IRS Interpretation Causes Reefer Madness

By Michael Kosnitzky and Matt Kaden

Michael Kosnitzky and Matt Kaden examine the tax treatment of expenses incurred in a legal (under state law) marijuana business. Included in their discussion are Code Secs. 280E and 263A and a recent IRS Chief Counsel Advice (CCA 201504011).

Today, 23 states (plus the District of Columbia and Guam) permit the sale of medical marijuana, and four states (Alaska, Colorado, Oregon and Washington) now or in the near future will allow sales for recreational use.[1] Despite general public acceptance of the use of medical marijuana and the growing sentiment in favor of recreational use, U.S. federal income tax law governing the treatment of expenses incurred in a legal (under state law) marijuana business has yet to catch up to the evolution of the marijuana industry. This failure to adapt the Internal Revenue Code ("the Code") and other tax rules to the changing economic and legal environment places the entire industry at risk of failure. One example of the shortcomings of the law in this area has been cast into stark relief by a recent IRS Chief Counsel Advice—CCA 201504011 (the "CCA")[2]—which adopts an overly technical, and in our opinion, mistaken view of applicable law. Worse, the conclusion reached by Chief Counsel would violate the Sixteenth Amendment by denying taxpayers their right to take into account the full amount of costs of goods sold (COGS) when calculating gross income.

While the CCA touches on other matters related to the tax treatment of marijuana business-related expenses, we primarily take issue with the conclusion of the CCA that Code Sec. 263A and the regulations thereunder do not apply to the inventory costing of a marijuana business. Although the CCA is merely the government's interpretation of the law and has no precedential value,[3] this conclusion creates a chilling effect on both producers and resellers of marijuana. The CCA's consequences would be particularly severe for large resellers without grow operations (*e.g.*, dispensaries), who would generally not be able to include any indirect costs in calculating COGS.[4] Many marijuana businesses have not

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been taking the narrow view of what can be included in COGS espoused by Chief Counsel in the CCA.

Code Sec. 280E

The first tax case to address the issue of the tax treatment of expenses incurred in the conduct of an illegal drug business was the 1981Tax Court case *J. Edmondson*.[5] In *Edmondson*, the Tax Court allowed a taxpayer operating an illegal drug business to deduct business expenses and take COGS into account in determining its taxable income.

Congress disapproved and sought legislation to overturn *Edmondson*. The result was the enactment in 1982 of Code Sec. 280E.[6] That section provides:

This failure to adapt the Internal Revenue Code ("the Code") and other tax rules to the changing economic and legal environment places the entire industry at risk of failure.

> 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.

Note specifically that Code Sec. 280E does not distinguish between marijuana businesses that are legal producers or retailers under state law, on the one hand, and illegal drug businesses under state law, on the other. Simply put, since marijuana is a controlled substance under Schedule I of the federally enacted Controlled Substances Act , the IRS takes the position that "[n]o deduction or credit" may be taken by a taxpayer in the related marijuana business.

Moreover, the IRS and the Tax Court have consistently held that Code Sec. 280E applies with equal force to the legal sale of marijuana for *medical purposes* under state law, because the federal Controlled Substances Act referred to in Code Sec. 280E makes no exception for medical marijuana. In Information Letter 2011-0005, the IRS responded to requests from a number of congressmen (including Pete Stark (D-Cal.), the original sponsor of the bill containing Code Sec. 280E) to refrain from applying Code Sec. 280E to medical marijuana dispensaries by explaining: "Because neither section 280E nor the Controlled Substances Act makes exceptions for medically necessary marijuana, we lack the authority to publish the guidance that you request. The result you seek would require the Congress to amend either the Internal Revenue Code or the Controlled Substance Act."[7] Thus, the IRS will not create an administrative exception to the clear statutory language.

Code Sec. 280E Prohibits Deductions but Not Adjustments for COGS

Note also how broad the language is: "no deduction or credit." But, the legislative history to Code Sec. 280E clarifies that this blanket prohibition does not extend to "adjustment[s] to gross receipts with respect to effective costs of goods sold."[8] According to the legislative history, this significant carve-out was made "[t]o preclude possible challenges on constitutional grounds." By drawing this distinction between its power to limit deductions (from gross income) on the one hand and its lack of power to limit adjustments (to gross receipts) on the other, Congress is acknowledging the restrictions on its power to tax anything besides "income" as that term is used in the Sixteenth Amendment and interpreted in a significant body of case law.

