No. 19-73078

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

PATIENTS MUTUAL ASSISTANCE COLLECTIVE CORPORATION, DBA HARBORSIDE HEALTH CENTER,

Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appeal from the United States Tax Court
Nos. 29212-11, 30851-12, 14776-14
The Honorable Mark V. Holmes

AMICUS BRIEF OF MARIJUANA INDUSTRY GROUP AND CANNABIS TRADE FEDERATION ACTION IN SUPPORT OF APPELLANT SUPPORTING REVERSAL

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rules of Appellate Procedure 26.1 and 29(a)(4)(A), *amici curiae* certify that they have no parent corporations or any publicly held corporations owning 10% or more of their stock.

Date: June 2, 2020

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INTEREST OF THE *AMICI CURIAE*[1]

Amicus Marijuana Industry Group ("MIG") is a nonprofit corporation, business industry group comprised of hundreds of state-licensed and state-regulated marijuana businesses based in Colorado, many of which conduct business not only in Colorado but in other states as well. MIG was founded in 2010 and is one of the oldest regulated marijuana business industry groups in the nation. MIG members are among the oldest regulated and tax paying marijuana businesses in the country.

Amicus Cannabis Trade Federation Action ("CTFA") is an I.R.C. § 501(c)(4) organization. CTFA is a national coalition of cannabis-related businesses that represent all aspects of the industry including cultivators, dispensaries, wholesalers, distributors, and ancillary businesses. CTFA's members include state-legal marijuana companies located in all states which have legalized marijuana.

The state-regulated marijuana industry is subject to higher tax rates that any other industry due to the application of I.R.C. § 280E, which, as interpreted to date, denies all deductions to businesses selling substances categorized by the

[1] Pursuant to Fed. R. App. P. 29(a)(2), all parties consent to the filing of this brief. Further, *amici* state that no party's counsel authored this brief in whole or in part, and no individual or entity other than *amici*, their members or their counsel contributed money for the brief's preparation or submission. Fed. R. App. P. 29(a)(4)(E).

Controlled Substances Act as Schedule I or II substances, and only allows for a reduction of gross revenue for cost of goods sold ("COGS") in determining taxable income.

Due to the lack of Internal Revenue Service ("IRS") guidance addressing the interpretation and application of I.R.C. § 280E, combined with overwhelming IRS enforcement efforts, most of MIG's and CTFA's members have been subject to IRS examinations. *Amici* and their members have carried the burden of educating the IRS on the operation of the industry and have incurred overwhelming costs defending their tax return positions when there has been no clear guidance. *Amici*'s members are subject to exorbitant taxes due to the application of I.R.C. § 280E. Due to the lack of guidance available and the impact on the taxable income of its members, *amici* are directly impacted by this and any court's interpretation of how inventory costs are determined when I.R.C. § 280E applies. Thus, *amici* have a direct interest in whether this Court agrees with the Tax Court regarding the application of I.R.C. § 280E and inventory accounting principles.

INTRODUCTION

The Sixteenth Amendment authorizes Congress to tax gross income, from whatever source derived. U.S. Const. amend. XVI. Gross income derived from sales of property is defined as "gains derived from dealings in property." I.R.C. § 61(a)(3). For manufacturing and retail businesses, gross income means "the total

sales, less the cost of goods sold." Treas. Reg. § 1.61-3(a). Unless some other provision applies, taxpayers are also generally permitted to reduce taxable income by deductions for the ordinary and necessary costs incurred in carrying on a trade or business. I.R.C. § 162.

I.R.C. § 280E, passed during the 1980's war on drugs, limits the ordinary and necessary business deductions of state-licensed marijuana businesses. Californians Helping to Alleviate Med. Problems, Inc. v. Comm'r (CHAMP), 128 T.C. 173, 177 (2007). I.R.C. § 280E was enacted before state-legal marijuana businesses existed. I.R.C. § 280E dramatically reduces the after-tax cash flows of state-licensed marijuana businesses because it denies taxpayers within its reach the benefit of any "deduction or credit . . . for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business . . . consists of trafficking in controlled substances . . ." I.R.C. § 280E. However, in the legislative history, Congress acknowledged that "[t]o preclude possible challenges on constitutional grounds, the adjustment to gross receipts with respect to effective cost of goods sold is not affected by this provision of the bill." S. Rep. No. 97-494, vol. 1, at 309 (1982). This dispute involves the unique question of how to determine the reduction of gross income for inventory costs when a business is denied a deduction for all otherwise deductible ordinary and necessary business expenses, while giving deference to the legislative history of I.R.C.

