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subject: Taxpayers Trafficking in a Schedule I or Schedule II Controlled Substance --  
Capitalization of Inventoriable Costs

This advice responds to your request for assistance. This advice may not be used or cited as precedent.

#### ISSUES

- (1) 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")?
- (2) May Examination or Appeals require a taxpayer trafficking in a Schedule I or Schedule II controlled substance to change to an inventory method for that controlled substance when the taxpayer currently deducts otherwise inventoriable costs from gross income?

#### CONCLUSION

- (1) A taxpayer trafficking in a Schedule I or Schedule II controlled substance determines COGS using the applicable inventory-costing regulations under §471 as they existed when §280E was enacted.

- (2) Yes, unless the taxpayer is properly using a non-inventory method to account for the Schedule I or Schedule II controlled substance pursuant to the Code, Regulations, or other published guidance.

## BACKGROUND

In the Comprehensive Drug Abuse Prevention and Control Act of 1970, 21 U.S.C. §801–971 (1970), (“Controlled Substances Act” or “CSA”), Congress created a regime to curtail the unlawful manufacture, distribution, and abuse of dangerous drugs (“controlled substances”). Congress assigned each controlled substance to one of five lists (Schedule I through Schedule V). See §812 of the CSA. Schedule I includes: (a) opiates; (b) opium derivatives (e.g., heroin; morphine); and (c) hallucinogenic substances (e.g., LSD; marihuana (a/k/a marijuana); mescaline; peyote).

Though a medical marijuana business is illegal under federal law, it remains obligated to pay federal income tax on its taxable income because §61(a) does not differentiate between income derived from legal sources and income derived from illegal sources. See, e.g., *James v. United States*, 366 U.S. 213, 218 (1961). Under the Sixteenth Amendment of the United States Constitution (“Sixteenth Amendment”), Congress is authorized to lay and collect taxes on income. In a series of cases, the United States Supreme Court has held that income in the context of a reseller or producer means gross income, not gross receipts. In other words, Congress may not tax the return of capital. See, e.g., *Doyle v Mitchell Bros. Co.*, 247 U.S. 179, 185 (“As was said in *Stratton’s Independence v. Howbert*, [citation omitted], ‘Income may be defined as the gain derived from capital, from labor, or from both combined.’”); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934) (“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.”).

Section 61(a) defines “gross income” broadly using 15 examples of items that are includible in gross income. Consistent with the Sixteenth Amendment, §61(a)(3) provides that gross income includes net gains derived from dealings in property, which includes controlled substances produced or acquired for resale. “Gains derived from dealings in property” means gross receipts less COGS, which is the term given to the adjusted basis of merchandise sold during the taxable year. Section 1.61-3(a) of the Income Tax Regulations. See also §§1001(a); 1011(a); 1012(a). As the Tax Court explained in *Reading v. Commissioner*, 70 T.C. 730, 733 (1978), “[t]he ‘cost of goods sold’ concept 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.” A taxpayer derives COGS using the following formula: beginning inventories plus current-year production costs (in the case of a producer) or current-year purchases (in the case of a reseller) less ending inventories. In general, the taxpayer first determines gross income by subtracting COGS from gross receipts, and then determines taxable income by

subtracting all ordinary and necessary business expenses (e.g., §162(a)) from gross income.

In 1981, the Tax Court allowed an illegal business to recover the cost of the controlled substances (*i.e.*, amphetamines; cocaine; marijuana) obtained on consignment and also to claim certain business deductions (a portion of the rent he paid on his apartment which was his sole place of business, the cost of a small scale, packaging expenses, telephone expenses, and automobile expenses). See *Jeffrey Edmondson v. Commissioner*, T.C. Memo. 1981-623.

In 1982, Congress enacted §280E, which reverses the holding in *Edmondson* as it relates to deductions other than the cost of the controlled substances. Section 280E reads as follows:

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.

Under Explanation of Provision, the Senate Report reads as follows:

All deductions and credits for amounts paid or incurred in the illegal trafficking in drugs listed in the Controlled Substances Act are disallowed. 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.

S. REP. NO. 97-494 (Vol. I), at 309 (1982). The Senate bill was adopted in conference. CONF. REP. NO. 97-760, at 598 (1982), 1982-2 C.B. 661.

