NO. 19-73078

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

PATIENTS MUTUAL ASSISTANCE COLLECTIVE CORPORATION D.B.A
HARBORSIDE HEALTH CENTER,
Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

On Appeal from the United States Tax Court
Nos.: 2912-11; 30851-12; 14766-14
Hon. Mark V. Holmes

OPENING BRIEF FOR APPELLANT

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Fed. R. App. P. 26.1 and Fed R. App. P. 28(a)(1), Appellant, Patients Mutual Assistance Collective Corporation d.b.a. Harborside Health Center ("Harborside"), states that it has no parent corporation and that no publicly held corporation owns 10% or more of its stock.

Dated: May 26, 2020

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JURISDICTIONAL STATEMENT

This case is an appeal from the October 17, 2019 decision of the United States Tax Court (the "Tax Court"), in which it ordered and decided that there are deficiencies in income tax due from Harborside for 2007, 2008, 2009, 2010, 2011, and 2012. The Tax Court exercised jurisdiction pursuant to I.R.C. § 6213, and the decision of the Tax Court is final and appealable pursuant to I.R.C. § 7481. This Court has jurisdiction to consider this appeal pursuant to I.R.C. § 7482(a)(1). Harborside timely field a notice of appeal on December 2, 2019 pursuant to I.R.C. § 7483. II ER 76.

ISSUES PRESENTED

(1) Does § 280E of the Internal Revenue Code violate the Sixteenth Amendment of the Constitution of the United States because it is not a tax on income?

(2) Should taxpayer be free to determine its cost of goods sold in the same fashion as other similar businesses?

An Addendum containing the pertinent constitutional provisions, statutes and regulations is annexed to this brief.

STATEMENT OF THE CASE

I. Factual Background

Serving thousands of patients and generating millions of dollars of revenue annually, Harborside has grown to be one of the largest cannabis dispensaries in the United States since being founded in 2005. I ER 17–18. While cannabis remains a schedule I controlled substance under federal law, an increasing number of states have opened up medical and recreational cannabis markets. I ER 16, 31. California authorized the collective cultivation of medical cannabis with the passage of the 2003 Medical Marijuana Program Act. I ER 16–17, 28. As a result, medical cannabis dispensaries, operating under the collective cultivation model, began to spring up in California in the early to mid-2000s. I ER 16–17.

In this new frontier, Harborside was founded with the vision of becoming the "gold standard" for the industry as a whole. I ER 17. For Harborside, achieving this "gold standard" meant, in large part, ensuring it complied with state laws. I ER 13. California required

> that medical-marijuana cooperatives should be formally organized, not operate for profit, maintain business licenses and permits, pay tax, verify each member's status as a patient, execute an agreement with each member regarding the use and distribution of marijuana, keep records of distribution, and neither buy marijuana from nor distribute marijuana to nonmembers.

I ER 28–29. As a result, Harborside operated and was taxed as a non-profit – at least by California. I ER 23–24. For federal tax purposes, however, Harborside files and is treated as a C corporation. [1] *Id.*

The products that Harborside sold to its patient-members can roughly be divided into four categories: marijuana flowers, marijuana-containing products, clones, and non-marijuana containing products. I ER 19. The expenses involved in acquiring and processing these four types of products are the "cost of goods sold" that are the heart of this case — Harborside believes that many of these expenses are part of acquiring inventory and preparing it for sale but the Tax Court disagrees.

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[1] "[T]o comply with California's nonprofit requirement, [Harborside's] bylaws prohibited it from paying dividends or selling equity, and required it to use any excess revenue for the benefit of its patients or the community." I ER 23–24 (footnote omitted).

The first kind of product Harborside sold was marijuana flower. *Id.* Harborside did not grow any of the marijuana flower it sold. I ER 19–21. Rather, all of the marijuana flower Harborside sold was purchased by Harborside from its members. *Id.* When a member wanted to sell marijuana flower to Harborside, Harborside would require the member to enter into a cultivation agreement. *Id.* Then, Harborside would conduct an initial inspection of the marijuana in its purchasing office.[2]

Harborside helped its patients find specific strains of cannabis for particular medical problems. II ER 136. Not only were there important differences among the forms of cannabis to be given to the patient, the ratio between THC (psychoactive) and CBD (therapeutic but non-psychoactive) chemicals varied from strain to strain, and even from batch to batch.[3] II ER 136–37. For example, children being treated for

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[2] "At all relevant times 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." I ER 18; II ER 110.

[3] A cannabinoid is any of a group of closely related compounds which include cannabinol and the active constituents of cannabis. Albert

seizures from "intractable childhood epilepsy" need strains that are rich in CBD but low in THC. II ER 135–36. The co-founder of Harborside testified that, as a result:

> [T]here have been times when we needed very precise cannabinoid profiles. And so essentially we go on a cannabinoid hunt and really be very, very proactive. And contact dispensaries all over the state. Contact growers that we knew all over the state and really put out the call that a particular needs [sic] has developed for a certain cannabinoid profile.

I ER 137.

If satisfied, Harborside would purchase the marijuana flower from the seller at a price "based on its weight, quality, and market factors." III ER 225. After purchasing, there was a three-stage quality control process. First, personnel at Harborside would use microscopes to identify the strain and check for contaminants. II ER140–141.

Second, Harborside would then pay a third-party laboratory to test a representative sample of the marijuana flower. I ER 21. The lab would test the sample to determine its cannabinoid profile and to screen

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Weissman, *On the Definition of Cannabinoids: Botanical? Chemical? Pharmacological?*, J. Clinical Pharmacology 159 (1981).

it for safety issues, such as pathogenic mold. I ER 20; II ER 163; III ER 226.

Third, Harborside sent out the cannabis to a different laboratory that "conducts an analysis of pathogenic mold spores in the sample." II ER 141–142.

If the sample met Harborside's standards, the marijuana flower that the sample was representative of "would go to a processing room where it was reinspected, remanicured, retrimmed, and then weighed, packaged, and labeled." I ER 19–21.

Occasionally, the cannabis required curing before being processed—"if the cannabis had a suboptimal moisture profile . . . we used a variety of techniques to adjust that moisture profile," which involved "putting the cannabis in various different containers with . . . hydrogenating substances or desiccating substances." II ER 166.