§ 280E, which expressly acknowledged that the denial of a reduction of gross income for inventory costs violates the Sixteenth Amendment of the United States Constitution.

For *amici*'s members and other businesses subject to I.R.C. § 280E, any cost not categorized as an inventory cost will never reduce taxable income. For each of these dollars, the business's actual cost is the dollar spent plus the business's marginal tax rate. No other industry is the subject of such a broad tax sanction. As a result, businesses subject to I.R.C. § 280E are motivated to rigorously track inventory costs and apply the most expansive inventory accounting methods available.

In enforcing I.R.C. § 280E, the IRS is constrained by the Sixteenth Amendment, which requires the IRS to allow taxpayers to reduced gross receipts by inventory costs. Treas. Reg. § 1.61-3(a); see also S. Rep. No. 97-494, vol. 1, at 309. This exception for inventory costs was conceded by the IRS in CHAMP and subsequent cases addressing the application of I.R.C. § 280E. See, e.g., 128 T.C. at 177; Olive v. Comm'r, 139 T.C. 19, 38 n.19 (2012), aff'd 797 F.3d 1146 (9th Cir. 2015) . However, the IRS's lack of published guidance, coupled with a resistance to the application of otherwise acceptable inventory methods, including methods recognized under generally accepted accounting principles, has led not only to this litigation but also to thousands of audits and resulting controversies with industry

taxpayers, including *amici*'s members, creating tremendous costs beyond the tax cost.

SUMMARY OF THE ARGUMENT

For most businesses, the determination of whether a cost is an inventory cost or a deduction is merely a timing decision and the inability to capitalize a cost to inventory may change the year in which tax is paid but not the aggregate amount of taxable income over time. By determining that Harborside was a reseller, and therefore disallowing a reduction of gross income for inventory costs such as processing, packaging, and labeling costs, the Tax Court opinion denies costs incurred in creation of a final, sellable inventory item. While a taxpayer not subject to I.R.C. § 280E is able to reduce its taxable income for processing, packaging, and labeling costs as an I.R.C. § 162 deduction when incurred, the finding of the Tax Court denies these costs permanently because I.R.C. § 280E applies. This application of the inventory rules arguably renders I.R.C. § 280E unconstitutional.

Historically, taxpayers generally were subject to inventory accounting rules under either I.R.C. § 471, or, beginning in 1986, I.R.C. § 263A. Since 2015, several years after many of *amici*'s members began operating their business, the IRS has maintained that if I.R.C. § 280E applies, the only inventory rules available to taxpayers were those rules set forth under I.R.C. § 471. IRS Chief Couns.

Advice Memo. 201504011 (Jan. 23, 2015). I.R.C. §§ 263A and 471 provide a mandatory floor for inventory costs, and many inventory costs not captured by these rules are categorized as deductions for tax reporting purposes. Nevertheless, accounting and tax concepts require that a cost must be considered in light of its contribution to the creation of a final, sellable inventory item in determining whether that cost, even if classified as a deduction, is actually an inventory cost not limited by I.R.C. § 280E.

The Tax Court's focus on determining whether inventory rules for resellers or producers applied to Harborside misses an important fact: sometimes inventory costs are permitted to be reported as deductions under I.R.C. § 162. When I.R.C. § 280E applies, this fact cannot be ignored and inventory costs must be removed from deductions and included in COGS so that the application of I.R.C. § 280E does not lead to an unconstitutional result. Further, language in I.R.C. § 263A purporting to limit inventory costs reported as deductions under I.R.C. § 162 results in an overly narrow application of inventory cost rules when I.R.C. § 280E applies.

To avoid constitutional frailty, I.R.C. § 280E must allow taxpayers to reduce gross receipts by inventory costs to determine gross income. Thus, state-licensed marijuana producers and sellers must be allowed to reduce their gross receipts by all inventory costs, even if those costs may be permitted as deductions to taxpayers

not subject to I.R.C. § 280E. Under the doctrine of constitutional avoidance, this court should broadly interpret inventory rules to avoid an application of I.R.C. § 280E that creates unconstitutional results.

