IRS Position Paper Denies Application of §263A

to Calculation of COGS for Marijuana Businesses

A Review of CCA 201504011

Running title: CCA Memo denies UNICAP Rules to Illegal Marijuana businesses

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ABSTRACT

This article provides an analysis of the recent IRS Position Paper that concludes that marijuana businesses are denied the application of §263A when calculating costs of goods sold for federal income tax purposes. This conclusion is based upon an arguably strict and tautological analysis of the flush language after §263A(a)(2). This paper argues that a well-reasoned construction of the applicable statute suggests that there is adequate authority for marijuana businesses to apply §263A in the calculation of their costs of goods sold.

KEY WORDS

Costs of Goods Sold, Marijuana businesses, UNICAP rules, I.R.C. §280E

INTRODUCTION

On December 10, 2014 (release date January 23, 2015), the Office of the Chief Counsel of the Internal Revenue Service issued Chief Counsel Advice Memorandum (CCA 201504011) (Memo). The subject of this Memo was "Taxpayers Trafficking in a Schedule I or a Schedule II Controlled Substance – Capitalization of Inventoriable Costs." The Memo dealt with 2 issues. The second of the two issues, which is not the focus of this paper, in the Memo dealt with whether the IRS could require a business trafficking in Schedule I drugs (§280E taxpayer) to change to an inventory method when the taxpayer currently deducts otherwise inventoriable costs as deductions from gross income rather than treating said costs as COGS. Regarding this

second issue, the Memo concluded that yes, the IRS does have the authority under §446(b) to require a taxpayer to change to an accounting method that more clearly reflects gross income.

The first issue in the Memo, which is the subject of this paper, was: "How does a taxpayer trafficking in a Schedule I or Schedule II controlled substance determine cost of goods sold (COGS) for the purposes of §280E of the Internal Revenue Code (Code)?[1] With respect to the first issue, the Memo's conclusion was that: "A taxpayer trafficking in a Schedule I or a Schedule II controlled substance determines COGS using the applicable inventory-costing regulations under §471 as they existed when §280E was enacted."[2] Thus, the Memo denies to businesses that are subject to §280E the application of the more recently enacted §263A[3] to the calculation of COGS.

There are several reasons why an analysis of the IRS position on the calculation of COGS by a business subject to §280E is important. First has to do with the avoidance of tax preparer penalties (§6694) by the tax preparer and the avoidance of accuracy related penalties for the tax client (§6662). Even though the IRS Memo clearly states on its face: "This advice may not be used or cited as precedent"[4], and thus has no precedential value, "it gives us an important look into the IRS thought process on these important issues."[5] This combined with a lack of judicial interpretations on the issue makes it important to establish that there is adequate authority for taking an alternative position to that which reflects the IRS thinking in order to avoid the

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[1] Chief Counsel Adv. Mem. CCA 201504011 (Jan. 23, 2015).
[2] Chief Counsel Adv. Mem. CCA 201504011 (Jan. 23, 2015).
[3] §263A, commonly known as the UNICAP rules, was added by Congress in 1986. It generally increases the amount of costs that must be capitalized as inventoriable costs. Essentially the impact is to reclassify certain costs from being deductions from Gross Income to being treated as COGS deductible from gross receipts in arriving at gross income.
[4] Chief Counsel Adv. Mem. CCA 201504011 (Jan. 23, 2015).
[5] Marcuson, R., P. Lau, and C. Lendy, *The Evolving Taxation of the Marijuana Industry,* Taxes-The Tax Magazine, August 2017.

imposition of tax preparer penalties and/or taxpayer accuracy related penalties. Because of the lack of precedent this will require that such a position be “supported by a well-reasoned construction of the applicable statutory provision.”[6]

A second reason this issue is important is because of recent state legalization of the production, distribution, and use of marijuana for medicinal and/or recreational purposes, which has created a growing ‘legal’ market for tax and accounting services for said businesses.[7][8] However, even though marijuana may be legalized at the state level, it is still considered an illegal drug (a Schedule I controlled substance) and thus subject to §280E for federal tax purposes.[9]

Recent estimates suggest the “legal” marijuana industry is one of the fastest growing industries in the US. “Total “legalized” sales of marijuana were $5.4 billion in 2015 and were expected to grow by 24 percent in 2016 to $6.7 billion. This number is expected to increase by approximately 34 percent each year with projected 2020 legalized sales of approximately $21.8

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[6] Treas. Reg. §1.6662-4(d)(3)(ii).