After processing, the marijuana would either be housed in the vault, if in storage, or on the sales floor, if for sale. I ER 19–21. The vault was a concrete room made of reinforced concrete at least twelve, and in some places, eighteen, inches thick. II ER 151. The vault door was a bank vault type door about twelve inches thick with biometric locks that recorded identity and time of every entrant. *Id.*

During the years at issue, "Harborside had at least three employees dedicated to acquiring [marijuana flower], at least four devoted to managing [marijuana flower], and still others whose sole job it was to process the bulk marijuana [flower] and ready it for resale." I ER 19–21. The processing employees trimmed and manicured the product as needed and then put it into individual retail packages. II ER 157. Harborside marketed itself as the "home of the naked bud" so there was a final close inspection and possibly further trimming and manicuring. II ER 158. At that point every item was barcoded and subject to a custom-created secure chain of custody system. II ER 157.

Harborside believes that the costs of the personnel involved in finding the cannabinoids, the costs of the three stages of quality control, the costs of curing, the security costs for storing and guarding the inventory, and the costs of the employees trimming, manicuring and packaging the cannabis are properly allocable to the cost of goods sold since they are necessary to acquire, store and process the inventory to bring it to sale.

The second kind of product Harborside sold was marijuana-containing products. I ER 19–22. These "products included edibles, beverages, extracts, concentrates, oils, topicals, and tinctures." I ER 21. Harborside did not manufacture any of these products, but instead bought them from other collectives. I ER 21–22. However, Harborside would test, relabel, and sometimes repackage[4] these products before selling them. *Id.* Many of the edible products and some of the beverages were stored in special freezers. II ER 153.

Harborside believes that the costs of testing, relabeling, repackaging, and storing these products in special freezers are properly allocable to the cost of goods sold since they are necessary to acquire, store and process the inventory to bring it to sale.

The third kind of product Harborside sold was "live marijuana plant trimmings ('clones')." I ER 19–22. "Clones are cuttings from a female cannabis plant that can be transplanted and used to cultivate marijuana." I ER 19. As with marijuana flower, Harborside did not grow the clones that it sold. I ER 19; III ER 226–227. Rather,

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[4] Harborside would repackage these products "if they came in bulk or needed child-proof packaging." I ER 21–22.

"Harborside bought clones from clone nurseries[.]" I ER 19. Clones are living plants that need to be cared for in exacting ways:

> [T]hey need to be brought specifically and quickly into a designated area. That area needs to be maintained at a specific temperature, atmosphere conditions under certain kinds of lights. They need to be fed on a regular basis and monitored for any type of pest of mold infestations. . . . And then there's a pretty detailed packaging process as well to make sure that when they leave our facilities they're in a form and in a package so they don't get destroyed on a three, four-hour drive back up to the grove site.

II ER 144. "During the years at issue Harborside had at least four employees who spent their time entirely in the purchase and sale of clones." I ER 19.

Harborside believes that the costs of the personnel involved in purchasing and the costs of maintaining the live plants are properly allocable to the cost of goods sold since they are necessary to acquire, store and process the inventory to bring it to sale.

The fourth and final kind of product Harborside sold were non-marijuana containing products. I ER 22. Products included items such as clothing, books, and assorted marijuana accessories. *Id.*

Harborside's commitment to achieving the "gold standard" extended beyond how it managed its inventory, customers, and employees to how it prepared its tax returns. I ER 13. In preparing its tax returns for the years at issue (and for the amended returns for 2007, 2008, and 2009), Harborside sought expert accounting advice and made a voluntary attempt to perform an allocation of expenses and not claim as a deduction those that appeared to be related to "trafficking." II ER 175–179. In doing so, Harborside used a precise method of measuring square footage and employee time to determine what was nondeductible. II ER 148, 172, 175–79.

Further, Harborside kept good books and records. I ER 12. Indeed, "[k]eeping good books and records was one of Harborside's strengths." *Id.* All this, coupled with the lack of guidance from the IRS,[5] led the Tax Court to find that Harborside "acted with reasonable cause and in good faith when taking its tax positions for the years at issue." I ER 13.

For each of the years at issue, 2007 to 2012, Harborside filed a Form 1120, U.S. Corporation Income Tax Return.[6] I ER 26; III ER 236–

[5] "[T]he IRS has never promulgated regulations for § 280E and didn't issue any guidance on marijuana businesses' capitalization of inventory costs until 2015." I ER 11.
[6] The 2007, 2008, and 2009 returns were later amended, I ER 26, and all references to the 2007, 2008, and 2009 returns herein refer to the amended returns.

276. Each return properly reflected Harborside's gross receipts, total deductions, and total cost of goods sold for each year. III ER 232–234. Harborside's returns showed:

TABLE I -- TAX RETURNS

Year	Revenue	Cost of Purchases	Other Items Claimed in Cost of Goods Sold	Expenses
2007	$ 5,449,122	$ 3,844,671	$ 80,018	$ 1,905,256
2008	$ 10,920,904	$ 6,602,218	$ 384,998	$ 3,395,093
2009	$ 17,351,475	$11,114,965	$1,095,178	$ 5,238,699
2010	$ 22,089,864	$13,753,995	$1,022,240	$ 6,716,779
2011	$ 20,954,411	$11,846,707	$1,044,857	$ 7,750,908
2012	$ 25,520,648	$13,816,278	$3,668,080	$ 6,568,224

III ER 234.[7]

The IRS selected Harborside's returns for the above years for audit, issuing three notices of deficiency—one for 2007 and 2008, one for 2009 and 2010, and one for 2011 and 2012. IV ER 424–444, 449–469, 475–502. These notices denied most of Harborside's claimed deductions[8]

[7] "The parties disagree as to the proper characterization of the 'Other Items Claimed in Cost of Goods Sold' and 'Expenses' as inventory costs, deductible expenses, or non-deductible business expenses." III ER 235.
[8] *See* notes 11, 12, and 13.

and costs of goods sold,[9] asserting tens of millions of dollars in deficiencies and accuracy-related penalties.[10] *Id.*

For 2007 and 2008, the Commissioner determined a deficiency in income tax in the amounts of $628,516.00 and $1,387,199.00, respectively.[11] IV ER 475. For 2009 and 2010, the Commissioner determined a deficiency in income tax in the amounts of $6,013,658.00 and $7,409,470.00, respectively.[12] IV ER 449. For 2011 and 2012, the Commissioner determined a deficiency in income tax in the amounts of $7,184,077.00, and $7,151,506.00, respectively.[13] IV ER 425.