When enacting §280E, Congress exercised its authority to withhold the legislative grace mentioned in *New Colonial Ice Co.*, *supra*. It is important to understand that §280E even disallows a deduction for expenses that are not illegal per se (e.g., salaries; rent; telephone). Thus, §280E has a greater reach than §162(c), which disallows a deduction for specified illegal payments (e.g., bribes; kickbacks).

When §280E was enacted, taxpayers using an inventory method were subject to the inventory-costing regulations under §471. Specifically, resellers were subject to §1.471-3(b), and producers were subject to §§1.471-3(c) and 1.471-11 (“full-absorption regulations”).

Four years after enacting §280E, Congress enacted the Tax Reform Act of 1986, which added the uniform capitalization rules of §263A to the Code. Under §263A(a), resellers and producers of merchandise are required to treat as inventoriable costs the direct costs of property purchased or produced, respectively, and a proper share of those indirect costs that are allocable (in whole or in part) to that property. Flush language at the end of §263A(a)(2) provides, “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 flush language at the end of §263A(a)(2) was added by §1008(b)(1) of the Technical and Miscellaneous Revenue Act of 1988 (“TAMRA”)<sup>1</sup> (P.L. 100-647), *reprinted in* 1988 U.S.C.C.A.N. 4621, as a retroactive, technical correction. Under Explanation of Provision, the Senate Report reads as follows:

The bill also clarifies that a cost is subject to capitalization under this provision only to the extent it would otherwise be taken into account in computing taxable income for any taxable year. Thus, for example, the portion of a taxpayer’s interest expense that is 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.

S. Rep. No. 100-445, at 104 (1988).

The Tax Court has tried a few cases involving taxpayers that sell medical marijuana. In the seminal case in this area, the Tax Court held that the taxpayer trafficked in medical marijuana, which is a Schedule I controlled substance, and that §280E disallows all deductions attributable to that trade or business. The Tax Court also held, however, that §280E does not disallow the deductions attributable to the taxpayer’s separate and lawful trade or business. *Californians Helping to Alleviate Medical Problems, Inc., v. Commissioner*, 128 T.C. 173 (2007) (“CHAMP”). In CHAMP, the government conceded that §280E does not prohibit a taxpayer from claiming COGS. *Id.* at 178, n. 4. In other cases involving nonmedical marijuana or other Schedule I controlled substances, the Tax Court recognized that §280E does not disallow adjustments to gross receipts for COGS. See, e.g., *Peyton v. Commissioner*, T.C. Memo. 2003-146; *Franklin v. Commissioner*, T.C. Memo. 1993-184; *McHan v. Commissioner*, T.C. Memo. 2006-84.

Applied literally, §280E severely penalizes taxpayers that traffic in a Schedule I or Schedule II controlled substance but don’t use an inventory method for the controlled substance. When required to use an inventory method, a taxpayer also is required to use an accrual method for purchases and sales of merchandise. See §§1.471-1; 1.446-

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<sup>1</sup> TAMRA began as the Technical Corrections Act of 1988 (S. 2238) and the Miscellaneous Revenue Bill of 1988 (H.R. 4333).

1(c)(2)(i). *But see* §1.61-4(b).<sup>2</sup> Thus, the taxpayer will capitalize inventoriable costs when incurred and will remove these costs from inventory when units of merchandise are sold. Stated differently, the taxpayer will compute COGS as an adjustment to gross receipts. On the other hand, when not required to use an inventory method, a taxpayer might be permitted to use the cash method. *See, e.g.*, §446(c)(1). *See also* Rev. Proc. 2001-10, 2001-1 C.B. 272; Rev. Proc. 2002-28, 2002-1 C.B. 815. Under the modified cash method as described in Rev. Proc. 2001-10 and Rev. Proc. 2002-28, a reseller may account for merchandise as “inventories” or as “materials and supplies that are not incidental.” *See* §1.162-3 (a)(1). When a unit of merchandise is sold, the reseller will account for that cost as a deduction from gross income in the taxable year that the unit is sold or the payment is received, whichever is later. Similarly, a cash-method producer or farmer will deduct production expenses from gross income in the taxable year paid and, thus, will have no basis in the merchandise that it eventually sells. In the case of a cash-method reseller, producer, or farmer, the obligation to pay an income tax on gains derived from the sale of a controlled substance creates a tension between the accepted interpretation of “income” under the Sixteenth Amendment and §280E, which disallows all deductions of a trade or business trafficking in a Schedule I or Schedule II controlled substance.

