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In This Issue:

Recreational Cannabis—Section 280E and Tax Efficient Structuring

By Lewis M. Horowitz and Justin E. Hobson[1]

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 intended to reconsider the classification of cannabis in the first half of 2016. At the time of this writing, it was unclear whether the DEA would 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.[2] 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

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2 In August, 2016, the DEA ultimately did announce that it was currently not going to change the federal legal status of marijuana. See, http://www.businessinsider.com/dea-refuses-to-reclassify-marijuana-2016-8.

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,*[3] 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.[4] 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.

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*."[5]

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.[6] 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.[7]

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

The second approach to minimize the impact of section 280E is to 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"[8] (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.[9] 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.

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

In response to the above treatment of COGS by taxpayers in the cannabis industry, a recent IRS pronouncement attempts to limit reliance on section 263A to maxi-

3 T.C.M. 1981-623.

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

5 *Lawson v. Commissioner,* T.C. Memo 1994-286 (emphasis added).

6 128 T.C. 173 (2007).

7 139 T.C. 19 (2012).

8 *Reading v. Commissioner*, 70 T.C. 730, 733 (1978).

9 Reg. § 1.471-3(c).

mize 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.[10] 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.[11] 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.[12] 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, then 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.

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 in 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.

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10 *See Doyle v. Mitchell Bros. Co.*, 247 U.S. 179 (1918).

11 292 U.S. 435, 440 (1934).

12 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."

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.

Treasury Department Issues New "Customer Due Diligence" Rules

By Lee Kersten[13]

The Treasury Department has issued new rules requiring "financial institutions" to obtain the identities of "beneficial owners" of client company account holders and at least one senior manager. While financial institutions will have to verify identities through documents such as passports, they will not have to confirm the ownership stakes in the companies. Called the Customer Due Diligence rule, it has been in the works since 2010, but may have been released recently in response to the notoriety of the "Panama Papers." [For detailed text and description of the new rules, see https://www.gpo.gov/fdsys/pkg/FR-2016-05-11/pdf/2016-10567.pdf or go to the Treasury's website at www.FinCen.gov] The Final Rules were effective July 1, 2016.

Legislation proposed by the agency, which requires congressional approval, would create a federal database and require companies to register either when they incorporate or transfer ownership to the U.S. from overseas. It is unclear how workable this rule will be as in April 2016 alone more than 12 million ownership changes – 400,000 a day – took place at corporations worldwide, according to Orbis, a database of incorporation records.

Under the new rules, "covered financial institutions" are required to create and maintain written procedures by May 11, 2018 which will identify and verify "beneficial owners" of "legal entity customers." Planners accordingly need to be aware that their clients will be undergoing higher levels of scrutiny when dealing with banks and security companies. An individual must own at least 25% of the entity or be "in control" to be a "beneficial owner." Covered financial institutions must identify each individual meeting the ownership test (up to four) and one "control" individual. Legal Entity Customers are defined as corporations, LLCs, general partnerships, any entity formed by a filing with a Secretary of State or similar office, and foreign equivalents. There also are some exceptions. Note that trusts are not included in this definition (unless it is a business trust filing with the corporation division).

Where a legal entity customer is owned by one or more other legal entities, the customer is required to look through those other legal entities to determine each natural person who owns at least 25% of the equity interests. FinCEN confirmed it is generally the responsibility of the legal entity customer to determine whether a natural person meets the equity test. Critics have said that this could allow criminals to provide false information with little risk of getting caught. Treasury and law enforcement officials can contact the person who a company names as a senior manager if they want to investigate further.

Planners will need to keep these rules in mind as they structure and form entities covered by the new rules. Clients should be advised to expect additional scrutiny when dealing with financial institutions and to be prepared to identify beneficial owners. This may be challenging in many instances as there is little guidance regarding items such as stapled stock, phantom stock, repurchase arrangements, and other more sophisticated ownership devices.

2016 Award of Merit Recipient: Marc Sellers

By, Megan M. Halley

The recipient of this year's Taxation Section Award of Merit is Marc Sellers. The Award of Merit is bestowed upon an attorney who honors and exemplifies professionalism in the practice of tax law in Oregon. Among the factors considered are the candidate's leadership activities, integrity, reputation and service within the community. Mr. Sellers is a shareholder at Schwabe Williamson & Wyatt, where he has practiced for over 36 years. He served as Chairman of the Oregon Bar's Taxation Section in 2007 and remains an active member of the section. For more than 30 years Mr. Sellers has advocated for those who are treated inequitably by the tax system and has taken an active role in the professional development of the associates with whom he works.