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[9] *See* notes 11, 12, and 13.

[10] The Tax Court ultimately held that Harborside was not subject to any accuracy-related penalties because Harborside "acted with reasonable cause and in good faith when taking its tax positions for the years at issue." I ER 13; *infra*, at 23.

[11] For 2007 and 2008, the Commissioner made adjustments to income in the amounts of $2,130,554.00 and $4,136,255.00, respectively. IV ER 479. This included adjustments to cost of goods sold in the amount of ($3,155,485.00) and $258,750.00 for 2007 and 2008, respectively. IV ER 481; *see also* IV ER 489–502 for itemized list of denied deductions.

[12] For 2009 and 2010, the Commissioner made adjustments to income in the amounts of $17,232,131.00 and $21,148,327.00, respectively. IV ER 453. This included adjustments to cost of goods sold in the amount of $11,943,352.00 and $14,508,909.00 for 2009 and 2010, respectively. IV ER 455; *see also* IV ER 457–471 for itemized list of denied deductions.

[13] For 2011 and 2012, the Commissioner made adjustments to income in the amounts of $20,512,128.00 and $20,383,662.00, respectively. IV ER

The Commissioner's asserted basis for denying Harborside's claimed deductions was § 280E of the Internal Revenue Code:

> No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on a trade or business that consists of trafficking in controlled substances (within the meaning of schedule I or II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business was conducted.

See IV ER 441–444, 457–471, 489–502.

II. Procedural History

Harborside petitioned the Tax Court for a redetermination of the deficiencies asserted by the Commissioner. IV ER 446–447, 472–473. The first petition was filed on December 20, 2011 for 2007–2008. IV ER 472. Subsequently, petitions related to the 2009–2010 and 2011–2012 were filed on December 26, 2012 and June 24, 2014, respectively. IV ER 421, 445. All three cases were eventually consolidated for trial, briefing, and opinion on April 7, 2015.[14] IV ER 417–20, 445.

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429. This included adjustments to cost of goods sold in the amount of $12,916,565.00 and $13,816,278.00 for 2011 and 2012, respectively. *Id.*; *see also* IV ER 441–444 for itemized list of denied deductions.

[14] On May 23, 2013, Docket No. 29212-11, related to 2007 and 2008, was consolidated for trial, briefing, and opinion with Docket No. 30851-12,

After the consolidation, the case was tried in the Tax Court before Judge Holmes in June 2016. *See* II ER 87–88. On November 29, 2018 the court issued its first decision in this case. I ER 14. In that decision, the court held that (1) § 280E of the Internal Revenue Code does not violate the Sixteenth Amendment of the Constitution, and (2) Harborside must calculate its costs of goods sold as a reseller according to Treas. Reg. § 1.471-3(b). I ER 61, 75.

Soon thereafter, on December 20, 2018, the court issued its second decision in this case, in which it found Harborside was not subject to accuracy-related penalties under I.R.C. § 6662. I ER 7, 13.

The Tax Court then ordered the parties to conduct Rule 155 computations in accordance with these decisions. II ER 83–86. On October 11, 2019, the parties submitted their Rule 155 computations. II ER 77–82. After receiving all of the Rule 155 computations, the Tax Court entered final judgment in this case. I ER 1–6. The Tax Court ultimately found Harborside liable for a total of $11,013,236.75 (the

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related to 2009 and 2010. IV ER 445. On April 07, 2015, Docket Nos. 2912-11 and 30851-12, related to 2007 and 2008 and 2009 and 2010, respectively, were consolidated for trial, briefing, and opinion with Docket No. 14776-14. IV ER 417–420.

sum of $545,328.00 for 2007, $1,439,149.00 for 2008, $2,090,080.00 for 2009, $2,551,434.75 for 2010, $2,948,096.00 for 2011, and $1,439,149.00 for 2012). *Id.* It is from these decisions that Harborside appeals to this court, having timely filed a notice of appeal on December 2, 2019. II ER 76.

SUMMARY OF THE ARGUMENT

The application of § 280E to Harborside results in a tax liability that is inconsistent with the U.S. Constitution. The Sixteenth Amendment only permits Congress to levy non-apportioned taxes on “income,” and income is defined as gain from labor and capital. *See Eisner v. Macomber*, 252 U.S. 189, 207. However, taxpayers subject to § 280E can be forced to pay tax even in the absence of gain. Harborside is forced to pay taxes in years when it is losing money.

While Congress certainly has the power to limit deductions in various ways, § 280E exceeds such power as it disallows *all* deductions. As a result, the only allowed reduction to income is from the costs of goods sold. Since the deductions for rent, labor, and utilities (for example) are disallowed, § 280E fabricates gain where there was none and imposes a tax based on artificial income. Therefore, § 280E should not be applied to Harborside, as it unconstitutionally results in the taxation of amounts that are not "income" under the Sixteenth Amendment.

The Tax Court erred in holding that Harborside incorrectly calculated its cost of goods sold for years 2007–2012. The issue in this case is an inventory tax accounting issue—whether Harborside correctly calculated its cost of goods sold. There are only two requirements under the tax law for any accounting method, including cost of goods sold: 1) that proper accounting practices be followed; and 2) that the accounting method clearly reflects income.

Internal Revenue Code § 280E, which denies deductions and credits related to trafficking in controlled substances, does not affect Harborside's cost of goods sold calculation. For taxpayers subject to § 280E, such as Harborside, an item of expense either is allocated to cost of goods sold or it is allocated as a deductible expense that is denied by § 280E. In other words, § 280E only works to deny deductions "below-the-line," while cost of goods sold, calculated "above-the-line," is unaffected by § 280E. By claiming that part of Harborside's cost of goods sold should be treated instead as ordinary deductions, those of

Harborside's expenses that are allocated to cost of goods sold are moved below the line and thus disallowed.

