Recreational Cannabis — Section 280E and Tax Efficient Structuring

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I. The Conflict: The long arm of federal law

Recreational cannabis businesses operate in a world of conflicting state and federal laws. Several states have legalized recreational cannabis, yet, under federal law, cannabis remains an illegal Schedule I drug under the Controlled Substances Act (CSA). The CSA created five classifications of controlled substances. These classifications range from Schedule I to Schedule V, with varying qualifications for a substance to be included in each. The criteria for a Schedule I controlled substance includes a high potential for abuse, a lack of currently accepted medical use, and a lack of accepted safety for use under medical supervision. Controlled substances in Schedules II through V generally have a lower potential for abuse and/or some degree of currently accepted medical use. On April 4, 2016, the Department of Health and Human Services, the Drug Enforcement Administration (DEA), and the Office of National Drug Control Policy issued a letter indicating the DEA intends to reconsider the classification of cannabis in the first half of 2016. It is unclear if the DEA will continue to classify cannabis as a Schedule I drug, reclassify it to a different schedule, or remove it from the five schedules of controlled substances. Legalization at the state level does not protect recreational cannabis businesses from federal prosecution. The federal government continues its war on drugs and drug trafficking. This war currently includes cannabis. Cannabis businesses need cannabis to be removed from the schedules of controlled substances in order to eliminate the threat of federal prosecution.

State legalization rules are limited in scope to in-state purchase and consumption in an effort to "legitimize" the legislation and avoid federal intervention. For instance, state laws in Oregon and Washington do not permit a recreational cannabis consumer to acquire cannabis in Washington and later consume it in Oregon. States have carefully drafted their laws to prohibit importing or exporting cannabis. It is not so easy, however, to prevent federal intervention in all respects, and the long arm of federal law is felt most deeply in two areas: taxation and banking. This article addresses the tax challenges.

II. IRC Section 280E: Limiting U.S. federal income tax deductions

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 will cease to apply to cannabis businesses if and when cannabis is no longer classified as a Schedule I or Schedule II controlled substance.

Section 280E was enacted in 1982 to overturn the result in the Tax Court case *Jeffrey Edmondson v. Commissioner*,[1] which held that the taxpayer, who was engaged in an illegal drug dealing business, was entitled to deductions for "telephone, auto, and rental expenses" that he incurred in his business. The Senate report makes clear that section 280E was intended to overturn the decision in *Edmondson* and deny *deductions* to illegal drug dealing businesses.[2] However, for Constitutional reasons, Congress did not attempt to prevent taxpayers from using cost of goods sold (COGS) to compute gross income. Thus, section 280E denies all deductions *from* gross income in computing taxable income, but illegal drug dealing businesses are permitted to take COGS into account in computing gross income.

[1]T.C.M. 1981-623.

[2]*See* S. REP. NO. 97-494 (Vol. I), at 309 (1982).

Section 61 defines "gross income" as "all income from whatever source derived." One category of income listed in section 61 is "gross income derived from business." Reg. § 1.61-3 states that "gross income" for manufacturing and merchandising businesses "means total sales, less the cost of goods sold." As the Tax Court has observed, "cost of goods sold is an item taken into account in computing gross income and is *not an item of deduction*."[3]

Cannabis businesses have developed two approaches to minimize the impact of section 280E:

First, taxpayers have tried separating their trade or business activities into two sets of businesses: businesses that consist of "drug trafficking" and businesses that do not. For example, in *Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner (CHAMP)*, a California medical cannabis business provided medical cannabis to patients, but also provided non-cannabis related counseling and caregiving services to its members.[4] The Tax Court in *CHAMP* held that section 280E did not apply to expenses related to the nondrug trafficking-related business of the taxpayer. Following this case, medical and recreational cannabis businesses have increasingly attempted to create business structures that achieve the same result. However, not all cannabis businesses have been successful in separating their businesses between trafficking and non-trafficking activities. In the Tax Court case *Olive v. Commissioner*, the Court found that the taxpayer's activities of providing free yoga classes, chess and other board games, movies with popcorn and drinks, chair massages, use of vaporizers, education on medical marijuana and its responsible use, tea, water, snacks, and other light food did not constitute a business separate from the taxpayer's trafficking business.[5]

III. IRC 263A: Attempts to maximize costs of goods sold

The second approach to minimizing the impact of section 280E is characterize as many costs as possible as COGS rather than operating expenses.

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"[6] (or, simply, the total costs incurred to create a product or service that has been sold). In general, a taxpayer first determines *gross income* by subtracting COGS from gross receipts, and then determines *taxable income* by subtracting expenses from gross income.

Section 471 gives broad authority to the IRS to force taxpayers to account for inventory in a way that most clearly reflects income. IRS regulations under section 471, which have been in effect since 1958, provide that a producer of property generally is required to treat indirect costs as COGS if they are "incident to and necessary for production" or manufacturing operations.[7] In 1986, Congress enacted section 263A, which requires purchasing, handling, and storage expenses, as well as a portion of third party service costs such as accounting or legal fees, to be included in COGS in addition to the costs covered by the section 471 regulations.

Absent an inclusion in COGS, indirect costs for cannabis businesses are subject to section 280E. Section 280E denies deductions *from* gross income. It does not impact costs *for* determining gross income. Increasing COGS decreases gross income and decreases the amount of denied deductions *from* gross income as a result of section 280E. This creates an incentive for cannabis businesses to maximize their costs included in COGS.