The case law establishes that gross receipts must first be reduced by COGS to arrive at gross income before Congress can exercise its power to tax.[9] While any further reductions (*e.g.,* deductions and credits) to gross income are strictly a matter of legislative grace,[10] the reduction for COGS is a constitutional mandate.

Therefore, despite the apparently unambiguous prohibition in Code Sec. 280E, which proscribes the taking of business deductions by taxpayers in a marijuana business, taxpayers are nevertheless permitted to recover their costs that qualify as COGS or, stated differently, taxpayers are always permitted to recover their cost of inventory no matter what the nature of their business. The IRS actually conceded this point in a 2007 Tax Court case—*Californians Helping to Alleviate Medical Problems, Inc.* ("*CHAMPS*").[11]

Unfortunately, *CHAMPS* did not reach the question that the Chief Counsel addressed in the CCA: How does a marijuana business calculate COGS? Although the simple response would (and should) be: "like any other taxpayer," the CCA complicates and confuses the issue significantly. The confusion is caused by how the IRS interprets Code Sec. 280E in light of subsequent legislation enacted in 1986, four years after Code Sec. 280E, and a technical correction to that 1986 legislation, enacted in 1988, six years after Code Sec. 280E. It is the interplay between these provisions that may control the future of the marijuana industry.

Code Sec. 263A

The Tax Reform Act of 1986 (TRA) (P.L. 99-514) added Code Sec. 263A, which was quickly followed by voluminous Treasury Regulations. Collectively, these rules are known as the uniform capitalization rules or UNICAP rules. These rules specify the items that retailers and producers must treat as included in the cost of inventory rather than as currently deductible by the taxpayer when the cost is incurred. The UNICAP rules result in a broader list of items needing to be capitalized than under prior law. The effect of the UNICAP rules on most businesses is to slow down the timing of deductions since costs that are capitalized as part of a taxpayer's inventory only reduce taxable income in the year that the inventory is actually sold. The effect of the UNICAP rules on most non-marijuana resellers is particularly severe because, in contrast to non-marijuana producers, resellers were permitted to deduct all of their business expenses other than acquisition costs (and certain transportation costs) under prior law.[12]

While most businesses are adversely affected by Code Sec. 263A because it forces them to capitalize various costs as part of inventory rather than being able to deduct them in the year incurred, marijuana businesses have generally interpreted these rules as favorable to them because the expenditures enumerated therein should fall under the legislative exception from Code Sec. 280E for "adjustments to gross receipts," *i.e.*, COGS.[13] The CCA does not, however, follow this pro-taxpayer interpretation of the effect of Code Sec. 263A on Code Sec. 280E.

The CCA relies primarily on a technical correction to the TRA enacted in 1988 that provides that if an item is not allowed in computing taxable income, it is not subject to being (or permitted in this case) capitalized under Code Sec. 263A. The example accompanying this technical correction was interest expense on a personal loan, which is nondeductible under Code Sec. 163(h).[14] The CCA holds:

> Read together, §280E and the flush language at the end of §263A(a)(2) prevent a taxpayer trafficking in a Schedule I or Schedule II controlled substance from obtaining a tax benefit by capitalizing disallowed deductions. Congress did not repeal or amend §280E when it enacted §263A. Furthermore, nothing in the legislative history of §263A suggests that Congress intended to permit a taxpayer to circumvent §280E by treating a disallowed deduction as an inventoriable cost or as any other type of capitalized cost. In fact, the legislative history of §263A(a)(2) states that "a cost is subject to capitalization ... only to the extent it would otherwise be taken into account in computing taxable income for any tax year." If a taxpayer subject to §280E were allowed to capitalize "additional §263A costs," as defined for new taxpayers in §1.263A-1(d)(3), §263A would cease being a provision that affects merely timing and would become a provision that transforms non-deductible expenses into capitalizable costs. Thus, we have concluded that a taxpayer trafficking in a Schedule I or Schedule II controlled substance is entitled to determine inventoriable costs using the applicable inventory-costing regulations under §471 as they existed when §280E was enacted.