There are many cases in which courts have allowed taxpayers to allocate such expenses to cost of goods sold, rather than to deductible business expenses, especially when, like Harborside, a taxpayer used proper accounting methods. *See, e.g., Comm'r v. Idaho Power,* 418 U.S. 1 (1974); *Max Sobel Wholesale Liquors v. Comm'r*, 630 F.2d 670 (9th Cir. 1980).

Harborside's allocation of certain expenses to cost of goods sold, instead of to deductible business expenses, is also permitted by other parts of the tax law. Treas. Reg. § 1.162-1(a) makes clear that there is a category of expenses that can be allocated to either deductible business expenses or to cost of goods sold. Again, Harborside's accounting methods were "best accounting practice" and therefore its allocations to cost of goods sold should be allowed, just as similar allocations were allowed by this Court in *Max Sobel* and by other courts in myriad cases.

There is no suggestion anywhere in the record of this case that Harborside's cost of goods sold accounting either is an improper method of accounting or fails to clearly reflect income—not in the notices of deficiency, not in the Commissioner's briefs in the trial, and not in the Tax Court's opinion. The significance of that absence cannot be overstated—this is a dispute about the federal income tax, after all, and the reality that there is nothing that Harborside has done that unfairly deprives the Treasury of revenue makes this case remarkable.

It should also be noted that there is no dispute of fact in this case—the stipulated facts provide that "the total claimed direct cost of goods sold for Harborside's [2007–2012 returns] are properly reflected on Harborside's [2007–2012] returns," that "these amounts are substantiated and that they were paid or incurred in acquiring inventory." III ER 233–34. "The parties disagree as to the proper characterization of these costs as inventory costs, deductible business expenses, or non-deductible business expenses." III ER 234–235.

STANDARD OF REVIEW

(1) The Ninth Circuit "review[s] the tax court's legal conclusions, including its interpretation of the Internal Revenue Code and Treasury Regulations, de novo." *Estate of Saunders v. Comm'r*, 745 F.3d 953, 957 (9th Cir. 2014) (citing *Metro Leasing & Dev. Corp. v. Comm'r*, 376 F.3d 1015, 1021 (9th Cir.2004)).

(2) The Ninth Circuit "analyze[s] the constitutionality of a statute de novo." *Acosta v. City of Costa Mesa*, 718 F.3d 800, 810 (9th Cir. 2013) (citing *Planned Parenthood of S. Ariz. v. Lawall*, 307 F.3d 783, 786 (9th Cir.2002)).

ARGUMENT

I. § 280E violates the Sixteenth Amendment

A. Summary

In this case, the government is demanding tax payments from Harborside on income it didn't make, and that's a violation of the Sixteenth Amendment to the Constitution. That amendment authorizes only "taxes on incomes, from whatever source derived...."

In 2007 Harborside's taxable income was a loss of $26,407, and yet the Commissioner is claiming Harborside owes $628,516 in tax. That's not because Harborside incorrectly calculated its ordinary expenses—the Commissioner concedes that all the expenses on the return were appropriate and verified but for the application of § 280E. Rather, the Commissioner under § 280E has disallowed Harborside's deductions for salaries, rent, licenses, interest and all the other normal costs of operating a retail establishment, so after those disallowances

Harborside suddenly had taxable income of $2,077,740 instead of a loss of $26,407.

Harborside didn't have any "income" in the conventional meaning of the word, and the conventional meaning is the one used when the Sixteenth Amendment was ratified and subsequent court decisions interpreting "income." § 280E is unique in the entire Internal Revenue Code in that it disallows ALL ordinary deductions and expenses, and its unparalleled scope necessarily results in taxpayers not paying tax on their incomes in clear violation of the Sixteenth Amendment. If more than Harborside's income is being taxed, then it's not an income tax and it's unconstitutional.

B. The Sixteenth Amendment only allows taxes on income

1. Introduction

Harborside is being subjected to an unconstitutional tax because § 280E results in a "direct tax" that's not "apportioned." A brief explanation of how those words are used in the Constitution is therefore necessary.

2. Text of the Sixteenth Amendment

The Sixteenth Amendment to the Constitution, passed by Congress in 1909 and ratified in 1913 (by 42 states): "The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. Const. amend. XVI.

3. Congress has the power to levy two kinds of taxes—direct and indirect

a. Congress has the general power to tax

Congress' basic taxing authority is found in Article I, § 8, Clause 1 of the U.S. Constitution: "The Congress shall have Power to lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defense and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States."

b. There are two different kinds of taxes—direct taxes and indirect taxes

Indirect taxes include duties, imposts and excises—taxes paid on the possession or sale of property when bought. Indirect taxes are limited by the Uniformity Clause (quoted above).

The second type of federal tax permitted in the Constitution is direct taxes, and they are subject to a different limitation—apportionment. Apportionment is imposed on direct taxes in two different places in the Constitution:

Article I, § 9, Clause 4:

> No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or enumeration herein before directed to be taken.

Article I, § 2, Clause 3:

> Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers, which shall be determined by adding to the whole Number of free Persons, including those bound to Service for a Term of Years, and excluding Indians not taxed, three fifths of all other Persons.

Apportionment means that each State is liable for the tax in proportion to its share of the United States population:

> Imagine state X with twice the population of state Y. For any tax subject to apportionment, X's aggregate liability must be twice Y's. Supposed an income tax has to be apportioned (something that's no longer the case because of the Sixteenth Amendment). If the per capita income in the two states is equal, the same rates could apply in both, and, as required, X's total collection would double Y's. But now suppose X's per capita income is only one-half Y's. *The rates in state X would have to be twice those in state Y to satisfy the apportionment requirement.*

Erik M. Jensen, *The Taxing Power, the Sixteenth Amendment, and the Meaning of "Incomes",* 33 Ariz. St. L.J. 1057, 1067 (2001) (emphasis in original).

The Framers were concerned about this sweeping power to tax, and so they made it politically and administratively difficult to impose a direct tax. Direct taxes would be used to raise revenue only in exceptional circumstances like a war. Jensen, *supra*, at 1077–8.

4. *Hylton v. United States*

The definition of direct tax was first taken up by the Supreme Court in 1796 in *Hylton v. United States*, 3 U.S. 171 (1796). The Court considered the question whether a tax on carriages was a direct tax and thus subject to apportionment. The three opinions in *Hylton* all agree that it was not. Justice Chase wrote "that the direct taxes contemplated by the Constitution, are only two, to wit, a capitation, or poll tax, simply, without regard to property, profession, or any other circumstance, and a tax on LAND." *Id*. at 175.