ARGUMENT

I. THE HOLDING OF THE TAX COURT UNCONSTITUTIONALLY DENIES A REDUCTION OF GROSS RECEIPTS FOR INVENTORY COSTS.

The Tax Court determined that:

> Harborside operated out of an approximately 7,500-square-foot space that had a reception area, healing room, *purchasing office, processing room, clone room*, and multipurpose room. The facility also had a large sales floor, offices, storage areas, restrooms, and a break room with a kitchen.

Patients Mut. Assistance Collective Corp. v. Comm'r, 151 T.C. 176, 178 (2018) (emphasis added). And that Harborside's purchased inventory:

> . . . would go to a processing room where it was reinspected, remanicured, retrimmed, and then weighed, packaged, and labeled . . . Harborside had at least three employees dedicated to acquiring inventory, at least four devoted to managing inventory, and still others whose sole job was to process the bulk marijuana and ready it for resale.

Id. at 180. Despite these findings, the court concluded that "Harborside is . . . a reseller for purposes of I.R.C. § 471 and must adjust for its COGS according to section 1.471-3(b), Income Tax Regs." Id. at 213. In footnote 26, the Tax Court acknowledged that:

> Harborside did have a "processing room." See supra p. [180]. But the "processing" that went on there–reinspection, packaging, and labeling–

> fall within the category of "purchasing, handling, and storage" that resellers do without losing their character as resellers. See sec. 1.263A-3(c), Income Tax Regs.

Id. *Amici* respectfully suggest that this finding was erroneous, and this application of inventory accounting rules when I.R.C. § 280E applies violates the Sixteenth Amendment. The activities described improve the product, and the Tax Court's determination is contrary to I.R.C. § 263A(g)(1) which, in defining production costs included in inventory costs, defines "produce" as "construct, build, install, manufacture, develop, or improve."

Treas. Reg. § 1.471-3(b) defines inventory costs of a reseller as the "invoice price . . . [and] transportation or other necessary charges incurred in acquiring possession of the goods." Because the Tax Court determined Harborside was a reseller, and not a producer, Harborside's reinspection, remanicuring, retrimming, weighing, packaging, and labeling costs were disallowed as selling costs. Because the court focused on whether Harborside is a reseller or a producer, it lost sight of the key issue that matters: what were Harborside's inventory costs? The producer/reseller determination makes sense for businesses that (1) clearly fall within one category or the other, (2) are not subject to I.R.C. § 280E, and (3) are permitted to deduct most other costs. For taxpayers not subject to I.R.C. § 280E, inventory costs such as reinspection, remanicuring, retrimming, weighing, packaging, and labeling are allowed to reduce taxable income, as either COGS (for

producers) or deductions (for resellers). But this dichotomy falls short when applied to state-legal marijuana businesses because it results in the failure to reduce gross income for all inventory costs.

Tax and financial accounting rules both acknowledge that inventory costs include all costs that must be incurred to create the final, sellable inventory item. Treas. Reg. § 1.471-1 states that all costs that "will physically become a part of merchandise intended for sale" are inventory costs. Financial accounting rules mandate that inventory costs include "the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location." Fin. Accounting Standards Bd., Accounting Standards Codification, 330-10-30 (2009). ASC section 330-10-30 provides that inventory costs include "acquisition and production cost, and its determination involves many considerations." Id.

Most state-regulated marijuana businesses are subject to strict labeling and packaging standards.[2] Often, this required packaging and labeling occurs at the dispensary store location, at the time of the sale. Until the product is packaged and labeled according to applicable state law, the product is not in final, sellable condition. Costs incurred to reinspect, remanicure, retrim, package, and label a

[2] See, e.g., Cal. Code Regs. tit. 17, § 40400-40417 (2019); 1 Colo. Code Regs. § 212-3-3-1000, et. seq. (2020).

product are integral to the creation of the inventory items that Harborside and *amici*'s members sell.