Worse, the conclusion reached by Chief Counsel would violate the Sixteenth Amendment by denying taxpayers their right to take into account costs of goods sold (COGS) when calculating gross income.

The CCA Incorrectly Analyzes the Interplay Between Code Secs. 280E and 263A

The reasoning of the CCA suffers from a fatal circularity. The clearly expressed congressional intent behind Code Sec. 280E is that taxpayers in the marijuana business, like all other taxpayers, are entitled to adjust gross receipts for COGS. The legislative history to Code Sec. 263A is equally clear that "a single, comprehensive set of rules should govern the capitalization of costs."[15] Moreover, the legislative history provides that the UNICAP rules are necessary so that costs that are "in reality" part of COGS are treated as such.[16] Accordingly, Code Sec. 263A is necessary to accurately reflect COGS, which is constitutionally guaranteed to all taxpayers in calculating gross income, including those in a marijuana business whose deductions from gross income are limited pursuant to Code Sec. 280E. Thus, the only provision that could cause Code Sec. 263A to not be applicable to those in the marijuana business is the flush language of Code Sec. 263A(a)(2) itself. Yet, that language specifically provides that it only applies if a *different* provision prohibits the inclusion of the item in figuring income. But, there is no such provision. Clearly that provision cannot be Code Sec. 280E, which does not prohibit but rather mandates adjustments for COGS. Its prohibition of deductions from gross income exists in a plane parallel to, and separate from, the congressional and constitutional mandate for all proper adjustments to gross receipts.

> *Although the CCA is merely the government's interpretation of the law and has no precedential value, this conclusion creates a chilling effect on both producers and resellers of marijuana.*

Under the CCA, taxpayers in the marijuana industry (and those who illegally sell other controlled substances) must determine their COGS under the Treasury Regulations that existed in 1982 while all other taxpayers may use the currently existing rules under Code Sec. 263A to calculate their COGS. But the Code and case law do not contain any allowance for calculating COGS in a manner that Congress has determined to be inferior and inaccurate. The case law in the Sixteenth Amendment context looks only at the current understanding of COGS when assessing whether a tax provision trespasses upon taxation of gross receipts and not at some historical, outdated one.[17] This is consistent with the Supreme Court's approach of interpreting the Constitution as a "living document adaptable to new situations."[18]

Congress has the right to determine that taxpayers in a certain industry are not entitled to a particular deduction while others in a different industry are entitled to the same deduction, but it may not enact legislation that restricts taxpayers in a particular industry from recovering their costs of goods sold. Since Congress cannot do this in contravention of the U.S. Constitution, certainly the IRS may not do so. The government wants to apply Code Sec. 263A only when it results in capitalizing costs that will likely increase taxable income for a category of taxpayers and not apply it when it will have the effect of reducing taxable income for a different category of taxpayers.

The CCA also argues that Code Sec. 263A is a "timing provision" because it does not change the character of any expense from nondeductible to deductible and therefore marijuana businesses cannot rely on it to convert their nondeductible Code Sec. 280E expenses into costs of goods sold. But this argument is likewise disingenuous because the predecessor rules, like any inventory capitalization rules, are also only timing rules. What the IRS really seems to be saying in the CCA is that Congress when it enacted Code Sec. 280E in 1982 only intended to modify the capitalization rules in effect at that time and since Code Sec. 263A became law four years later and the technical correction two years after that in 1988, Congress didn't intend the broader application of the inventory capitalization rules under UNICAP to apply to the businesses whose deductions are restricted under Code Sec. 280E. A far more plausible analysis, however, is that Congress did not intend to have two sets of inventory capitalization rules that treat taxpayers differently in terms of their Sixteenth Amendment right to only be taxed on income and not gross receipts. Furthermore, had Congress not intended Code Sec. 263A to apply to marijuana businesses and other businesses effected by the limitations imposed by Code Sec. 280E, it would have clearly stated its desire when Code Sec. 263A was originally enacted in 1986, or when the technical corrections for the TRA was passed in 1988 or any time thereafter for that matter. It is far more logical to interpret Congress' silence on the subject as indicating that the UNICAP rules should apply to all taxpayers and that the recovery of COGS for a taxpayer selling a controlled substance should incorporate any subsequent legislative or administrative changes and judicial rulings affecting the definition or calculation of COGS. The Sixteenth Amendment requires as much.[19]