The opinions all agree that the meaning of "direct taxes" as used in the Constitution was a bit murky. Bruce Ackerman, *Taxation and the Constitution,* 99 Colum. L. Rev. 1, 20-25 (1999); *see also* Calvin H.

Johnson, *Apportionment of Direct Taxes: The Foul-up in the Core of the Constitution*, 7 Wm. & Mary Bill Rts. J. 1 (1998).

It is worth noting that all four justices were involved in the creation of the Constitution—three of them participated in the Constitutional Convention and the fourth was a leader in the Constitution's ratification in North Carolina. Ackerman, *supra*, at 21.[15] It therefore seems reasonable that their interpretation of direct tax would be treated with deference, and *Hylton*'s narrow definition of direct tax prevailed for nearly a century.

5. *Pollock* and the passage of the Sixteenth Amendment

Pollock v. Farmers' Loan and Trust Co., 158 U.S. 601 (1895), concerned the constitutionality of the Wilson Tariff Act of 1894 which provided for a tax of 2% on the amount above $4,000 on the "gains, profits, and income received in the preceding calendar year by every citizen of the United States . . . ." 158 U.S. 601, 639 (1895).[16] In a 5-4

[15] The lawyer for the United States was the former Secretary of the Treasury, Alexander Hamilton.

[16] A previous decision, *Pollock v. Farmers' Loan and Trust, Co.*, 157 U.S. 429 (1895), concerned taxes on income from real estate and bonds, but

decision, the Supreme Court held that the Wilson income tax was a direct tax and it was unconstitutional because it was not apportioned. *Id*. at 634.

The importance of *Pollock* is that for the first time, a tax was struck down on the grounds that it was an unapportioned direct tax. Jensen, *supra*, at 1070–72.

The public outcry over *Pollock* eventually resulted in the passage of the Sixteenth Amendment. Jensen, *supra*, at 1107–23. Affirming the desire of the progressive movement to secure an income tax, President Taft announced his support for a constitutional amendment declaring the income tax to be exempt from challenge as a direct tax. Ackerman, *supra*, at 35.

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public outcry over the first decision lead the Supreme Court to take up the issue of the constitutionality of the general income tax in the second Pollock case. The first *Pollock* was overruled with respect to taxes on bonds by *South Carolina v. Baker*, 485 U.S. 505, 524 (1988).

C. "Income" in the Sixteenth Amendment means gain

1. *Doyle v. Mitchell*

As a result of the passage of the Sixteenth Amendment in 1913, it became possible to have an income tax that was not apportioned. The courts then turned to the question of the definition of income, because only a tax on income would be constitutional.

Doyle v. Mitchell Bros. Co., 247 U.S. 179 (1918) concerned the calculation of income from lumber sales, that is, whether the proceeds of the sale of lumber were to be treated entirely as income or whether "income" requires deductions of expenses from the proceeds of the sale to arrive at the amount to be taxed. The decision explains:

> Whatever difficulty there may be about a precise and scientific definition of "income," it imports, as used here, something entirely distinct from principal or capital either as a subject of taxation or as a measure of the tax; conveying rather the idea of gain or increase arising from corporate activities. As was said in *Stratton's Independence v. Howbert*, 231 U.S. 399, 415, 34 Sup. Ct. 136, 58 L. Ed. 285: "Income may be defined as the gain derived from capital, from labor, or from both combined."

Id. at 185.

From the very start, income was gain.

2. *Eisner v. Macomber* recognizes limits on congressional ability to define "income" for purposes of the Sixteenth Amendment

While *Doyle v. Mitchell Bros. Co.* defined "income" for purposes of a federal tax statute, *Eisner v. Macomber*, 252 U.S. 189 (1920), takes the common understanding of "income" and applies it to the Sixteenth Amendment.

Eisner v. Macomber concerned the taxation of a stock dividend where the stockholder held the same percentage ownership of the stock issuing corporation before and after the dividend. The Revenue Act of 1916 provided that stock dividends were to be considered income "to the amount of its cash value[.]" *Id*. at 200 n.1. The taxpayer contended that the statue violated the constitutional provisions "requiring direct taxes to be apportioned according to population, and that the stock dividend was not income within the meaning of the Sixteenth Amendment." *Id*. at 201.

The Supreme Court held for the taxpayer, concluding that the stock dividend was not income and thus could not be taxed under the Sixteenth Amendment, and was not apportioned by population and thus failed the requirements of U.S. Constitution Article I, § 2, Clause 3 and Article 1, § 9, Clause 4. *Id.* at 219.

Eisner v. Macomber is critically important because it shows the Supreme Court's willingness to hold that a specific section of the tax law was not valid on Sixteenth Amendment grounds.

Furthermore, it places the Sixteenth Amendment in constitutional context—the Sixteenth Amendment "did not extend the taxing power to new subjects, but merely removed the necessity which otherwise might exist for an apportionment among the states of taxes laid on income." *Id.* at 206 (citations omitted).

As a result, the Sixteenth Amendment only applies to income taxes:

> A proper regard for its genesis, as well as its very clear language, requires also that this amendment shall not be extended by loose construction, so as to repeal or modify, except as applied to income, those provisions of the Constitution that require an apportionment according to population for direct taxes upon property, real and personal. This limitation still has an appropriate and important function, and is not to be overridden by Congress or disregarded by the courts.

Eisner, 252 U.S. at 206.

The Sixteenth Amendment limits Congress:

> [I]t becomes essential to distinguish between what is and what is not "income," as the term is there used, and to apply the distinction, as cases arise, according to truth and substance, without regard to form. Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives the power to legislate, and within whose limitations alone that power can be lawfully executed.

Id.

Congress is limited to levying taxes on income as it commonly understood: "Income may be defined as the gain derived from capital, from labor, or from both combined . . . ." *Id.* at 207 (citations omitted).

Eisner v. Macomber stands for the common sense proposition that Congress is limited under the Sixteenth Amendment to levying non-apportioned taxes only on income, and that income is defined as gain from labor and capital.