[7] 23 states, Guam, and Washington DC have passed laws allowing for the use of marijuana to treat certain medical conditions. In addition, four states, Alaska, Colorado, Oregon, and Washington, have passed laws legalizing and regulating the recreational use of marijuana. Another 18 states considered legislation to legalize the recreational use of marijuana. Another 5 states are expected to prepare similar initiatives. An *Issue Brief on State Marijuana Laws and the CPA Profession*, prepared by the AICPA, in cooperation with the Colorado Society of CPAs (COCPA) and the Washington Society of CPAs (WSCPA), Issued July 24, 2015 and updated January 8, 2016.

[8] As of November 1, 2017 there are now 29 states that have legalized marijuana, including 8 states and the District of Columbia that have legalized the ‘recreational’ use of marijuana (*It's 2017: Here's where you can legally smoke weed now,* Business Insider (Jan.8, 2017).

[9] Although various states have legalized the production, distribution, and use of Marijuana for medical and/or recreational purposes, it is still considered an illegal controlled substance for federal tax purposes and such ‘legal’ marijuana businesses are still subject to IRC §280E. *M. Olive* 139 TC 19, 38, Dec. 59146 (2012), aff’d CA-9, 2015-2 USTC 50,377; *Canna Care, Inc.,* 110 TCM 408, Dec. 432(M), TC Memo 2015-206.

billion.[10] Based on this information, for 2017 legalized sales of marijuana should be approximately $9.0 billion and would be $12.0 billion for 2018. Given the projected size of this potential market for 'legal' tax services, it makes it important to know how best to advise said clients on the calculation of COGS for tax purposes since these businesses are still subject to §280E and may fall afoul of the IRS position as discussed above.

Thirdly, this issue not only provides a venue for examining the tension placed on federal tax law by a conflict between state and federal legislation, but also at the interpretative interplay within IRC Sections themselves, as well as the interpretative interplay with the 16th amendment when these various primary authorities are juxtaposed against each other. This is important since being able to develop a well-reasoned construction of the applicable statutes depends upon a proper understanding of these interpretative interplays.

This article will review the reasoning and construction of the applicable statutory framework followed by the IRS in the Memo. It will then conclude with an alternative reasoning and construction that more adequately fulfills the standard required of IRC Reg. §1.6662-4(d)(3)(ii), for a 'well reasoned construction of the applicable statutory provision(s)' than the Memo's analysis.

A REVIEW OF MEMO's REASONING AND CONSTRUCTION OF APPLICABLE STATUTES

In this Letter Ruling the IRS separated their reasoning under two headings, Background and Analysis.[11]

[10] Marcuson, R., P. Lau, and C. Lendy, *The Evolving Taxation of the Marijuana Industry*, Taxes-The Tax Magazine, August 2015 referencing Tom Huddleston, Jr., *Legal Marijuana Sales could hit $6.7 billion in 2016*, Fortune (Feb 1, 2016).
[11] Chief Counsel Adv. Mem. CCA 201504011 (Jan. 23, 2015).

Background

In this section the IRS followed the approach of starting with a very broad overview of the history and application of the Federal Income tax statutes, including reference to the 16th amendment and then gradually narrowing its focus to the relevant code sections being analyzed. A review of the Background section of the Memo follows.

