As we read the Tax Court's opinion in Alterman & Gibson[1] it became quite clear that IRC Sec. 280E was not the primary issue in the case. The primary issues were a combination of:

- Inadequate, sloppy bookkeeping and record organization.
- Failure to properly maintain inventory records and to substantiate of Cost of Goods Sold.
- A lack of knowledge, skills and experience on the part of the business owners, the individuals responsible for the bookkeeping and tax return preparation, and counsel for the failure to properly develop technical aspects of the income tax issues.
- The misguided and improper attempt to use the multiple business concept from CHAMP.

We highlighted our concerns that a failure to take corrective action lays the foundation for the Internal Revenue Service to assert the existence of pattern of repeated and potentially reckless and intentional disregard of the regulations and requirements. Such a pattern can result in the assertion of the "second tier" enhanced penalty under IRC Sec. 6694(b)(2). Such a penalty assertion could result in an additional sanction through a practitioner disciplinary referral to the Office of Professional Responsibility ["OPR"].

Professor Bryan Camp wrote an exceptionally insightful piece regarding the importance of proper tax accounting in connection with the calculation and maintenance of records that should be used in the computing Cost of Goods Sold in Lesson from The Tax Court: Into the Weeds on COGS

We have written extensively about our analysis and views in A Methodology for Cost and Expense Allocations for IRC Sec. 280E. We have learned several important points in working with a range of cannabis industry businesses. IRC Sec. 280E has the potential to apply in different ways to different types of cannabis businesses. Retailers [dispensaries], Distributors, Manufacturers [Extractors] and Cultivators are engaged in different aspects of the supply chain. IRC Sec. 280E applies to all businesses in the chain, although it applies in a different fashion to each such a business.

The cannabis industry taxpayers that the IRS seems to have focused their attention on for examination have been retail dispensaries. We certainly notice that the majority of cases which have reached the Tax Court where IRC Sec. 280E issues have arisen have involved dispensaries almost to the complete exclusion of other types of cannabis businesses. The Californians Helping to Alleviate Medical Problems ("CHAMP") *v. C.I.R.*, 128 T.C. 173 (2007) case created a theory which is centered around two distinct trade or businesses being operated within a dispensary space, usually a cannabis business and another business involving caregiving services or similar health related services.

The second part of most of the cannabis litigation has involved calculations of Cost of Goods Sold and accuracy, completeness and sufficiency of inventory and other accounting records. We believe that is instructive to take a step back and consider the other participants within the cannabis Cultivator to Dispensary supply chain.

Cultivators

[1] T.C. Memo 2018-83.

A business in California that cultivates cannabis is engaged in agricultural activity [aka "farming][2] is subject to the general rules under the tax law that apply to farmers. Simply stated, farmers that raise crops [rather than purchase crops for other uses such as feed] which complete the planting growth, and harvest for sale cycle within a calendar year are referred to as annuals. The income tax accounting rules for annuals are straight forward:

- The costs associated with structures and improvements that have a long-term useful life such as out buildings, irrigation ditches and the like are capitalized and depreciated[3].

- Certain single purpose agricultural structures which are used by a farmer in a trade or business may be expensed.[4]

[2] We have written extensively about the classification issue in California Cannabis Cultivation - Qualification as Farming

[3] The TCJA shortened the recovery period for machinery and equipment used in a farming business from seven to five years (but excluding grain bins, cotton ginning assets, fences or other land improvements). The original use of the property must occur after 2017, and the shortened recovery period is effective for property placed in service after 2017. Also, property used in a farming business and placed in service after 2017, is not required to use the 150% declining balance method, except for 15-year or 20-year property.

[4] A taxpayer may elect to expense the cost of any Code Sec. 179 property (see below) and deduct it in the year the property is placed in service. The TCJA increased the maximum deduction from $500,000 to $1 million, and increased the phase-out threshold from $2 million to $2.5 million, effective for property placed in service in tax years beginning after 2017.

The TCJA also expanded the definition of Code Sec. 179 property, also effective for property placed in service in tax years beginning after 2017, to allow taxpayers to elect to include the following improvements made to nonresidential real property after the date when the property was first placed in service:

- Qualified improvement property, which means any improvement to a building's interior, *except* improvements attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building.
- Roofs, HVAC, fire protection systems, alarm systems and security systems.