D. The Tax Court's Sixteenth Amendment analysis is wrong

1. Summary of Tax Court analysis

The Tax Court's opinion below upholds the constitutionality of § 280E in four steps:

a. The Sixteenth Amendment limits tax to gross income

"The Constitution does limit Congress to taxing only gross income...." *Patients Mut. Assistance Collective Corp. v. Comm'r*, 151 T.C. 176, 151 T.C. at 208.

b. Gross income is sales minus cost of goods sold ("COGS")

"[G]ross income...is gross receipts minus the cost of goods sold (COGS)." *Patients Mut. Assistance Collective Corp.*, 151 T.C. at 204.

c. All other business expenses can be denied by Congress

"Deductions are statutory, and Congress can grant or deny them as it chooses...." *Patients Mut. Assistance Collective Corp.*, 151 T.C. at 205.

d. Therefore § 280E which denies all other business expenses is constitutional

Harborside "pays tax only on the amount it realizes on sales, which is what the Constitution requires." *Patients Mut. Assistance Collective Corp.*, 151 T.C. at 209.

Steps a, c and d are entirely incorrect, and the Tax Court's misunderstanding of step b is the subject of the second part of this brief see *infra*, at 51.

2. The Sixteenth Amendment limits tax to a common sense definition of income, not gross income

a. The cases cited by the Tax Court do not support using gross income as the Sixteenth Amendment measure of income

The opinion asserts "[t]he Constitution does limit Congress to taxing only gross income, and courts have consistently held—including in cases Harborside cites—that gross income is gross receipts minus *direct* costs." *Id.* At 208. The three cases that the opinion cites show that the statement is flatly incorrect.

In *Reading v. Commissioner*, the Tax Court held (supporting Harborside's position), that "some kind of 'gain' must be realized for there to be income" for purposes of the Sixteenth Amendment but that an individual taxpayer could not deduct the cost of his labor in arriving at gross income. 70 T.C. 730, 733 (1978), *aff'd* 614 F.2d 159 (8th Cir. 1980).

In *Pittsburgh Milk v. Commissioner*, 26 TC 707 (1956), the Tax Court held that the Sixteenth Amendment definition of income looks to realized amounts and that income from milk sold below legal price limits should be calculated based on amounts actually received, and is not relevant to the idea that income for Sixteenth Amendment purposes is gross income.

In *Hofferbert v. Anderson Oldsmobile*, 197 F.2d 504 (4th Cir. 1952), the Court specifically declined to decide the cost on Sixteenth Amendment grounds, holding instead that "Congress intended to tax as income ...only the difference between the sales price and the actual cost of goods sold, even though a part of this cost was paid unlawfully...." *Id.* at 506. In fact, the District Court decision supports Harborside, observing that "[c]onstitutionally the only thing that can be taxed by Congress is 'income.' And the tax actually imposed by Congress has been on net income as distinct from gross income." *Anderson Oldsmobile v. Hofferbert*, 102 F.Supp. 902 (D. Md. 1952).

None of these cases relate to the idea that the Sixteenth Amendment idea of income is identical to the Internal Revenue Code's definition of gross income. This is the missing link in the opinion—because income as used in the Sixteenth Amendment is the conventional idea of income, and not gross income as that term is used in the Internal Revenue Code, these cases discussing gross income are irrelevant.

b. *The Eisner v. Macomber* definition of income as gain continues to be valid

It is well-established that other necessary expenses in addition to costs of goods sold must be subtracted from gross receipts to arrive at an amount of income that is subject to taxation under the Sixteenth Amendment.

In *Davis v. United States*, the Court of Appeals for the Second Circuit upheld the constitutionality of allowing deductions for short-term capital losses only to the extent of short-term capital gains. 87 F.2d 323 (2d Cir. 1937). With respect to the relevant section of the Revenue Act of 1932, the taxpayer argued: "(1) that its effect is to cause a direct tax to be levied without apportionment contrary to article 1, § 9 of the Constitution; and (2) that the classification resulting is so unreasonable, arbitrary, and capricious as to violate the due process clause of the Fifth Amendment." *Id.* at 324.

The opinion provides a comprehensive description of the calculation of income for purposes of the Sixteenth Amendment:

> It will be well to note at the start that our scheme of income taxation provides for a method of computation whereby all receipts during the taxable period which are defined as gross income are gathered together and from the total are taken **certain necessary items like cost of property sold; ordinary and necessary expenses incurred in getting the so-called gross income;** depreciation, depletion, and the like in order to reduce the amount computed as gross income **to what is in fact income under the rule of *Eisner v. Macomber***, 252 U.S. 189, 40 S. Ct. 189, 64 L. Ed. 521, 9 A.L.R. 1570, and so lawfully taxable as such. In this way true income is ascertained by **taking from gross income as defined that which is necessary as a matter of actual fact in order to determine what as a matter of law may be taxed as income.** While such subtractions

> are called deductions, as indeed they are, they are not to be confused with deductions of another sort like personal exemptions; deductions for taxes paid; losses sustained in unrelated transactions and other like privileges which Congress has seen fit to accord to income taxpayers under classifications it has established. **While the first kind of deductions are inherently necessary as a matter of computation to arrive at income, the second may be allowed or not in the sound discretion of Congress....Such deductions as distinguished from the first kind are allowed by Congress wholly as a matter of grace.** *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 54 S.Ct. 788, 78 L.Ed. 1348; *Van vleck v. Comm'r*, 80 F.2d 217 (2d Cir. 1935), *Gillette v. Comm'r*, 76 F.2d 6 (2d Cir. 1935).

Id. at 324–25 (emphasis added).

Davis takes *Eisner v. Macomber*'s common sense definition of income and applies it to the different determinants of income—not just cost of goods sold, but other necessary business expenses. The Tax Court decision doesn't mention either *Eisner v. Macomber* or *Davis*, the two cases most directly on point for the Sixteenth Amendment issue in this case. No case contradicts that *Eisner v. Macomber* still stands for the proposition that "income" as used in the Sixteenth Amendment necessarily entails gain.[17]

[17] *Commissioner v. Glenshaw Glass*, 348 U.S. 426 (1955) concerns the taxability of exemplary damages for fraud and treble damages awarded

3. Congress does not have the power to deny all deductions

As *Davis* and *Eisner v. Macomber* both point out, it is a violation of the Sixteenth Amendment to deny all deductions—any measure of income must include the idea of gain, and gain can only be measured after necessary expenses for the production of income are taken into account.