ENDNOTES

1. *See www.ncsl.org/research/health/state-medical-marijuana-laws.aspx* (last visited March 10, 2015); Colorado Amendment 64, Amending Colo. Const. Art. XVIII §16(4), Oregon Measure 91, §1(c). Washington Initiative 502 §4. The Alaska legislature in the midst of rulemaking period which is expected to result in a regime governing commercial sales of marijuana by the Summer of 2016. *See www.drugpolicy.org/news/2015/02/tuesday-alaska-marijuana-legalization-law-takes-effect* (last visited March 10, 2015). Oregon will begin accepting commercial vending licenses in January 2016, *www.oregon.gov/olcc/marijuana/Pages/Frequently-Asked-Questions.aspx* (last visited March 10, 2015).
2. Chief Counsel Advice is defined in Code Sec. 6110(i)(1)(A) as follows:

   For purposes of this section, the term "Chief Counsel advice" means written advice or instruction, under whatever name or designation, prepared by any national office component of the Office of Chief Counsel which—

   (i) is issued to field or service center employees of the Service or regional or district employees of the Office of Chief Counsel; and

   (ii) conveys—

   (I) any legal interpretation of a revenue provision;

(II) any Internal Revenue Service or Office of Chief Counsel position or policy concerning a revenue provision; or

(III) any legal interpretation of State law, foreign law, or other Federal law relating to the assessment or collection of any liability under a revenue provision.

[3] Code Sec. 6110(k)(3).

[4] Vertically integrated marijuana businesses, which are common in Colorado where there was, until recently, a law in effect requiring dispensaries to produce a percentage of what they sell, would capitalize many of their indirect production costs but would not be able to capitalize their advertising and other sales, including dispensary-related costs.

[5] *J. Edmondson,* 42 TCM 1533, Dec. 38,379(M), TC Memo. 1981-623.

[6] Tax Equity and Fiscal Responsibility Act (P.L. 97-248). It should be noted that the enactment of Code Sec. 280E predated both California's medical marijuana law, passed in 1996, and the 1991 opening of the first medical marijuana dispensary, which is widely reported to be Dennis Peron's San Francisco cannabis buyers club. The club was operating pursuant to Proposition P, a San Francisco city initiative supporting the use of medical marijuana. *www.marijuana.com/news/2014/08/the-cannabis-buyers-club-how-medical-marijuana-began-in-california/* (last visited April 1, 2015).

[7] Two bills recently introduced in Congress would do just that. The first bill, actually, a pair of companion bills co-sponsored by Representatives Jared Solis (D-Colo.) and Earl Blumenauer (D-Or.) and introduced in late February (H.R. 1013 and H.R. 1014), is merely a reworking of their 2013 proposed legislation that would have declassified marijuana as a controlled substance under the Controlled Substances Act (rendering Code Sec. 280E inoperative as to recreational and medical marijuana businesses alike) and impose an excise tax upon marijuana production. The second—The Compassionate Access, Research Expansion and Respect States (CARERS) Act (S. 683)—introduced last week by Senators Cory Booker (D-N.J.), Rand Paul (R-Ky.) and Kirsten Gillibrand (D-N.Y.), would exempt the dealings of medical marijuana businesses that are legally operating under state law from the Controlled Substances Act, and by extension, Code Sec. 280E. The CARERS Act has received some early bipartisan support, but would not provide any tax relief to *recreational* marijuana businesses that are legal under state law.

[8] S. Rep. No. 97-494 (Vol. 1), 97th Cong., 2d Sess., at 309 (1982).