Marijuana is an Illegal CSA Schedule I Drug under Federal Law

Even though under certain state laws it is legal to traffic in marijuana for medical and/or recreational uses, under federal law, said trafficking is illegal. The federal Controlled Substances Act of 1970 classifies marijuana as a Schedule I hallucinogenic drug.[12]

All Businesses Whether Legal or Illegal are Subject to Federal Income Tax

The IRS Memo continues by arguing that the source of the gross income, whether legal or illegal is not determinative in the application of federal income tax under §61(a). A Supreme Court case, James v. United States[13] is cited as support of their conclusion that illegal businesses are subject to federal income taxation. Although the court in this case affirmed that all illegal income was taxable, the Court was primarily concerned with correcting a prior Supreme Court decision that ruled that embezzled income might not be subject to §61(a).

In the Wilcox case, a Supreme Court case prior to James,[14] the court had ruled "since Wilcox embezzled the money, held it without any semblance of a bona fide claim of right, and therefore was at all times under an unqualified duty and obligation to repay the money to his

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[12] The Schedule I category includes opiates, opium derivatives such as heroin and morphine, and hallucinogenic substances such as LSD and marijuana. *The Comprehensive Drug Abuse Prevention and Control Act of 1970*, 21 U.S.C. §801-971 (1970).

[13] *James v. United States*, 366 U.S. 213 (1961), 61-1 USTC ¶9449.

[14] *Commissioner v. Wilcox*, 327 U.S. 404 (1946), 46-1 USTC ¶9188.

employer," the Court found that the money embezzled was not includible within "gross income."[15] The Supreme Court in James v. US ruled that the prior Wilcox ruling was in error and stated "We believe that Wilcox was wrongly decided and we find nothing in congressional history since then to persuade us that Congress intended to legislate the rule. Thus, we believe that we should now correct the error and the confusion resulting from it, … We should not continue to confound confusion, particularly when the result would be to perpetuate the injustice of relieving embezzlers of the duty of paying income taxes on the money they enrich themselves with through theft while honest people pay their taxes on every conceivable type of income."[16] In commenting on the legislative history of the Federal income tax statutes the court said,

> "Section II B of the Income Tax Act of 1913 provided that "the net income of a taxable person shall include gains, profits, and income . . . from . . . the transaction of any lawful business carried on for gain or profit, or gains or profits and income derived from any source whatever . . . ." (Emphasis supplied.) 38 Stat. 167. When the statute was amended in 1916, the one word "lawful" was omitted. This revealed, we think, the obvious intent of that Congress to tax income derived from both legal and illegal sources, to remove the incongruity of having the gains of the honest laborer taxed and the gains of the dishonest immune."[17]

And thus the importance of the James case to this Memo is not in merely establishing that illegal income is subject to IRC §61(a) but rather that all illegal income, including income from embezzlement activities, is included under the afore mentioned 'well-established principle that unlawful gains are subject to income tax under IRC §61(a).'[18] Therefore this would include income from trafficking in illegal drugs.

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[15] *James v. United States*, 366 U.S. 213 (1961), 61-1 USTC ¶9449.
[16] *James v. United States*, 366 U.S. 213 (1961), 61-1 USTC ¶9449.
[17] *James v. United States*, 366 U.S. 213 (1961), 61-1 USTC ¶9449.
[18] *James v. United States*, 366 U.S. 213 (1961), 61-1 USTC ¶9449.

All businesses whether legal or illegal are permitted to deduct COGS from Gross receipts in arriving at Gross Income for tax purposes

The Memo continued it background section with a discussion of how the 16th Amendment's use of the term income has been interpreted by the Supreme Court. The Court's interpretation was that the term income refers not to gross receipts but to gross income. The 16th amendment does not authorize the government to tax gross receipts but gross receipts less the taxpayer's return of capital (i.e., gross income). There can be no gross income until the taxpayer has recovered their economic investment. For merchandising and manufacturing businesses the costs of goods sold represents the taxpayer's return of capital. Thus, unlike a deduction from gross income, the ability to reduce gross receipts by costs of goods sold does not depend upon legislative grace but rather is a constitutional mandate under the 16th amendment as interpreted by the Supreme Court. The Memo quoted from a 1934 Supreme Court case, "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."[19]

Federal Tax Treatment of a Business Trafficking in a "Controlled Substance

The background section now narrows further and begins to focus on trafficking in Controlled Substances by discussing the background to the passage of §280E in 1982. Prior to 1982 a business that trafficked in a Controlled Substance received the same tax treatment as a legal business for both its costs of goods sold and its deductions from gross income. In 1981 the Edmondson case was tried in the Tax Court where the IRS argued that a business trafficking in a Controlled Substance was not allowed to deduct its ordinary and necessary business expenses.