The Tax Court decision repeats a common saying about deductions: "Congress can grant or deny them as it chooses—the standard refrain is that they're a matter of Congress's 'legislative grace.'" *Patients Mut. Assistance Collective Corp. v. Comm'r*, 151 T.C. at 205 (citing *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79, 84 (1992), *New Colonial Ice v. Helvering*, 292 U.S. 435, 440 (1934); *Olive v. Comm'r*, 139 T.C. 19, 32 (2012)).

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in private antitrust actions. The Court held that such damages were taxable as gross income under I.R.C. § 61, pointing out that *Eisner v. Macomber* "was not meant to provide a touchstone to all future gross income questions." *Id*. at 477. However, the opinion is referring to broadening the definition of gross income, not the central idea of *Eisner v. Macomber* that income necessarily requires gain. In fact, *Eisner v. Macomber* (as well as *Pollock)* was cited with approval by the Supreme Court as recently as 2012 in *Nat'l F'n Indep. Bus. v. Sebelius*, 567 U.S. 519, 571 (2012).

The phrase “legislative grace” comes from the opinion in *New Colonial Ice v. Helvering*, 292 U.S. 435 (1934) and is cited in the opinion for the idea that Congress can define deductions from gross income in any way that it chooses and that the resulting tax is still an income tax. Not only is that notion incorrect, it is entirely mistaken that *New Colonial Ice* affirms it.

New Colonial Ice concerns an ice making company that ran out of capital before the ice making equipment was fully installed at the factory and the plant was being operated at only 40% of capacity. Creditors’ and stockholders’ committees were formed which discovered that “much stock had been issued of which there was no record and for which no consideration was received.” *Id*. at 438. A new company was organized to take over the assets and liabilities of the old company and continue the business. New stock was issued for new funds, and the new corporation took over from the dissolved old corporation. *Id*.

The tax issue in *New Colonial Ice* was whether the new company was entitled to deduct net operating losses of the old company. The holding is confined to the specific facts:

> [W]e are of opinion that in law and in fact the two corporations were not identical but distinct. This was plainly implied in the transfer of the assets and business from one to the other. That transaction was voluntary and contractual, not by operation of law. Thereafter neither corporation had any control over the other; the old corporation had no interest in the assets or business, and the chance of gain and the risk of loss were wholly with the new one.

Id. at 441–42 (footnote omitted).

New Colonial Ice is an unremarkable case that would long ago have been confined to the dustbin of forgotten tax cases were it not for a truly unfortunate rhetorical flourish sitting in the middle of the opinion:

> What is being taxed in this instance is the income realized by the new company in conducting the business after the transfer; and the sole matter for decision is whether, under § 204(b), there shall be deducted from that income the losses suffered by the old company in its conduct of the same business before the transfer. . . .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.* . . . Obviously, therefore, a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms.

Id. at 439–40 (emphasis added).

The emphasized sentence is obviously mere dicta. Erwin Griswold, arguably the most important tax lawyer of his generation, wrote a Harvard Law Review article arguing against its use:

> Although the *New Colonial Ice* formula is a "now familiar rule," and is cited by Government lawyers in their briefs as glibly as taxpayers' lawyers once relied on *Gould v. Gould* [tax laws should be construed in favor of the taxpayer], it has never been fully considered by the Court. Taken literally, it would mean that Congress may deny all deductions and impose a tax on gross income. This is a large question, about which there may be reasonable doubts, even today. Could Congress, for example, impose the tax on the entire proceeds from the sale of property without any allowance for the cost of the property? Could it deny deductions for all wages paid?

Erwin N. Griswold, *An Argument Against the Doctrine that Deductions Should Be Narrowly Construed as a Matter of Legislative Grace*, 56 Harv. L. Rev. 1142, 44 (1943) (footnote omitted).

New Colonial Ice did not address any currently deductible item of expense but instead addressed one taxpayer's income tax attributes (items of expense that had been rightfully been deducted in previous tax years that were being brought forward to future tax years in the form of net operating loss carryforwards) *and whether such taxpayer could unilaterally transfer such attributes to a separate taxpayer/legal entity.*

It is most regrettable that courts have used this language to disallow current deductions of items of expense to which a taxpayer is rightfully entitled under the Sixteenth Amendment concept of an income tax.

E. An Example and Conclusion

As discussed above, Harborside is being taxed on income it doesn't have, so that tax isn't an income tax.

A more general example clarifies why this is a common result with § 280E. To begin with, it's clear that COGS must be applied to reduce gross receipts:

> [A] congressional attempt to tax the gross receipts of a business engaged in sales should fail. A taxpayer who purchased 100 widgets at a cost of $10 each and sold them at a price of $9 each would have gross receipts or sales of $900, which after being reduced by "the cost of goods sold" ("COGS") of $1,000 . . . would yield a loss of $100. Given that obvious loss, Congress could not tax the gross receipts of $900 as if it were "income".... That is, under the Sixteenth Amendment it is "mandatory" to allow a reduction for COGS, since we do not know whether a taxpayer-seller had any "income" at all until we know whether the price he obtained for the item he sold exceeded the cost he had incurred to produce that item.

N. Cal. Small Bus. Assistants Inc. v. Comm'r, 153 T.C. No. 4, 26–27 (Gustafson, J., dissenting).

But allowing COGS is necessary but not sufficient—the problem with § 280E, however, is that is disallows all deductions, and as a result "the determination of the supposed 'income tax' liability of a taxpayer trafficking in illegal drugs bypasses altogether any inquiry as to his gain." *Id.* at 32. Judge Gustafson's example compels her conclusion:

> This point is illustrated by expanding upon the example of the widget seller. Suppose he purchased 100 widgets at a cost of $6 per widget (instead of $10 as above), yielding COGS of $600, and suppose that for his business he leased a retail space for $200 and paid wages of $200 to employees, yielding additional expenses of $400, so that his out-of-pockets expenditures for COGS ($600) and additional expenses ($400) totaled $1,000. If he then sold the 100 widgets at a price of $9 each, he would have gross receipts of $900, which would, after being reduced by his total costs of $1,000 (the sum of COGS and total expenses), yield a loss of $100. No one would propose that this seller had any gain. And if his product had not been widgets costing $600 but illegal drugs costing the same amount, he would have the same negative outcome—a loss of $100. But despite this obvious loss, § 280E would disallow any deduction for his rent and wage expenses totaling $400, yielding a supposed taxable "income" of $300—despite his having incurred not gain but loss. § 280E would fabricate gain where there was none and would impose a tax based on artificial income.
>
> I would hold that this wholesale disallowance of all deductions transforms the ostensible income tax into something that is not an income tax at all, but rather a tax on an amount greater than a taxpayer's "income" within the meaning of the Sixteenth Amendment. Accordingly, I would hold that the Sixteenth Amendment does not permit

> Congress to impose such a tax and that § 280E is therefore unconstitutional.

