Federal Taxation of Marijuana Businesses

Although the cultivation and distribution of marijuana is now legal under the laws of several states (whether for medical or recreational use), marijuana is considered a Schedule I drug under federal law. Therefore, all marijuana producers and resellers are subject to Internal Revenue Code ("IRC") § 280E, which disallows deductions and credits incurred in the trade or business of trafficking controlled substances (which are the Schedule I and II drugs).

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However, since IRC § 280E does not affect the adjustment to gross receipts due to cost of goods sold ("COGS"), producers and resellers can deduct the cost of growing or acquiring marijuana. Consequently, many tax professionals have suggested that marijuana businesses allocate as many expenses as possible to COGS under the uniform capitalization rules of § 263A, which requires certain indirect costs attributable to inventory, such as labor, storage, and rent, to be capitalized rather than expensed.

In early 2015, the IRS Office of Chief Counsel released a Memorandum[1] which stated the IRS's position that taxpayers in the marijuana business are required to determine COGS using the applicable inventory-costing regulations under § 471 as they existed at the time § 280E was enacted. The IRS's position essentially prevents marijuana businesses from taking advantage of the uniform capitalization rules under § 263A to capitalize expenses under COGS, because § 263A was enacted four years after the enactment of § 280E. Despite the Memorandum, there are several strategies that may be considered to minimize the tax liability of a licensed marijuana business. Additionally, the Memorandum provides only the IRS's position, which has not yet been challenged or addressed in U.S. Tax Court.

Separate Line of Business

Any entity operating a separate business in addition to the business of producing or reselling marijuana may allocate expenses between the marijuana business and the separate business, because deductions attributable to the separate business are not disallowed by § 280E. *California Helping to Alleviate Medical Problems, Inc. v. Commissioner*, 128 T.C. 173 (2007). Therefore, marijuana resellers and producers may include a separate and complimentary line of business operating out of the same location (e.g. gift shop, counseling services, relaxation therapy). This allows the licensed marijuana business to share expenses with a separate business that is not prohibited from claiming deductions under § 280E. The businesses would be organized as separate entities and would maintain detailed records of the allocation of expenses for each entity. Additionally, the businesses may consider entering into a joint venture agreement that defines the scope of each business in order to further segregate the separate business and the marijuana business. The joint venture agreement would state that the entity operating the separate business is prohibited from receiving any revenue produced by marijuana sales subject to the state or local marijuana laws.

Another benefit of setting up the two lines of business as separate entities is that the entities can have different tax status. Many marijuana businesses are established as C corporations. However, C corporation status tends to penalize small businesses due to double taxation (tax at both the entity and shareholder level). The separate line of business can choose to be an S corporation, partnership, or sole proprietorship and avoid the double tax it would be subject to if it were operated under the same entity as the marijuana business.

Capitalizing Costs Under § 263A

Although the Memorandum lays out a logical argument for not allowing marijuana businesses to utilize the uniform capitalization rules under § 263A, one could argue that the IRS's position uses the timing of the enactment of § 280E and § 263A as a pretext to penalize marijuana businesses operating legally under state law. The explanation in Senate Report of § 280E specifically states that adjustments with respect to COGS are not affected by § 280E. S. Rep. No. 97-494 (Vol. I), at 309 (1982).

However, the uniform capitalization rules under § 263A were not introduced until the Tax Reform Act of 1986, four years after the enactment of § 280E. At the time § 280E was enacted, the inventory-costing regulations used to calculate COGS were the regulations under § 471. Under the regulations under § 471, a reseller of marijuana is required to capitalize the invoice price of the marijuana purchased, less trade or other discounts, plus transportation and other necessary charges incurred in acquiring the marijuana. Treas. Reg. § 1.471-3(b).

All other expenses are considered business expenses under § 162, which are disallowed by § 280E. Section 263A increased inventoriable costs by requiring taxpayers to capitalize certain expenses that had previously been deductible under § 162. Unlike most other businesses, marijuana businesses would prefer to capitalize costs under § 263A, rather than deduct those expenses under § 162, because such deductions are disallowed by § 280E.

However, § 263A(a)(2) provides that "[a]ny 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 IRS argues that when § 263A(a)(2) is read with §280E, it is clear that marijuana businesses cannot take advantage of the uniform capitalization rules under § 263A to convert non-deductible expenses into inventoriable costs. Additionally, the IRS argues that § 263A is a timing provision and that if a taxpayer were allowed to capitalize "additional 263A costs," § 263A would no longer be merely a timing provision and would become a provision that transforms non-deductible expenses into capitalizable costs.

It may be argued, however, that the IRS's position converts an otherwise inventoriable cost under § 263A into a deductible expense for the purpose of disallowing it under § 280E. Section 280E explicitly refers to a "deduction or credit." Furthermore, as noted above, the Senate Report specifically states that IRC § 263A does not affect adjustments with respect to COGS. The IRS's position forces certain taxpayers to calculate COGS differently from all other taxpayer's due to a code section that is not intended to affect the calculation of COGS. Although this argument may seem somewhat circular, it appears that the IRS is going out of its way to disallow deductions and penalize marijuana businesses that are operating lawfully under state law.

Despite the Memorandum, marijuana businesses may feel inclined to continue to capitalize costs under § 263A while the rule remains unresolved by the courts. Although a marijuana business reporting substantial expenses under "additional section 263A costs" on their Form 1125-S may be audited and the IRS may disallow the additional 263A costs in accordance with the Memorandum, the taxpayer would have the option of contesting some or all of the disallowed expenses. The taxpayer should not be subject to a penalty under § 6662 if the position is adequately disclosed on the return, because the taxpayer may argue that it has a reasonable basis for taking the disclosed position. Furthermore, a return preparer should not be subject to a penalty under § 6694 if the position is adequately disclosed. Therefore, until the Tax Court addresses this issue, a marijuana business may consider utilizing the uniform capitalization rules, but with the expectation that the position may be challenged by the IRS.

1 Office of Chief Counsel Memorandum No. 201504011 (1/23/15)

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In Memoriam

The local legal community suffered the loss of two of its beloved attorneys recently:

Fred Saul Steingold, 81, passed away on August 8, 2017.

J. Samuel Holtz, 60, passed away on September 3, 2017.

Our deepest sympathies are with their families.