[19] *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934), 4 USTC ¶1292.

The 1981 tax court case ruled in favor of the taxpayer that their deductions from gross income did qualify as ordinary and necessary expenses of the business.[20]

In discussing the Edmondson case a 2017 article in *Taxes-The Tax Magazine*, made the statement: “This angered many, including the U.S. Congress, which reacted by enacting Code Sec. 280E in 1982 to reverse the Edmondson holding by disallowing ordinary and necessary expenses to those trafficking in Schedule I and II drugs.”[21] The IRS Memo includes a discussion of congressional intent in only disallowing deductions from gross income and not also disallowing costs of goods sold to those trafficking in a controlled substance. Congressional intent as expressed in the Senate Report for not attempting to disallow costs of goods sold was: “To preclude possible challenges on constitutional grounds, the adjustment to gross receipts with respect to effective costs of goods sold is not affected by this provision of the bill.”[22]

Although not cited in the Memo, the 1982 Blue Book General Explanation of TEFRA used similar language in discussing the intent of Congress in passing this provision. The Blue Book stated: “To preclude possible challenges on constitutional grounds, the adjustment for gross receipts with respect to costs of goods sold is not affected by this provision of the Act.”[23]

Both the Senate Report and the Blue Book demonstrate that congressional intent was that §280E should have no negative impact on the calculation of costs of goods sold for businesses subject to §280E. The Memo then took the next step in bringing the background section of their

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[20] *Edmondson*, TC Memo 1981-623.

[21] Marcuson R., P. Lau, and C. Lendy, *The Evolving Taxation of the Marijuana Industry* (Taxes-the Tax Magazine (Aug. 7, 2017).

[22] S.R. Rep. No 97-494 (Vol. I), at 309 (1982).

[23] General Explanation Of The Revenue Provisions Of The Tax Equity And Fiscal Responsibility Act of 1982, JCS-38-82 (H.R. 4961, 97th Congress, Public Law 97-248) at 264.

Memo into sharper focus on the issue at hand by examining how a business subject to §280E should calculate its COGS for federal income tax purposes.

The Memo then noted that although Congress cannot deny the adjustment to gross receipts in arriving at gross income, Congress does have the power to legislate how COGS is to be calculated. IRC §471 and the related Treasury Regulations represented a foray by Congress into this arena. However, in 1986 Congress, believing that §471 and the related Treasury Regulations to be deficient revisited this provision and enacted IRC §263A, otherwise known as the UNICAP rules, which revised how COGS is to be calculated. In 1988 Congress made a retroactive revision to §263A and added the following flush language at the end of §263A(a)(2): "Any cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph."

The congressional intent for this flush language is referred to in the Memo by quoting from the Senate Report: "Thus, for example, the portion of a taxpayer's interest expense allocable to personal loans, and hence is disallowed under section 163(h), may not be included in a capital or inventory account and recovered through depreciation or amortization deductions, as a cost of sales, or in any other manner." The congressional intent was that nondeductible expenses such as personal interest were not contemplated to be subject to inclusion in COGS. However, the Memo was silent regarding the fact that there was no reference to §280E in the congressional committee reports that might indicate this flush language was to be applied to businesses subject to §280E as well.