In its opening brief, Harborside cites the following examples of how some large grocery store chains account for cost of goods sold:

> The "Merchandise costs" line item of the Consolidated Statements of Operations includes product costs, net of discounts and allowances; advertising costs (see separate discussion below); inbound freight charges; warehousing costs, including receiving and inspection costs; transportation costs; and food production and operational costs. . . . The Company's approach is to include in the "Merchandise costs" line item the direct, net costs of acquiring products and making them available to customers in its stores.

The Kroger Co., Annual Report (Form 10-K), 49-50 (Apr. 3, 2018) cited in Opening Brief for Patients Mut. Assistance Collective Corp. at 61, Patients Mut. Assistance Collective Corp. v. Comm'r, No. 19-73078, (9th Cir. appeal docketed, May 26, 2020).

> Cost of goods sold includes cost of inventory sold during the period (net of discounts and allowances), distribution and food preparation costs, and shipping and handling costs.

Whole Foods Market, Inc., Annual Report (Form 10-K), 44 (Nov. 22, 2013) cited in Opening Brief for Patients Mut. Assistance Collective Corp., supra, at 61.

The activities of grocery stores are analogous to Harborside's operations. Harborside acquired some inventory for resale "as is." However, Harborside also spent substantial time acquiring raw goods and engaged in in-store production to make items ready for sale to customers. So, in the same way a grocery store bakes

cakes, butchers meat, and prepares pre-made meals at the same location that it resells other goods, such as olive oil or pasta, which are simply removed from a container and placed on a shelf for sale to customers, Harborside took raw materials that were not ready for customer purchase and converted these materials into something that could be made available for sale to customers. In doing so, Harborside incurred inventory costs which the Tax Court denied as a reduction in determining gross income. Harborside should be allowed a reduction in its gross income for these costs.

A. Inventory Costs Are Inventory Costs And Where They Fall In The I.R.C. § 471 → 263A → 162 Spectrum Is Irrelevant.

In reaching its conclusion that the appropriate inventory rules for taxpayers subject to I.R.C. § 280E are contained in I.R.C. § 471, the Tax Court opinion relies heavily on analysis concluding that I.R.C. § 263A prohibits categorization as inventory costs any costs that were not deductible before I.R.C. § 263A was enacted. Patients Mut., 151 T.C. at 208. This conclusion violates the constitutional limits of I.R.C. § 280E and the Sixteenth Amendment because it denies taxpayers a reduction of gross income for inventory costs that do not fall within Treas. Reg. § 1.471-3(b) but may be mandated under I.R.C. § 263A regulations, or may be related to inventory but allowed as a deduction, even if not captured under I.R.C. § 263A.

I.R.C. § 263A was added to the Internal Revenue Code in 1986 because Congress believed that the current rules addressing the capitalization of costs (e.g., I.R.C. § 471) were "deficient," meaning they did not properly capture all costs incurred to produce or resell inventory. Tax Reform Act of 1986, Pub. L. No. 99-514, § 803, 100 Stat. 2085, 2350-58 (1986); S. Rep. No. 99-313, at 140. The purpose of I.R.C. § 263A was to capture inventory costs classified as deductions that were related to the production and resale of inventory. S. Rep. No. 99-313, at 140. However, I.R.C. § 263A did not recharacterize certain deductions as inventory costs, these costs had always been inventory costs. Rather, it mandated the inclusion in inventory of certain direct and indirect inventory costs normally deducted by a taxpayer applying I.R.C. § 471.[3]

The Tax Court's focus on whether an inventory cost can be categorized as a deduction is misplaced. Courts have long acknowledged that an inventory cost is still an inventory cost that reduces gross income, even if it can be claimed as a deduction for simplicity's sake or for any other reason.

> Congress, as a matter of grace, has allowed some specific deductions under section 23.[4] If it has allowed a deduction for some item which is in fact a part of the cost of production, the allowance of the deduction

[3] Legislative history acknowledges that the costs captured under I.R.C. § 263A include "indirect costs that benefit the assets produced or acquired for resale." S. Rep. No. 99-313, at 140 (1986).

[4] Section 23 is a predecessor of I.R.C. § 162, which permits a deduction for all ordinary and necessary expenses paid or incurred in carrying on any trade or business. 26 U.S.C.A. § 23 (1936).

> would not change the character of the item and the amount should, nevertheless, be subtracted from gross receipts in determining gross income from the business operation.