## ANALYSIS

**ISSUE 1:** How does a taxpayer trafficking in a Schedule I or Schedule II controlled substance determine COGS for the purposes of §280E?

To resolve this issue, we will consider: (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.

To be deductible by a business enterprise, a business expense (*e.g.*, salaries; rent) must be “ordinary and necessary” within the meaning of §162 and must satisfy the timing requirements of §461. Once these requirements are satisfied, the amount of that expense is deducted in the current taxable year, unless another provision of the Code or regulations requires this deduction to be deferred to a subsequent taxable year, capitalized to an asset, or disallowed entirely. *See, e.g.*, §§267(a)(2); 471(a); 263A(a); 280E. For example, in the case of a producer of property, inventory-costing rules typically require the capitalization of costs that are “incident to and necessary for production or manufacturing operations or processes” (*e.g.*, §1.471-11(b)(1)) or costs that “can be identified or associated with particular units or groups of units of specific property produced” (*e.g.*, §1.263A-1(e)(2)). Thus, when one of these inventory-costing regulations applies, a producer must capitalize, as an inventoriable cost, what otherwise

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<sup>2</sup> The rule that applies to farmers is different from the rule that applies to producers and resellers. A farmer using an overall accrual method also must use an inventory method because of its use of an accrual method.

would have been a deduction under §162 and must keep that cost in inventories until the taxable year that the producer sells the merchandise. At that point, the producer includes those costs in COGS and accounts for COGS as an adjustment to gross receipts.

As noted above, the legislative history of section 280E states that “[t]o 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.” When §280E was enacted in 1982, “inventoriable cost” meant a cost that was capitalized to inventories under §471 (as those regulations existed before the enactment of §263A). The specific regulations are §1.471-3(b) in the case of a reseller of property and §§1.471-3(c) and 1.471-11 in the case of a producer of property. Thus, a marijuana reseller using an inventory method would have capitalized the invoice price of the marijuana purchased, less trade or other discounts, plus transportation or other necessary charges incurred in acquiring possession of the marijuana. Similarly, a marijuana producer using an inventory method would have capitalized direct material costs (marijuana seeds or plants), direct labor costs (e.g., planting; cultivating; harvesting; sorting), Category 1 indirect costs (§1.471-11(c)(2)(i)), and possibly Category 3 indirect costs (§1.471-11(c)(2)(iii)).

Section 263A increased the types of costs that are inventoriable compared to the rules under §471, but did not revolutionize inventory costing. A reseller still is required to treat the acquisition costs of property as inventoriable. Now, a reseller also is required to capitalize purchasing, handling, and storage expenses. In addition, both resellers and producers are required to capitalize a portion of their service costs, such as the costs associated with their payroll, legal, personnel functions. Thus, under §263A, resellers and producers of property are required to treat some deductions as inventoriable costs.

Section 263A is a timing provision. It does not change the character of any expense from “nondeductible” to “deductible,” or vice versa. For a taxpayer to be permitted to treat an expense as an inventoriable cost, that expense must not run afoul of the 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.” See §1.263A-1(c)(2)(i).

Read together, §280E and the flush language at the end of §263A(a)(2) prevent a taxpayer trafficking in a Schedule I or Schedule II controlled substance from obtaining a tax benefit by capitalizing disallowed deductions. Congress did not repeal or amend §280E when it enacted §263A. Furthermore, nothing in the legislative history of §263A suggests that Congress intended to permit a taxpayer to circumvent §280E by treating a disallowed deduction as an inventoriable cost or as any other type of capitalized cost. In fact, the legislative history of §263A(a)(2) states that “a cost is subject to capitalization . . . only to the extent it would otherwise be taken into account in computing taxable income for any taxable year.” If a taxpayer subject to §280E were allowed to capitalize “additional §263A costs,” as defined for new taxpayers in §1.263A-

1(d)(3),<sup>3</sup> §263A would cease being a provision that affects merely timing and would become a provision that transforms non-deductible expenses into capitalizable costs. Thus, we have 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.