Finally, at this point in the background section the last prop is put in place for the defense of the IRS analysis yet to come. From here the IRS will argue in the analysis section that because none of a §280E business' ordinary and necessary business expenses are allowable as deductions

from gross income, this flush language in §263A precludes businesses subject to IRC §280E from the applicability of §263A. In other words, the Memo argues that only statutes that were in place regarding COGS at the time §280E was enacted are applicable, which means only the §471 rules and regulations as of 1982 apply to such businesses.[24]

See Table 1 for an historical timeline of important events related to this analysis of the Memo' background.

(Insert Table 1 about here)

Analysis

In the analysis section of the Memo develops its reasoning in arriving at its conclusion that 263A does not apply to §280E businesses by considering three questions: "(1) When and how an item becomes an inventoriable cost; (2) what Congress intended to include within the meaning of inventoriable costs when they enacted §280E; and (3) whether Congress changed their definition when they enacted §263A."[25]

When and How an Item Becomes an Inventoriable Cost

[24] It is educational at this point to understand why illegal drug businesses want §263A to apply and why the government prefers §263A not apply. This is a reversal of positions with respect to the applicability of §263A. As a result of §280E, illegal drug businesses cannot deduct their ordinary and necessary business expenses, and thus they are at a distinct disadvantage tax wise as compared to a legal drug business. This is because an illegal drug business' gross income is effectively its taxable income as well, subjecting it to a substantially greater tax burden. And since §263A, in general, results in an increase in COGS, for an illegal drug business, this automatically translates into a decrease gross income, which translates into a corresponding decrease in taxable income for such a business, which reduces their tax burden. Thus, because of §280E's disallowance of all ordinary and necessary expenses for an illegal drug business, §263A is a win-win situation for such businesses. This explains why the IRS might be motivated to oppose §263A's application to these businesses, if for no other reason then to protect a potentially lucrative stream of tax revenue for the government from such businesses.

[25] Chief Counsel Adv. Mem. CCA 201504011 (Jan. 23, 2015).

Rather than follow the logical progression of their presentation of the historical and legal background for this issue as developed in their background section of the Memo, which included the constitutional mandate for costs of goods sold, the Memo seems to take a different approach. It argues that before a cost can be included in costs of goods sold it must first qualify as a deductions from gross income in the tax statutes. And then it is only subject to reclassification as a cost of goods sold to the extent the tax statutes permit said deduction to be reclassified as a cost of goods sold. It is almost as if they know the conclusion they want to defend (i.e., disallowance of §263A to §280E businesses) and work backwards from the desired outcome to a defense of said outcome. Based upon this approach the IRS Memo argues that §263A is a timing statute and seem to overlook the congressional intent for the statute, which was to prevent distortions of the constitutionally mandated costs of goods sold. The congressional intent was never expressed as merely an exercise in changing the timing of certain deductions by reclassifying them as costs of goods sold (which may only be deducted in the period the inventory is sold). Using this line of reasoning, it would seem the implication from the Memo is that when and how a cost becomes a cost of goods sold is not constrained by constitutional mandate but is dependent upon legislative grace.

Based on this line of reasoning what seems to be implied in the Memo is that any statute dealing with costs of goods sold, including §471 is nothing more than a timing provision. This circular type reasoning seems to allow the IRS to imply that that tax statutes addressing costs of goods sold need not be interpreted in light of the constitutional mandate for costs of goods sold but rather may be interpreted by reference to the legislative grace empowered to Congress with respect to deductions from gross income.

What Congress Intended to Include within the Meaning of Inventoriable Costs when they enacted §280E