Woodside Acres, Inc. v. Comm'r, 46 B.T.A. 1124, 1127 (1942), aff'd, 134 F.2d 793 (2d Cir. 1943).

> Yet whether or not something is correctly called gross income may be, as it is here, decisive as to the nature of a taxpayer's liability for surtaxes like those assessed against the petitioner. Then it is essential that things called alike shall be alike.

Woodside Acres, Inc. v. Comm'r, 134 F.2d 793, 794 (2d Cir. 1943), aff'g, 46 B.T.A. 1124 (1942).

Thus, due to the unique nature of I.R.C. § 280E, to avoid an unconstitutional application of law, the rigorous application of historical inventory rules must be revised so that businesses subject to I.R.C. § 280E are not denied an allowance for inventory costs, even if those costs are also permitted as deductions.

B. I.R.C. § 471 And I.R.C. § 263A Are Not Mutually Exclusive.

The Tax Court incorrectly concluded that Harborside was a reseller and therefore incorrectly limited inventory costs to those allowed under Treas. Reg. § 1.471-3(b), even though the findings of fact clearly state that Harborside processed its inventory – by retrimming, reinspecting, remanicuring, packaging, and labeling. Patients Mut., 151 T.C. at 180. If the Tax Court had determined that Harborside was a producer, it would have applied the producer regulations under I.R.C. § 471 which mandate "full absorption" accounting for inventory costs.

Treas. Reg. § 1.471-11. Under the producer I.R.C. § 471 regime, taxpayers are not prohibited from including in COGS inventory costs in excess of those mandated under the I.R.C. § 471 full absorption rules.

The full absorption method is a floor, not a ceiling or cap, on the costs that may be included in inventory. Treas. Reg. § 1.471-11(e)(4) allows, but does not mandate, that taxpayers switch "from a method of inventory costing which is more inclusive of indirect production costs" to the full absorption method of inventory costing, when full absorption results in fewer costs being included in inventory. Treas. Reg. § 1.471-11(e)(4) applies when a change from taxpayer's inventory costing method to the full absorption method would result in a *decrease* in costs in ending inventory. For most taxpayers, this is a benefit because more inventory costs can reduce taxable income as current deductions. But, when I.R.C. § 280E applies, there is no deduction benefit available. On the other hand, taxpayers not using full absorption inventory costing and whose inventory method resulted in lower ending inventory than would be determined by applying full absorption methods were *required* to transition to full absorption inventory costing, and, as a result, deferred some costs to later tax periods. Treas. Reg. § 1.471-11(e)(1). Because taxpayers applying inventory methods more expansive than full absorption are not required to change to a less inclusive inventory method, it is

reasonable to conclude that the I.R.C. § 471 rules are not a cap on the calculation of inventory costs.

Thus, under I.R.C. § 471, it is acceptable for a producer to include indirect costs in inventory in excess of the costs mandated under the full absorption rules contained in the I.R.C. § 471 regulations. Acknowledging this, it logically follows that the methods outlined in I.R.C. § 263A, which are generally perceived as more inclusive than I.R.C. § 471's "deficient" full absorption methods, even if not mandated, were permissible under I.R.C. § 471. Therefore, it is permissible and reasonable for a business subject to I.R.C. § 280E to apply expansive inventory costing methods, including those that are set forth in I.R.C. § 263A and its regulations. Because of the application of I.R.C. § 280E, applying expansive inventory costing methods is in the industry's best interest and it is a best practice to do so. Further, as is discussed in detail in Harborside's brief, this approach is bolstered by the fact that such methods are consistent with financial accounting principles.[5]

C. I.R.C. § 263A's Flush Language Does Not Operate To Vitiate The Inventory Rules.

In 1988, the following language was added to I.R.C. § 263A(a)(2):

[5] Opening Brief for Patients Mut. Assistance Collective Corp. at 56-61, Patients Mut. Assistance Collective Corp. v. Comm'r, No. 19-73078.

> 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.

H.R. 4333, 100th Cong., § 108 (1988). The legislative history gives the example of the denial of the deduction for personal interest, under I.R.C. § 163(h), as illustrative of the purpose behind the amendment. S. Rep. No. 100-445, at 104 (1988). The legislative history states that personal interest "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." Id. In other words, the intent of this change was to preclude costs that are not deductible, whether or not I.R.C. § 280E applies, and whether or not related to the production or resale of inventory, from being included in inventory.

