cost of goods sold (COGS).

Craig Smalley • Dec. 21, 2018

In Patience Mutual Assistance Corp, et al, the Tax Court has denied a California medical cannabis company's deduction for ordinary and necessary expenses, and cost of goods sold (COGS).

BACKGROUND

Under Section 280E, the code states:

No deduction or credit shall be allowed for any amount paid or incurred during the taxable

which is prohibited by Federal law. Nonetheless, several state legislatures have passed laws legalizing the cultivation and sale of marijuana.

Four years after enacting Code Sec. 280E, Congress added the uniform capitalization (UNICAP) rules of Code Sec. 263A to the Code. Under Code Sec. 263A(a), resellers and producers of merchandise are required to treat as inventoriable costs the direct costs of property purchased or produced, respectively, and a proper share of those indirect costs that are allocable to that property. Flush language at the end of Code Sec. 263A(a)(2) provides, "Any cost which (but for this subsection) could not be taken into account in computing taxable income for any tax year shall not be treated as a cost described in this paragraph."

In Californians Helping to Alleviate Med. Problems, Inc., (2007) 128 TC 173 ("CHAMP"), the taxpayer, CHAMP, had the primary purpose of providing caregiving services to individuals. Its secondary purpose was providing members with medical marijuana under the California Compassionate Use Act of '96 (CCUA). IRS disallowed all of CHAMP's deductions under Code Sec. 280E. The Tax Court held that marijuana is a schedule I controlled substance for this purpose, even if it's medical marijuana recommended by a physician as appropriate to benefit the user's health. However, the Tax Court allowed CHAMP to deduct its expenses attributable to its counseling and other caregiving services. The Court rejected IRS's contentions that CHAMP was engaged in a single business activity (trafficking in marijuana) or that Code Sec. 280E required the denial of all CHAMP's expense deductions.

The Code Sec. 471 regs have different rules for resellers and producers. Under the regs, resellers must use as their COGS the price they pay for inventory plus any transportation or other necessary charges incurred in acquiring possession of the goods. (Reg § 1.471-3(b)) On the other hand, producers must include in COGS both the direct and indirect costs of creating their inventory. (Reg § 1.471-3(c), Reg § 1.471-

11) Producers have to capitalize the cost of raw materials, expenditures for direct

beverages, extracts, concentrates, oils, topicals, and tinctures (marijuana-infused alcohol, vinegar, or glycerin) which Harborside bought from other collectives, tested, and repackaged if needed. Harborside also purchased all of its marijuana flowers (buds) from its patient-growers with some of these growers promising to sell what they cultivated back to Harborside. Harborside gave them either seeds or clones (cuttings) to get started. Once a grower had cultivated, harvested, trimmed, flushed, dried, and cured his marijuana buds, he would bring them to Harborside to sell.

2. The sales of products with no marijuana. This included branded clothing, hemp bags, books about marijuana, and marijuana paraphernalia such as rolling papers, pipes, and lighters.
3. Therapeutic services. A portion of each marijuana sale included free holistic services.
4. Brand development. Harborside maintained that its branding activities were part of a "unified business enterprise" with its activities that did make money during the years at issue

In July 2012, the federal government filed a civil forfeiture action in the California district court in which it alleged that that the property which Harborside rented and on which it operated 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. The action was dismissed with prejudice in May 2016 by stipulation of the parties.

On audit, IRS determined that Harborside's sole trade or business was trafficking in a controlled substance and that Code Sec. 280E prevented it from deducting business expenses. IRS also determined that Harborside had to calculate COGS using the Code Sec. 471 regs for resellers. Harborside argued that Code Sec. 280E didn't apply to it, that it was a producer, and that a dismissed civil-forfeiture action precluded a

related expenses

Specifically, the Court found 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. And the Court found that Harborside's holistic services offered free alongside its sales of cannabis had a business purpose: it justified premium pricing and helped Harborside meet the community-benefit standards California law required. As for Harborside's brand development, the Court noted that ther was no evidence that if was in any way a separate trade or business: its branding using the same entity, management, capital structure, employees, and facilities as Harborside's marijuana sales.

In addition, the Tax Court determined that Harborside had to adjust for COGS according to the Code Sec. 471 regs for resellers. Looking at the flush language at the end of Code Sec. 263A(a)(2), the Court reasoned that if something wasn't deductible, taxpayers couldn't use that section to capitalize it. Code Sec. 263A makes taxpayers defer the benefit of what used to be deductions—it doesn't make what was once nondeductible now deductible.

The Court concluded that the Code Sec. 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 Code Sec. 471 regs. Code Sec. 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 Code Sec. 471.

While 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, the situation was more complex for the marijuana bud it sold. Harborside insisted that it produced this marijuana and could include in its COGS the indirect inventory costs that Reg § 1.471-3(c) describes. IRS said Harborside was a reseller and, under

for its COGS, according to Reg § 1.471-3(b).

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