This then sets the stage for the resolution of the second question addressed in the analysis section of the Memo. Namely, if it can be implied that Congress' attempt at defining costs of goods sold is to be interpreted, not in light of the constitutional mandate, but instead by reference to the power given to Congress to legislate what is and what is not a deduction from gross income, then a plausible argument can be made that when §280E was enacted congressional intent was to disallow any deductions in arriving at taxable income only to the extent that the current tax statutes had not already reclassified such deductions as costs of good sold (i.e., §471 and related Treasury Regulations as of that date). This reasoning would then allow the Memo to interpret Congress' recognition that to attempt to disallow costs of goods sold would raise the specter of a constitutional challenge to only those deductions that had already been legislated as costs of goods as of the passage of §280E. And since §263A was not enacted until several years later and it is, according to this Memo, a timing provision, not an attempt to more correctly calculate the constitutional mandate for COGS, Congress must not have intended §263A to apply to §280E. It is instructive to note that when, two years later, the flush language of §263A(s)(2) was added that limited the §263A definition of COGS to only those costs that meant the definition of ordinary and necessary deductions there is no mention in the congressional record that the intent of this provision was to prevent illegal drug businesses from using §263A to more correctly calculate COGS.

Although it may be unclear what the IRS purpose was when it stated, "§263A…did not revolutionize inventory costing." What is clear from the congressional reports is that Congress clearly believed that the 'current' rules were deficient and that they could cause distortions in

allocations of economic resources and in the organization of certain economic activities.[26] The congressional record establishes that Congress believed that the current rules “may allow costs that are in reality costs of producing, acquiring, or carrying property to be deducted currently, rather than capitalized into the basis of the property and recovered when the property is sold.”[27] The focus of congressional intent was not on the conversion of deductions into costs of good sold but the focus was to more clearly reflect income and to prevent costs that are more correctly defined as costs of goods sold from being treated as deductions from gross income. Thus it would seem to be an unreasonable construction of the flush language to argue said language precludes §280E businesses from the application of §263A.

This reasoning also fails to recognize that the flush language only applies if a different provision that prohibits the inclusion of the item in figuring taxable income should apply. Because congressional intent clearly indicates that their intent with respect to §280E was not to prohibit costs of goods sold but rather to mandate it for illegal drug traffickers, it is unreasonable to argue that §280E prohibits taxpayers from more accurately calculating costs of goods sold via the use of §263A. From the congressional record the intent of the flush language was actually aimed at preventing taxpayers from including in costs of goods sold costs that could not reasonably be viewed as inventory costs, such as interest allocable to personal loans.[28] In other words, the §280E prohibition against deductions from gross income for illegal drug traffickers exists “in a plane parallel to and separate from, the congressional and constitutional mandate for

[26] S.R. Rep. No. 313, 99th Cong., 2d Sess.11 (1986), 1986-3 C.B. Vol. 3 at 140.
[27] S.R. Rep. No. 313, 99th Cong., 2d Sess.11 (1986), 1986-3 C.B. Vol. 3 at 140.
[28] H.R. Rep. No. 1104, 100th Cong., 2d Sess. (1988), 1988-3 C.B. 473.

all proper adjustments to gross receipts."[29] Thus it may be argued that the Memo's construction of §263A and in particular the flush language of §263A(a)(2) is not a reasonable construction.

In addition it was clearly the intent of Congress, as expressed in the Senate Report, that a "single, comprehensive set of rules should govern the calculation of COGS."[30] In other words it was not congressional intent for §263A to only apply to legal businesses but not apply to illegal businesses such as §280E businesses. It would seem that here the IRS is arguing that illegal businesses should be treated differently under the federal tax statutes. Thus ignoring their own background section of the Memo where they so carefully argued, "§61(a) does not differentiate between income derived from legal sources and income derived from illegal sources."[31]

Whether Congress changed their definition when they enacted §263A

In an attempt to impart a final convincing blow to the non-applicability of §263A to §280E the third argument addressed in the Memo is "(3) whether Congress changed their definition when they enacted §263A."[32] With the tautological reasoning followed for questions (1) and (2) the Memo arrives at what they consider to be an inescapable conclusion to this final question, no, Congress did not change their definition of costs of goods sold that should apply to illegal drug businesses when they enacted §263A. They merely expanded the deductions that could be reclassified as costs of goods sold for those businesses that were not illegal drug traffickers. The authors of the Memo seem to attempt to bolster this conclusion with the