Instead of focusing on the legislative history and intent, the Tax Court reasoned that "costs" are amounts otherwise deductible, focusing on the example in the regulations addressing disallowed meal deductions under I.R.C. § 274(n). Patients Mut., 151 T.C. at 207-208 (citing Treas. Reg. § 1.263A-1(c)(2)(i)). Both I.R.C. §§ 163(h) and 274(n) disallow deductions for costs that are personal in nature. S. Rep. No. 100-445, at 104 (1988) (quoted above); H.R. Rep. 99-426, at 120-21 (1985) ("This reduction rule reflects the fact that meals and entertainment inherently involve an element of personal living expenses . . ."). Under I.R.C. § 274(n), there is no doubt that a portion of meals and entertainment expenses are

not a reduction of taxable income, whether or not they are attributable to the creation of inventory. The amount of business meals includible in inventory costs or as a deduction will always be limited because it is a personal living cost, not a business cost. It would be improper to argue that I.R.C. § 274(n) does not apply to a business meal expense attributable to a meal provided to a factory worker because the expenses of the factory are inventory costs. However, it *is* improper to conclude that provisions which disallow a personal cost, such as the portion of meals and entertainment expenses not eliminated under I.R.C. § 274(n), whether or not they are an inventory cost or a deduction, are the same as I.R.C. § 280E costs.

Costs disallowed under I.R.C. § 280E are fundamentally different from the costs disallowed under I.R.C. §§ 163(h) and 274(n) because these costs are personal in nature, and therefore are not "ordinary and necessary" business expenses under I.R.C. § 162. I.R.C. § 280E costs are not personal costs, they are ordinary and necessary business expenses attributable to the taxpayer's trade or business. I.R.C. § 280E disallows all costs not disallowed as personal costs, *and* which cannot be classified as inventory costs. In determining the amount of inventory costs and deductions, it makes sense for a taxpayer to first apply I.R.C. §§ 163(h) and 274(n), to disallow personal expenses that do not qualify as I.R.C. § 162 business deductions. However, I.R.C. § 280E will only disallow the remaining 50 percent of the meal and entertainment expense if it is not an

inventory cost, even if it is an inventory cost that *could be* categorized as a deduction.

In Harborside's case, the Tax Court determined that costs, such as wages for an employee who inspects, retrims, remanicures, packages, or labels inventory, are not inventory costs, because when applying I.R.C. § 471's reseller rules, these costs are not required to be included in inventory costs. While, absent I.R.C. § 280E, this determination will benefit a taxpayer who will currently deduct these expenses, a taxpayer should not be precluded from including the cost in inventory when the taxpayer is denied the benefit of the deduction because I.R.C. § 280E applies. Further, under I.R.C. § 263A, rent, occupancy, storage, handling, and other indirect and overhead costs associated with production of inventory *are* inventory costs, which is evidence that they were always inventory costs, even though they were not required to be capitalized prior to the passage of I.R.C. § 263A, and still are not required to be included in inventory costs by certain businesses excepted from I.R.C. § 263A. See e.g., I.R.C. §§ 263A(d), (i). Harborside's inventory costs should also include the rent and other occupancy costs attributable to where these activities are performed as well as all other indirect costs incurred related to the activities of the employee and the overall business. The purpose of I.R.C. § 263A was to capture inventory costs classified as deductions that were related to the production and resale of inventory.

Therefore, any items captured by I.R.C. § 263A can be lawfully and appropriately categorized as inventory costs.

Unlike I.R.C. §§ 163(h) and 274(n), I.R.C. § 280E does not limit inventory costs. I.R.C. § 280E only limits non-inventory costs. Any and all inventory costs must be determined before the amount of non-inventory deductions disallowed under I.R.C. § 280E can be determined. Therefore, the flush language of I.R.C. § 263A cannot be interpreted to prevent inventory costs described in I.R.C. § 263A and its regulations, or any other cost related to the production or resale of a finished good that may be permitted as a deduction, from reducing gross income because I.R.C. § 280E applies. Any contrary interpretation is unconstitutional.

II. THE DOCTRINE OF CONSTITUTIONAL AVOIDANCE SHOULD RESULT IN BROAD APPLICATION OF INVENTORY RULES WHEN I.R.C. § 280E APPLIES.

