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**Craig Smalley** • Jul. 27, 2018

In 28 States and the District of Columbia, cannabis is legal in one way or another. The problem is when you are dealing with the Federal Government. Cannabis is an illegal Schedule I Narcotic. That being said, when it comes to cannabis, legal dispensaries and growers are treated like drug traffickers.

This all stems from a drug dealer by the name of Jeffery Edmondson. He was arrested and served his time in prison for drug dealing. When he got out of prison, the IRS issued him a Notice of Deficiency (NOD). Mr. Edmondson fought this all the way to the US Tax Court.

Mr. Edmondson sold his drugs on consignment, and like most drug dealers, didn't keep any records. Using the *Cohen Rule*, the court at the time, accepted his testimony as truthful and gave him credit for expenses of the drugs, travel, and other expenses. This was in 1981. Congress was furious, and passed Section 280E, which says:

*"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."*

Fast forward to today, and we have a mess on our hands. We have a legal business, that can only deduct the cost of the cannabis. Again, the Tax Court came to the rescue.

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Now, you probably think that's that. Problem solved. Not so fast. The Vapor Room was a sole proprietorship run by Martin Olive. Using the ruling in CHAMPs, he not only sold cannabis, is gave away massage, yoga, and had movie nights with popcorn. The Tax Court threw that out determining that the main business was dispensing cannabis and the other ancillary services, were not aggressively pursuing income.

The second strategy revolves around cost of goods sold (COGS). As the Tax Court has observed, "[the concept of COGS] embraces expenditures necessary to acquire, construct or extract a physical product which is to be sold; the seller can have no gain until he recovers the economic investment that he has made directly in the actual item sold." In other words, the total costs incurred to create a product or service that has been sold. Generally, a taxpayer first determines gross income by subtracting COGS from gross receipts, and then determines taxable income by subtracting expenses from gross income.

A recent IRS pronouncement attempts to limit reliance on IRC §263A to maximize COGS and minimize expenses subject to IRC §280E. Chief Counsel Advice memorandum 201504011 (CCA) takes the position that a taxpayer who traffics in a Schedule I or Schedule II controlled substance must determine COGS using the applicable inventory – costing regulations under IRC §471 as that IRC § existed when IRC §280E was enacted. Thus, the IRS is taking the position that IRC §263A does not require — indeed, does not allow — taxpayers to include in COGS cannabis-related costs that would be nondeductible under IRC §280E if they were not capitalized.

The CCA interprets two tax provisions in making its conclusion. First, the CCA interprets language in IRC §263A(a) (2) to limit indirect costs included in COGS to those that are deductible from gross income when calculating taxable income. Stated differently, an indirect cost cannot be included in COGS by reason of IRC §263A for

determining gross income, if that cost could not be deducted from gross income if it

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existed when IRC §280E was enacted.” The CCA does not explain its basis for making this assertion. It is unclear why changes to the IRC §471 regulations subsequent to the enactment of IRC §280E should not apply to businesses trafficking in cannabis.

It appears the IRS is asserting that COGS, as defined by the IRC §471 regulations at the time IRC §280E was enacted, represents COGS that are Constitutionally protected when determining costs for gross income. Further, the IRS interpretation permits costs generally included in COGS to be denied as a cost for determining gross income whenever COGS includes incremental costs from when IRC §280E was enacted. Presumably, the IRS does not find these incremental costs to be Constitutionally protected.

The analysis in the CCA is flawed because:

- (1) it provides no support for the position that COGS may be defined differently for certain classes of taxpayers, and;
- (2) the fact that IRC § 263A does not apply to indirect costs of a cannabis business does not mean that those costs cannot be capitalized.

Cannabis businesses should be entitled to include in COGS all costs that may be included in COGS under all capitalization rules other than IRC §263A. The fact that IRC §263A requires the capitalization of particular costs does not preclude such costs from capitalization under other rules. Capitalization must be decided based on the IRC §471 regulations as currently written, and IRC §280E has no impact on capitalization requirements.

Under the 16th Amendment, Congress has the ability to tax only gross income, not gross receipts. The determination of what is included in COGS determines gross income. Both IRC §471 and IRC §263A determine whether a cost is included in COGS. The U.S. Supreme Court in *New Colonial Ice Co. v. Helvering* held that deductions

from gross income depend “upon legislative grace,” and a particular deduction can

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as it is taken into account for other businesses — that is, without regard to IRC §280E.

One case, *Alpenglow Botanicals, LLC, Et Al. v. U.S.*, is challenging the very concept of IRC §280E. On February 3, 2016, plaintiffs *Alpenglow Botanicals, LLC*, filed a Complaint against defendant *The United States of America*, seeking declaratory, injunctive, and monetary relief so as to overturn the Internal Revenue Service's (“IRS's”) decision to deny deductions to income obtained during the course of plaintiffs' business for the tax years 2010, 2011, and 2012. More specifically, plaintiffs raised the following claims:

- (1) the IRS went beyond its jurisdiction in administratively determining that plaintiffs were not entitled to certain deductions pursuant to 26 U.S.C. §280E (“§280E”);
- (2) Congress exceeded its power under the Sixteenth Amendment in passing §280E;
- (3) the IRS violated the Fifth Amendment in taking evidence from plaintiffs without informing them that they were under investigation for violating the Controlled Substances Act (“the CSA”); and
- (4) §280E violates the Eighth Amendment's prohibition on excessive fines and penalties.

The appellate court ruled in favor of the government, setting up a showdown that could soon take place in the Supreme Court.

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