Normally, taxpayers with inventories prefer to treat costs as deductible expenses rather than including them in COGS, because expenses are currently deductible, while COGS does not reduce income until the taxpayer sells the inventory items to which the COGS relates. However, because section 280E prevents the deduction of many cannabis-related costs *as current expenses*, taxpayers in the cannabis industry have reversed the normal tax planning objective and prefer to *maximize* the costs treated as COGS.

[3] *Lawson v. Commissioner,* T.C. Memo 1994-286 (emphasis added).
[4] 128 T.C. 173 (2007).
[5] 139 T.C. 19 (2012).
[6] *Reading v. Commissioner*, 70 T.C. 730, 733 (1978).
[7] Reg. § 1.471-3(c).

IV. CCA 201504011: IRS attempts to shut down cannabis industry's reliance on section 263A

A recent IRS pronouncement attempts to limit reliance on section 263A to maximize COGS and minimize expenses subject to section 280E. Chief Counsel Advice memorandum 201504011 (the 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 section 471 *as that section existed when section 280E was enacted*. Thus, the IRS is taking the position that section 263A does not require — indeed, does not allow — taxpayers to include in COGS cannabis-related costs that would be nondeductible under section 280E if they were not capitalized.

The CCA interprets two tax provisions in making its conclusion. First, the CCA interprets language in section 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 section 263A *for* determining gross income if that cost could not be deducted *from* gross income if it were not included in COGS.

Second, the CCA points to legislative history to interpret section 280E. The Senate report notes the adjustment to gross receipts for COGS was not affected to preclude Constitutional challenge. Congress feared denying COGS to determine gross income may be held unconstitutional.

Interestingly, the CCA concludes that a business trafficking in cannabis "is entitled to determine [COGS] using the applicable [COGS] regulations under section 471 *as they existed when section 280E was enacted*." The CCA does not explain its basis for making this assertion. It is unclear why changes to the section 471 regulations subsequent to the enactment of section 280E should not apply to businesses trafficking in cannabis. It appears the IRS is asserting that COGS, as defined by the section 471 regulations at the time section 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 section 280E was enacted. Presumably, the IRS does not find these incremental costs to be Constitutionally protected.

V. Conclusion: CCA's Analysis is Flawed

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 section 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 section 263A. The fact that section 263A requires the capitalization of particular costs does not preclude such costs from capitalization under other rules. Capitalization must be decided based on the section 471 regulations as currently written, and section 280E has no impact on capitalization requirements.

Under the 16th Amendment, Congress has the ability to tax only gross income, not gross receipts.[8] The determination of what is included in COGS determines gross income. Both section 471 and section 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 be allowed only if it is clearly provided by the statute.[9] By enacting section 280E, Congress has denied its legislative grace to deductions *from* gross income for businesses trafficking in Schedule I or Schedule II controlled substances. However, the IRS provides no evidence that a court has applied the concept of "legislative grace" to the inclusion of costs in COGS.[10] It is therefore unclear whether Congress has the authority to create a separate and narrower definition of COGS for these businesses. If it does not, the Constitution requires that section 263A be taken into account in determining COGS for cannabis businesses in the same manner as it is taken into account for other businesses — that is, without regard to section 280E.

[8] *See Doyle v. Mitchell Bros. Co.,* 247 U.S. 179 (1918).
[9] 292 U.S. 435, 440 (1934).
[10] S*ee next page.*

The legislative history supporting enactment of Section 280E indicates that Congress intended COGS of a drug-trafficking business to be deductible in determining taxable income precisely because Congress feared Constitutional challenge if COGS could not be deducted when determining gross income. The CCA takes the position that section 263A applies in determining COGS for every seller of inventory goods except businesses trafficking in controlled substances. However, disparate definitions of COGS for different kinds of businesses open the door to the Constitutional challenge Congress sought to avoid when it enacted section 280E. We are not convinced that a court would embrace the CCA.

Lastly, there is no support for the CCA's odd assertion that businesses trafficking in cannabis must use a definition of COGS found the section 471 regulations as they existed when section 280E was enacted. The only statutory language that arguably supports the CCA's analysis of section 263A (i.e., the last sentence of section 263A(a)(2)), applies only to costs that are included in COGS solely by reason of section 263A and not to costs that are included in COGS by reason of other historical and future changes to capitalization rules.

So the question becomes: What should taxpayers in the cannabis industry do in the face of the IRS's pronouncement in the CCA?

Unfortunately, like so many legal questions applicable to this industry, the answer is not entirely clear. Cannabis industry taxpayers should consult their tax advisors about the costs they report as COGS and their risk of penalty should they reject the position adopted by the CCA.

Visit Lane Powell's Taxation Practice Group webpage or Cannabis Practice Group webpage for more information.

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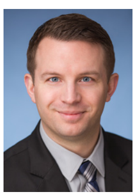

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[10]*In Pedone v. U.S.*, 151 F.Supp. 288 (1957), the Court fails to analyze the taxpayer's argument that excessive wage payments were costs *for* gross income rather than deductions *from* gross income. In referring to the Government's ability to deny deductions *from* gross income for reasonable salaries and wages the Court noted: "Common opinion, and acquiescence by those affected by legislation over a long period is evidence of a community sense that its Government has not exceeded its lawful powers." The written dissent notes, "the issues in this case are whether the cost of goods sold may be subject to income taxation in light of the 16th Amendment and, if not, are the wages in question paid by the plaintiffs to their employees … truly an element of the costs of goods sold."