**ISSUE 2:** May Examination or Appeals require a taxpayer trafficking in a Schedule I or Schedule II controlled substance to change to an inventory method for that controlled substance when the taxpayer deducts otherwise inventoriable costs from gross income?

A cash-method producer of a Schedule I or Schedule II controlled substance, such as marijuana, typically will deduct all production costs in the taxable year paid and, thus, will not have any adjusted basis in the product that it produces. When §280E is applied in the case of a producer trafficking in a Schedule I or Schedule II controlled substance, and all deductions from gross income are disallowed, the producer's taxable income for each taxable year will be significantly higher than what it would have been if the producer had used a permissible inventory method and recouped its production costs through COGS. Furthermore, the producer will not be able to take those disallowed production costs into account in any future taxable year. Thus, in this scenario, the overall cash method does not clearly reflect income because of the operation of §280E.<sup>4</sup> Stated differently, even a producer trafficking in a Schedule I or Schedule II controlled substance is subject to tax on "gains derived from dealings in property," not on gross receipts. Section 61(a)(3). This rule regarding "gains derived from dealings in property" applies equally to a reseller trafficking in a Schedule I or Schedule II controlled substance.

In our view, Examination and Appeals have the authority under §446(b) to require a taxpayer to change from a method of accounting that does not clearly reflect income to a method that does clearly reflect income regardless of whether that change results in a positive or negative §481(a) adjustment.<sup>5</sup> When a producer or reseller of a Schedule I

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<sup>3</sup> Section 1.263A-1(d)(3) provides, in part, "For new taxpayers, additional section 263A costs are defined as the costs, other than interest, that the taxpayer must capitalize under section 263A, but which the taxpayer would not have been required to capitalize if the taxpayer had been in existence prior to the effective date of section 263A."

<sup>4</sup> In addition, the overall cash method might not clearly reflect income because of §1.61-4(b) or §1.471-1.

<sup>5</sup> Section 446(b) provides that if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income. The Commissioner has broad discretion to determine whether a taxpayer's method of accounting clearly reflects income, and the Commissioner's determination must be upheld unless it is clearly unlawful. *See Thor*

or Schedule II controlled substance uses a method of accounting that causes a tax result contrary to the Sixteenth Amendment, to §61(a)(3), and to the legislative history of §280E, the proper exercise of the above-mentioned authority is warranted. Section 446(b). See also Rev. Proc. 2002-18. See also IRM 4.11.6.7.1 (05-13-2005). Consequently, if a producer or reseller of a Schedule I or Schedule II controlled substance is deducting from gross income the types of costs that would be inventoriable if that taxpayer were properly using an inventory method under § 471, it is an appropriate exercise of authority for Examination or Appeals to require that taxpayer to use an inventory method, to use the applicable inventory-costing regime (as discussed under Issue (1) of this memo), and to change from the overall cash method to an overall accrual method.<sup>6</sup> However, if that taxpayer is not required to use an inventory method (for example, small taxpayers properly using the modified cash method under Rev. Proc. 2001-10 or Rev. Proc. 2002-28 or farmers), it is not an appropriate exercise of authority for Examination or Appeals to require that taxpayer to use an inventory method. Instead, Examination or Appeals should permit that taxpayer to continue recovering, as a return of capital deductible from gross income, the same types of costs that are properly recoverable by a taxpayer both trafficking in a Schedule I or Schedule II controlled substance and using an inventory method under § 471. Thus, for example, a producer of a Schedule I or Schedule II controlled substance should be permitted to deduct wages, rents, and repair expenses attributable to its production activities, but should not be permitted to deduct wages, rents, or repair expenses attributable to its general business activities or its marketing activities.

Please call Leo F. Nolan II or Amy Wei at (202) 317-7007 (not a toll-free number) if you have any questions.

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*Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979); *RCA Corp. v. United States*, 664 F.2d 881 (2d Cir. 1981), *cert. denied*, 457 U.S. 1133 (1982).

<sup>6</sup> The §481(a) adjustment required to implement this method change does not include any amount attributable to non-inventoriable costs disallowed under §280E in any taxable year.