Applying I.R.C. §§ 471 and 263A too narrowly in the context of I.R.C. § 280E raises constitutional issues, which should be avoided. Crowell v. Benson, 285 U.S. 22, 62 (1932); Hooper v. California, 155 U.S. 648, 657 (1895) ("The elementary rule is that every reasonable construction must be resorted to, in order to save a statute from unconstitutionality.") In order for I.R.C. § 280E to avoid unconstitutional results, state-licensed marijuana producers and sellers must be allowed to reduce their gross receipts by all inventory costs. To the extent a cost is incurred to create the final, sellable product, this court should hold that the cost

must be included in inventory costs and allowed to reduce gross receipts, and that it is not disallowed by I.R.C. § 280E. This rule should apply regardless of whether the taxpayer is deemed a reseller, producer, manufacturer, or processor. Because any deduction that can be categorized as an inventory cost is disallowed under I.R.C. § 280E, the court should allow a broad application of the inventory rules to avoid an unconstitutional application of I.R.C. §§ 471, 263A, and 280E.

The INDOPCO line of cases cited by the Tax Court marginalize the impact of the capitalization vs. deduction dilemma by pointing out that, in those cases, the issue is a matter of timing. See, e.g., INDOPCO, Inc. v. Comm'r, 503 U.S. 79, 83 (1992) ("the primary effect of characterizing a payment as either a business expense or a capital expense concerns the timing of the taxpayer's cost recovery…"). The Tax Court relied on the analysis in INDOPCO for the commonly cited premise that "deductions are a matter of legislative grace," but missed the important distinction that, when I.R.C. § 280E applies, the difference is *not* a timing difference. Patients Mut., 151 T.C. at 205. Rather, any inventory cost not allowed to reduce a taxpayer gross income because I.R.C. § 280E applies impermissibly increases the taxpayer's gross income, taxable income, and amount of tax paid, with no offset in later years.

It is a violation of the Sixteenth Amendment for the application of I.R.C. § 280E to limit inventory costs. See S. Rep. No. 97-494, vol. 1, at 309. To the

extent the flush language in I.R.C. § 263A(a)(2) or any other theory under I.R.C. § 471 is used to deny an inventory cost that may be allowed as a deduction in the absence of I.R.C. § 280E, the court should overturn the holding of the Tax Court. There is no one-size-fits-all approach to determining inventory costs and when I.R.C. § 280E applies, the existing rules must be reanalyzed and reworked to avoid unconstitutional overreach.

CONCLUSION

Inventory accounting concepts and principles contained in both financial and tax accounting rules do not prohibit the inclusion of retrimming, reinspecting, remanicuring, packaging, and labeling costs in inventory costs. To avoid an unconstitutional application of law, taxpayers subject to I.R.C. § 280E should be permitted to capture a broad range of inventory costs in determining their gross income.

Based on the foregoing, this Court should: (1) overturn the Tax Court holding that Harborside must account for its inventory costs according to Treas. Reg. § 1.471-3(b); (2) overturn the Tax Court holding that I.R.C. § 263A does not apply to taxpayers subject to I.R.C. § 280E; and (3) hold that Harborside is entitled to reduce its gross income by all inventory costs.

Date: June 2, 2020

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

Pursuant to Fed. R. App. P. 29(a)(4)(G), 32(g)(1), and Cir. R. 32-1(e), I certify that:

This brief complies with the type-volume limitation of Fed. R. App. P. 29(a)(5) because this amicus brief contains 5,032 words, excluding parts of the brief exempted by Fed. R. App. P. 32(f) and Cir. R. 32-1(c).

This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because this brief has been prepared in a proportionately spaced typeface using Microsoft Word 2013 Times New Roman 14-point font.

Date: June 2, 2020

/s/ Jennifer E. Benda
Jennifer E. Benda

Attorney for Amici Curiae
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CERTIFICATE OF SERVICE

I hereby certify that on June 2, 2020, I electronically filed the foregoing with the Clerk of the Court for the United States Court of Appeals for the Ninth Circuit by using the appellate CM/ECF system.

Participants in the case who are registered CM/ECF users will be served by the appellate CM/ECF system.

Date: June 2, 2020

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