at 446-447. The Commissioner does not bear the burden of production regarding penalties related to corporations. NT, Inc. v. Commissioner, 126 T.C. 191 (2006).

On January 12, 2018, respondent filed a motion to reopen the record to admit into evidence the declaration of Laura L. Vidal and penalty approval forms for the Potters and Potter Sales for the years in issue. Reopening the record for the submission of additional evidence lies within the Court's discretion. Nor-Cal Adjusters v. Commissioner, 503 F.2d 359, 363 (9th Cir. 1974), aff'g T.C. Memo. 1971-200; Butler v. Commissioner, 114 T.C. 276, 286-287 (2000). The Court will

[*21] grant a motion to reopen the record only if the evidence relied on is not merely cumulative or impeaching, is material to the issues involved, and probably would change some aspect of the outcome of the case. Butler v. Commissioner, 114 T.C. at 287. Petitioners objected to respondent's motion. The Court will deny respondent's motion to reopen the record because, as discussed below, the evidence relied on will not change the outcome of these cases because petitioners acted with reasonable cause and in good faith.

A penalty will not be imposed under section 6662(a) if the taxpayer establishes that he acted with reasonable cause and in good faith. Sec. 6664(c)(1). Circumstances that indicate reasonable cause and good faith include reliance on the advice of a tax professional. Sec. 1.6664-4(b), Income Tax Regs.; see Higbee v. Commissioner, 116 T.C. at 448-449. For a taxpayer to rely reasonably upon advice so as to negate a section 6662(a) accuracy-related penalty determined by the Commissioner, the taxpayer must prove by a preponderance of the evidence that the taxpayer meets each requirement of the following three-prong test: (1) the adviser was a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer provided necessary and accurate information to the adviser, and (3) the taxpayer actually relied in good faith on the adviser's

[*22] judgment. Neonatology Assocs., P.A. v. Commissioner, 115 T.C. 43, 99 (2000), aff'd, 299 F.3d 221 (3d Cir. 2002).

Petitioners meet all of those requirements. The Potters and Potter Sales used the same CPA to prepare their respective Federal income tax returns for the years in issue. Petitioners' CPA has been licensed for 35 years, has been the Potters' CPA for almost that long, and has always prepared Potter Sales' corporate income tax returns. The record reflects that the Potters gave their CPA all the necessary information to prepare their and Potter Sales' tax returns. The Court is also satisfied that petitioners relied upon the CPA's advice; Mr. Potter had several discussions with their CPA regarding the termination payment and the activity. Therefore petitioners reasonably relied on their CPA; neither the Potters nor Potter Sales is liable for an accuracy-related penalty for 2010 or 2011.

The Court has considered all of the arguments made by the parties, and to the extent they are not addressed herein, they are considered unnecessary, moot, irrelevant, or without merit.

[*23] To reflect the foregoing,

An appropriate order will be issued denying respondent's motion to reopen the record, and decisions will be entered under Rule 155.