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[29] Kosnitzky, M., and M. Kaden. *IRS Interpretation Causes Reefer Madness*, Taxes-The Tax Magazine (April 15, 2015 at 75).
[30] Kosnitzky, M., and M. Kaden. *IRS Interpretation Causes Reefer Madness*, Taxes-The Tax Magazine (April 15, 2015 at 75).
[31] Chief Counsel Adv. Mem. CCA 201504011 (Jan. 23, 2015).
[32] Chief Counsel Adv. Mem. CCA 201504011 (Jan. 23, 2015).

comment that Congress did not intent to revolutionize costs of goods sold by enacting §263A.[33] The memo states: "263A increased the types of costs that are inventoriable… but did not revolutionize inventory costing."[34] From which the Memo must be expecting the reader to conclude that businesses subject to §280E are locked into using a deficient definition of COGS, i.e., §471.

Although it my be unclear why the Memo believes that stating that Congress did not intend to revolutionize inventory costing, what is clear from the congressional reports is that Congress clearly believed that the 'current' rules were deficient and that they could cause distortions in allocations of economic resources and in the organization of certain economic activities. The congressional record establishes that Congress believed that the current rules "may allow costs that are in reality costs of producing, acquiring, or carrying property to be deducted currently, rather than capitalized into the basis of the property and recovered when the property is sold."[35] Congressional intent was not to convert deductions into costs of good sold but was to more clearly reflect income and to prevent costs of good sold from being treated as deductions from gross income. It would be unreasonable to deny traffickers in illegal drugs the applicability of a statute whose express purpose was to allow all businesses to more clearly reflect income. In addition, to do so would fly in the face of the congressional intent to preclude a constitutional challenge to §280E.

[33] One wonders why the voluminous regulations the IRS issued were necessary if §263A was not meant to have a significant impact on the calculation of costs of goods sold but merely a reclassification of certain deductions. But I suppose that is not relevant to this point?
[34] Chief Counsel Adv. Mem. CCA 201504011 (Jan. 23, 2015).
[35] S.R. Rep. No. 313, 99th Cong., 2d Sess.11 (1986), 1986-3 C.B. Vol. 3 at 140.

Also, it was clearly the intent of Congress, as expressed in the Senate Report, that a "single, comprehensive set of rules should govern the calculation of COGS."[36] In other words it was not congressional intent for §263A to only apply to legal businesses but not apply to illegal businesses such as §280E businesses as espoused in this Memo. It would seem that here the IRS is arguing that illegal businesses should be treated differently under the federal tax statutes. This would suggest the authors of the Memo overlooked their own background section where they so argued, "§61(a) does not differentiate between income derived from legal sources and income derived from illegal sources." [37]

Based upon their analysis of these three questions, the Memo 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."[38]

CONCLUSION

For a tax professional to recommend a position to a taxpayer it is necessary for the tax professional to establish there is 'substantial authority' for the position (§6694). If there is not substantial authority but only a reasonable basis for the position, the tax professional may still recommend the position, if the position is disclosed on the tax return. If there is no judicial authority to make the determination as to whether the authority for the position is substantial the

[36] S.R. Rep. No. 313, 99th Cong., 2d Sess.11 (1986), 1986-3 C.B. Vol. 3 at 140.
[37] Chief Counsel Adv. Mem. CCA 201504011 (Jan. 23, 2015).
[38] Chief Counsel Adv. Mem. CCA 201504011 (Jan. 23, 2015).

regulations require the tax professional be able to support the position by a "well reasoned construction of the applicable statutory provision"[39]

Based on the above review of this IRS Memo, one question here is if it can be argued that there is a well-reasoned construction of the applicable statutory provision supporting taking a position contrary to the position advocated in this Memo. If so, then such a position would meet the criteria for being substantial authority for purposes of §6694 (tax preparer penalty provision) and §6662 (taxpayer accuracy related penalties provision).