- Special Purpose Agricultural Structures ["SPAS"] SPAS are defined as single-purpose livestock structures or single-purpose horticultural structures. A single-purpose livestock structure is any structure specifically designed, constructed and used

  (1) for housing, raising and feeding a particular type of livestock and its produce (such as eggs from a chicken), or

  (2) for housing the equipment necessary for housing, raising and feeding such livestock.

A hog confinement facility, milking parlor, etc., qualifies. A structure that handles more than one type of livestock does not qualify. A building with movable wall partitions that is used to store grain and machinery does not normally qualify for Section 179.

Dedicated grain bins (not flat grain storage) and certain other commodity storage structures may also qualify for these benefits. Commodity storage structures requiring specific temperatures, humidity levels, atmospheres and air movement may qualify for depreciation over seven years, although the Internal Revenue Service treatment is not as certain. In essence, these structures are viewed as large items of equipment

- The costs associated with conditioning and maintaining the soil, together with the cost of seed, fertilizer nutrients, labor associated with planting, trimming, tending and the actual harvesting of crops are all included in the cost of the crops which becomes part of the inventory, and when ultimately dispose of, are in Cost of Goods Sold ["COGS"].

- The costs of post-harvest breakdown of the plants between trim and flower, the placement in bulk packaging [typically "turkey bags" of approximately twenty pounds in weight] are included in inventory and ultimately COGS.

- Any Cannabis Cultivation Tax paid by the Cultivator should be included in the cost of inventory.

Unless a Cultivator has taken steps to develop a "brand" and incurred costs for intellectual property and marketing, it would be highly unusual for a Cultivator to incur costs which would qualify as "trafficking" costs and subject to IRC Sec. 280E. It is for precisely that reason that we are very hesitant to suggest that Cultivators avail themselves of the "Micro Business" provisions and involve themselves in Distribution activities as such involvement can cause a substantial amount of expenses to become subject to IRC Sec. 280E.

Manufacturers

The costs incurred in manufacturing are going to be divided into a number of categories. First, where the manufacturing consists of extraction from trim, the accounting becomes a process costing exercise which is in many ways similar to the operation of an oil refinery. The most significant accounting issues which require attention include:

- The accounting function, including software selection itself, the ability to track various batch's and samples of product that can be mixed, accurately measuring evaporation and weight loss are important.

- The allocation of costs to product batches will require consideration of the relative fair market value of different by-products and anything that should be treated as waste. Finally, the cost of consumables used in the extraction process will need to be accounted for.

- The extraction process described above, and subsequent manufacturing such as baking, or making candies should all be considered as part of the cost of inventory.

The expenditures which are typically viewed as "trafficking" expense include some testing, all costs of packaging, and the labor involved in getting product into packaging such as filling vape cartridges and placing product into retail packages, labeling and branding.

The discussion of an allocation of a portion of the cannabis Excise Tax ["CET"] to the value increment in the product created by the manufacturing process is beyond the scope of this overview.

It should be noted for Manufacturing, Distribution, and Retail that if there is dedicated storage, security systems or security for segregated inventory, an appropriate portion of these costs are properly allocated to inventory costs in order to escape IRC Sec. 280E.

Distributors

The Distributor role has the primary responsibility for getting products from either the Cultivator or Manufacturer to the retail level [Dispensary] including sole responsibility for transportation, testing, labeling, packaging and the collection and remittance of CET. As such, a very substantial portion, if not almost all of a Distributor's expenditures fall within the "trafficking: definition".

It is worth repeating that the dedicated costs of inventory storage and security may be subject to allocation and inclusion in inventory costs as are the costs of accounting, tax and executive management of the operation. We will discuss the options available for Distributors in another post.

We note that Distributors that do not take title to cannabis product, and merely transport it from licensed premises to licensed premises, are still required to be licensed, but none of their expenses should be subject to IRC Sec. 280E.

Retailers

We have reviewed the subject of IRC Sec. 280E allocations at the retail level ["Dispensaries"] in our previously referenced IRC Sec. 280E Analysis and are quoting herein.