[9] *See Doyle v. Mitchell Bros. Co*., SCt, 247 US 179, 185 (1918) ("Of course, gross income and not gross receipts is the foundation of income-tax liability, for it is only earnings, profits and gains which the statute subjects to tax. And manifestly, gross receipts cannot be called gross income, insofar as they consist of borrowings of capital, returns of capital, or any of the other items which * * * the Internal Revenue Code * * * has excluded from gross income. But when all of these things have duly been taken into account, no matter by what process it has been done, the amounts remaining of Gross Receipts necessarily may, in its character as a result, properly reflect taxpayer's Gross Income, which it is his duty to report."); *J.H. Sullenger,* 11 TC 1076, Dec. 16,735 (1948) ("The amounts in question were actually, as the stipulation shows, a part of the cost of goods sold and are not being claimed by this petitioner as a deduction under Section 23. Section 23 makes no provision for the cost of goods sold, but the Commissioner has always recognized, as indeed he must to stay within the Constitution, that the cost of goods sold must be deducted from gross receipts in order to arrive at gross income. No more than gross income can be subjected to income tax upon any theory."); *Hagen Adver. Displays, Inc.,* 47 TC 139, 153, Dec. 28,179 (1966) (Hoyt, J., dissenting), *aff'd*, CA-6, 69-1 USTC ¶9254, 407 F2d 1105; *E.H. Johnson Est.,* 42 TC 441, 444–45, Dec. 26,815 (1964), *aff'd without op*., CA-6, 66-1 USTC ¶9195, 355 F2d 931; *See also* Code Sec. 61(a)(3), Reg. §§1.61-3(a), 1.162-1(a).

[10] *See New Colonial Ice Co*, 4 USTC ¶1292, 292 US 435, 440 ("The power to tax income like that of the new corporation is plain and extends to the gross income. Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.").

[11] *Californians Helping to Alleviate Medical Problems, Inc.,* 128 TC 173, Dec. 56,935 (2007). *CHAMPS* also stands for the proposition that a dispensary or other marijuana business may conduct one or more nontrafficking businesses under the same roof (*e.g.,* counseling, sales of non-marijuana products), the expenses attributable to which will not be subject to Code Sec. 280E. Some practitioners have argued that this principle can be extended so that only the dispensary expenses that bear the same proportion to total expenses as the time the average customer spends actually purchasing the marijuana bears to the customer's total time in the dispensary should be subject to Code Sec. 280E. This should be seen as an aggressive position and has not been approved by formal IRS guidance or passed on by any court.

[12] *See* Reg. §1.471-3(b); S. Rep. No. 99-313, at 134 (1986). Resellers (who do not also conduct grow operations) whose average annual gross receipts do not exceed $10 million are technically exempt from Code Sec. 263A. Code Sec. 263A(b)(2)(B). Such small resellers will have to make the argument that the exemption was made for their benefit and they can therefore choose to not have it apply to them. Such taxpayers should consider adopting 263A through a change in method of accounting or by electing the treatment on their first tax return. *See* note 1.

[13] Code Sec. 263A does not apply to a taxpayer that is neither a C corporation nor a partnership with a C corporation partner that is engaged in the trade or business of farming plants with a preproductive period of less than two years. Code Sec. 263A(d). Arguably, this exemption for farming businesses does not apply to marijuana growers, who, according to Code Sec. 280E, are not in the farming business, but the business of "trafficking in controlled substances." Even if it were to apply, the exemption for farmers was clearly granted for their own administrative convenience, and they should be able to apply the UNICAP rules if they so choose.

[14] S. Rep. No. 100-445, at 104 (1988). Reg. §1.263A-1(c)(2)(i) also provides an illustration of the disallowed portion of meals and entertainment expenses as not being included in inventory costs.

[15] S. Rep. No. 99-313, at 140 (1986).

[16] *Id.*

[17] *See, e.g., G.S.Hays,* 32 TCM 195, Dec. 31,862(M), TC Memo. 1973-44.

[18] *Youngstown Sheet & Tube Co. v. Sawyer*, 343 US 579, 682, 72 SCt 863, 894, 96 LEd 1153, 1223 (1952).

[19] While an affected taxpayer may also be able to make out an Equal Protection claim based upon disparate treatment resulting from the different ways of calculating COGS, this would surely fail for the same reason that any challenge to Code Sec. 280E would fail—Congress would easily be able to assert a rational basis for taxing federal criminals differently than law abiding citizens.