As discussed above, when reviewing the IRS position there appears to be room in the interpretation of the applicable statutes, including the interpretation of the flush language of §263A, to argue that the substantial authority standard can be met for §280E businesses to apply §263A, the UNICAP rules, to the calculation of their costs of goods sold for federal tax purposes. A recap of the reasoning follows:

1. Costs of goods sold is a constitutional mandate as defined by the Supreme Court and not dependent upon legislative grace.

2. All businesses, whether legal or illegal are entitled to adjust their gross receipts for the amount of the costs of goods sold in order to clearly reflect income.

3. §280E affirms that even businesses trafficking in Schedule I or Schedule II controlled substances are also entitled to adjust their gross receipts by the amount of their costs of goods sold in order to correctly determine gross income.

4. Because congressional intent with the enactment of §263A was to correct prior deficiencies in §471 and the §471 Regulations (with the goal of businesses being able to more

[39] Treas. Reg. §1.6662-4(d)(3)(ii).

correctly reflect income), to require illegal drug traffickers to determine inventoriable costs using applicable inventory regulations under 471 as they existed when 280E was enacted in 1982 is not reasonable and is not consistent with the congressional intent for the enactment of §263A. Such businesses are also entitled to the application of §263A in the calculation of costs of goods sold.

5. A well reasoned construction of the flush language of §263A(a)(2) suggests that it is not intended to apply to §280E, since even a business subject to §280E is entitled to calculate its costs of goods sold in a way that Congress believes most clearly reflects income. To interpret the flush language under §263A(a)(2) as encompassing a prohibition of §263A to businesses subject to §280E is not reasonable as it would be contradictory to the clearly expressed congressional intent to correct prior statutory deficiencies in the calculation of costs of goods sold. Rather, the flush language was meant to preclude overly aggressive taxpayers from seeking to use the provision for converting expenses that were otherwise not considered ordinary and necessary, e.g., interest on a personal loan, into costs of goods sold.

As mentioned in the introduction this issue not only provides an intriguing venue for examining the tension placed on federal tax law by a conflict between state and federal legislation, but it also presents a fascinating look at the interpretative interplay within IRC Sections themselves, as well as the interpretative interplay with the 16th amendment, when these various primary authorities are juxtaposed against each other. The issue of costs of goods sold can be seen to require a careful interpretation. It is a constitutional mandate but it is also a subject of legislation as Congress has seen fit to provide guidance in the calculation of this 'non-deduction'. This suggests that it is important to recognize that when considering the prohibition of deductions under §280E that this prohibition exists "in a plane parallel to and separate from

the congressional and constitutional mandate for all proper adjustments to gross receipts."[40] To fail to pay appropriate attention to this in any legal analysis will jeopardize the viability of such an analysis.

[40] Kosnitzky, M., and M. Kaden. *IRS Interpretation Causes Reefer Madness*, Taxes-The Tax Magazine (April 15, 2015 at 75)

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Table I: An historical timeline of important events related to this analysis of the Memo's background of taxation of a marijuana business.

1913	16th Amendment makes income subject to Federal Income Tax.
1913	Congress enacts Section IIB of the Income Tax Act of 1913 legislating that both legal and illegal businesses are subject to federal income tax.
1934	Supreme Court case (New Colonial Ice Co. v. Helvering) rules that income subject to tax as contemplated by the 16th amendment is gross income. COGS is a return of capital not an ordinary and necessary deduction.
1954	IRC §471 (revised 1986 to reference 263A) defined what is a cost properly included in COGS.
1961	Supreme Court case (James v. US) reaffirms taxability of illegal businesses.
1982	IRC §280E disallows deductions from gross income for businesses trafficking in controlled substances. Intent was this provision should have no impact on calculation of COGS.
1986	IRC §263A clarifies what is a cost properly includable in COGS.
1988	IRC §263A revision retroactively clarified that otherwise non-deductible business expenses were not contemplated to be included as COGS.
1996 to present	Twenty-nine states have legalized marijuana for medical purposes.
2012 to present	Nine state have legalized marijuana for recreational purposes.
2015	IRS CCA Memo takes position that UNICAP Rules (§263A) are not applicable to businesses subject to §280E.