> *"For the purpose of describing a defensible methodology for allocating costs and expenses of a dispensary to determine the disallowance pursuant to IRC Sec.280E, it will be assumed a storefront dispensary makes all sales on-site and all of the revenue of the dispensary is generated by such sales. It is also assumed for the purposes of this memorandum 80% of the total sales of merchandise by the dispensary are sales of cannabis and cannabis products and 20% of the sales are of other products not subject to IRC Sec.280E.*
>
> *Further, it is assumed the dispensary purchases substantially all of its cannabis and cannabis products in bulk and processes and packages the bulk material for retail sale. It is assumed thirty percent of the total square footage of the dispensary is devoted to the processing, packaging and storage of cannabis material held for retail sale, thirty percent of the square footage is devoted to management, back-office record-keeping and personnel needs.*
>
> *The dispensary has sales revenue from the sale of cannabis and cannabis products as well as from the sale of non-cannabis products. Both these classes of products will have associated COGS. For the purposes of this memorandum, it is assumed the non-cannabis products are purchased by the dispensary and packaged and labeled for retail sale on site. Based on this assumption, all additions to COGS for costs and expenses incurred by the dispensary for the processing and packaging of products for retail sale will be added to the COGS for the cannabis and cannabis products.*
>
> *The first allocation of the costs and expenses of the dispensary that must be made is the allocation of costs and expenses between operating expenses and COGS. As a starting point, it is assumed all of the costs and expenses of the dispensary will be allocated among three functions:*
>
> *(1) costs and expenses associated with the processing and packaging of cannabis and cannabis products for retail sale;*

(2) costs and expenses associated with the general administration and management of the dispensary; and

(3) costs and expenses associated with the retail sale function.

Direct costs and expenses must be first allocated among these three functions as a first step. As a second step the indirect costs must be determined and allocated. As a third step, costs and expenses allocated to general administration and management must in turn be allocated between the processing and packaging function and the retail sale function.

Some specific costs and expenses will be directly attributable to one of the three functions described in the preceding paragraph. Other costs and expenses are only indirectly allocable among these three functions. In some instances, a specific type of cost or expense may be partially attributable to one of the functions as a direct cost and partially allocable among the functions as an indirect cost. For example, if an item of equipment that utilizes a substantial amount of power in connection with processing and packaging, the cost of power for this equipment could be directly attributed to this function while the balance of the power cost was attributed to the facilities and allocated among the three functions as an indirect cost.

Each item of cost or expense must be separately examined, although the various items will fall into a fairly limited number of categories for the purposes of attribution among the functions.

Each specific item of cost or expense must be classified into categories for the purpose of attributing these costs to the appropriate functions of a business. Labor costs are useful for illustrating the methodology that should be followed. Labor costs are a significant portion of the total cost of the operation of a dispensary and a portion of the labor costs generally will be allocable to each of the functions of a business operation. The compensation of the employees of a dispensary generally can be allocated based on job title and time expended in connection with a particular function.

In the case of a dispensary, the compensation of most of the employees should be easily allocated among the processing and packaging function, the general administration function, and the retail sale function, based on the activities of employees. The associated employment costs relating to these employees should be allocated in proportion to the compensation costs in most instances. There is one category of compensation cost for most dispensaries that must be separately considered. Most dispensaries will also have a significant compensation cost for security personnel. In the instance of a California dispensary that has a substantial processing function, a strong argument can be made that the entire cost of compensation for security personnel is allocable to the processing and packaging function.

Each specific item of cost or expense that is financially significant should be examined in a manner similar to the evaluation given to labor costs in the preceding paragraph. Items of cost and expense that are not specifically allocable to processing and packaging function or to the retail sale function should be allocated to the general administration function. When each specific item of cost and expense has been allocated to one of the three categories, the total amount of the cost and expense attributed to the general administration function should be allocated between the processing and packaging function and the retail sale function based on the relative proportions of the compensation allocated to the two functions.

The total amount of the direct and indirect costs and expenses are allocated to the processing and packaging function. The total amount of these costs and expenses will be an addition to COGS. The total amount of the direct and indirect costs and expenses allocated to the retail sale function must then be allocated between sales of cannabis and cannabis products and sales of other products. Based on the assumptions described above 80% of the total amount of the direct and indirect costs and expenses will be allocated to the sale of cannabis and cannabis products and not deductible pursuant to IRC Sec.280E."