His colleagues at Schwabe report that he consistently gives credit to the entire team, takes the time to provide meaningful feedback to associates on their work, willingly answers questions, and takes an active role in their career development. Marc's innate ability to divert attention from himself and turn the focus to those around him is evident in even casual conversation. In his role as a mentor, Marc stresses the fundamental importance of listening to the client and opposing counsel in order to provide the most effective advocacy. He strives to maintain positive professional relationships with everyone with whom he works, and believes in the importance of professionalism in the legal community to achieve the best outcome for clients.

When asked which professional accomplishment makes him proudest, he paused and then briefly mentioned that he was the first lawyer to obtain an award of attorney's

13 Lee Kersten is the owner of Kersten Law Group in Eugene, Oregon. He is a member of the Taxation Section and has been a member of the Oregon State Bar since 1982.

fees and costs against the IRS under the 1998 Revenue Act. He quickly moved on to discuss a project on which he has been working for the last 13 years, pursuing a lawyer/racekteer who defrauded several clients and other victims. This is an area of law in which Marc does not specialize, yet he has made the pursuit of this person, for the benefit of his clients and others, a priority for over a decade. Marc's fight to ensure the best and most equitable outcome for others has been one of the distinguishing characteristics of his career. He regularly takes on pro bono tax cases, most often representing battered or abused spouses in IRS collection actions. Marc is motivated to take these cases because he feels that these are truly cases of equity and that everyone deserves quality representation, regardless of their financial situation.

Marc received his Bachelor of Science degree in chemistry from the University of the Redlands in 1975 before going on to graduate from Loyola University Law School in Los Angeles. He practiced for a year at a small tax and securities law firm in Los Angeles, and then, in 1980, after graduating from the Tax LLM program at Georgetown, he moved to Portland to begin his career at Schwabe, Williamson, Wyatt, Moore & Roberts. He has received the John Schwabe Client Service Award, and the Willamette Management Associates *Insights* Standard of Excellence Award for his article "Introduction to the IRS's 'Parallel' Investigations." Marc was named "Tax Lawyer of the Year - Tax Litigation and Controversy" in Portland by *Best Lawyers in America 2012*, and has been listed in *Best Lawyers in America* for the last 14 years.

Mr. Sellers is an accomplished and well respected member of the Oregon Bar who embodies the standards set forth in the Bar's Statement of Professionalism. He gives back to the community through pro bono representation, is a true advocate for his clients, and actively mentors the younger lawyers with whom he works. For these reasons, and many others, the Taxation Section is pleased to present Marc Sellers with the 2016 Award of Merit.

Future Events

Dec 28, 2016
Portland Luncheon Series: Federal Legislative Update
Portland | 12:00-1:30 p.m.
Presenter: Mark Prater, Senate Finance Committee

On July 5, 2016, the Estate Planning community lost a dear colleague and friend in Jeff Cheyne. Jeff passed away after suffering a number of strokes in short succession. He was well known in the Pacific Northwest and the legal community for his intellect and legal skills, his deep understanding of the nuances of the law, his professionalism, and his contributions to the bar and community. He was an amazing mentor to the young and old. He was always just a phone call, email, or coffee break away. He made time for everyone.

Jeff had an amazing legal mind and an accomplished career. He was on, and headed, countless committees, study groups, and legislative work groups. He spent hours meeting with state representatives, giving testimony, and helping to shape our current estate, trust, and tax laws. When he saw a problem, he didn't simply ignore it, he did something about it. When he volunteered for something, he didn't just delegate tasks, but rolled up his sleeves and worked alongside you. His dedication to his craft, career, and profession was second to none.

Jeff was a cherished member of Samuels Yoelin Kantor, LLP since 2006. He was a very proud fellow of the American College of Trust and Estate Counsel and past president of the Oregon State Bar Estate Planning and Administration Section. But above all, he was a fierce and devoted counselor to his clients. He never lost the desire to learn and was always eager to discuss the finer points of the law. He was a valuable asset and friend to this community. He is missed.