Id. at 33.

The truth is that you can count as many different things as income as you please, but there still has to be gain. No case contradicts that. *Eisner v. Macomber* still stands for the proposition that "income" as used in the Sixteenth Amendment necessarily entails gain. As shown in the example from *Northern California Small Business Assistants* above at 41-43, taxpayers subject to § 280E can be forced to pay tax even in the absence of gain—just as Harborside was.

Of course Congress has the power to limit deductions in various ways, but that is not what § 280E does—it disallows all deductions. Before the enactment of § 280E in 1982 there has never been such a sweeping disallowance of deductions, and § 280E continues to be unique in the Internal Revenue Code in its breadth.

Harborside's tax liability on fictitious income and the clear reality that tax in the absence of gain flows directly from the disallowance of all deductions leads to the inescapable conclusion that § 280E violates the Sixteenth Amendment. Harborside is respectfully requesting that § 280E be invalidated accordingly as unconstitutional.

II. Harborside correctly calculated its cost of goods sold

A. Background

1. Origins of § 280E

A 1981 Tax Court decision held that a taxpayer engaged in selling illegal drugs was allowed to deduct his business expenses because they "were made in connection with [the taxpayer's] trade or business and were both ordinary and necessary." *Edmonson v. Comm'r*, 42 T.C.M. 1533 (1981). Citing public policy against drug dealing, Congress enacted Internal Revenue Code § 280E in 1982:

> 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 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.

I.R.C. § 280E (2018).

The Senate Finance Committee report explained:

> 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.[18]

S. Rep. No. 97-494, at 309 (1982).

2. Definition of COGS

COGS isn't defined in the Internal Revenue Code or any Treasury Regulation but is referred to in several places. Treas. Reg. § 1.61-3(a) provides that COGS must be subtracted from total sales in order to arrive at gross income, and states "[t]he cost of goods sold should be determined in accordance with the method of accounting consistently used by the taxpayer."

Treas. Reg. § 1.162-1(a) gives the general rule—"[t]he cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income." The regulation points out that if an item of expense may be categorized as either COGS or a deductible business expense, it must go into COGS:

[18] This is the entire "Explanation of Provision." There is no further discussion of the constitutional issue or why preserving the cost of goods sold calculation is necessary or sufficient to insulate against possible constitutional defect. *See* S. Rep. No. 97-494, at 309 (1982). The Senate Bill was adopted in conference. H.R. Rep. No. 97-760, at 598 (1982) (Conf. Rep.).

"No such item shall be included in business expenses, however, to the extent that it is used by the taxpayer in computing the cost of property included in its inventory or used in determining the gain or loss basis of its plant, equipment, or other property." *Id.*

The Regulations explicitly contemplate a category of expenses that can be allocated to either deductible business expenses or to COGS, and if the expense can be allocated to COGS under the taxpayer's accounting methods, it **must** be allocated to COGS.

3. COGS is Determined before Deductions

The leading case on the tax treatment of cost of goods sold is *Max Sobel Wholesale Liquors v. Commissioner*, 630 F.2d. 670 (9th Cir. 1980). The taxpayer, Max Sobel Wholesale Liquors, "secretly transferred, as an added consideration for sales, extra liquor to some of its customers in fiscal 1973 and 1974 in violation of California law providing for minimum prices." *Id.* at 671. The Commissioner "disallowed the inclusion of the value of the extra liquor in taxpayer's [COGS,]" asserting that such amount was instead a deduction and thus disallowed under I.R.C. § 162(c)(2) barring the deduction of illegal payments. *Id.*

This Court disagreed:

> For good or ill, tax law distinguishes between exclusions from gross income ("above the line" items) and deductions from gross income ("below the line" items). See generally *B.C. Cook & Sons v. Comm'r*, 65 T.C. 422 (1975), aff'd, 584 F.2d 53 (5th Cir. 1978). "Gross income," I.R.C. § 61, is determined by subtracting all "above the line" items from gross receipts. See Treas. Reg. § 1.61-3(a). The very definition of "gross income" has been thought to mandate the exclusion of certain amounts (e.g., the cost of goods sold) from that figure, even in the absence of specific statutory authority for such exclusion.

Id. at 671.

The Court concludes about the illegal payment:

> Rather than directly reducing gross receipts, taxpayer's price-adjustment method results in a decrease in the value of closing inventory, which is accounted for as an increase in the cost of goods sold, which in turn is subtracted "above the line" from gross receipts to determine gross income. See *Thor Power Tool v. Comm'r*, 439 U.S. 522, 530 n.9 (1979). Only after this computation will tax accounting consider potential deductions, if any, from gross income. Therefore if § 162(c)(2) operates only to disallow potential deductions, it is inapplicable to the present case.

Id. at 672.

Max Sobel makes clear that determination of COGS comes first—limitations on deductions come second.

4. Both the Tax Court and the Commissioner Misunderstand COGS

Max Sobel—clearly the controlling precedent in this Court on the priority of determining COGS before deductions—is absent from the Tax Court opinion and the Commissioner's arguments.[19]

The Commissioner's position is that first a taxpayer computes its deductions and then determines which expenses are deferred under COGS. Gov't brief at 77. "[T]he Court's conclusion on the extent of § 280E's application to petitioner's business will inform its holding on the proper method for computing its inventory." Gov't brief at fn. 321. Under *Max Sobel*, this is exactly backwards—determine COGS first, then determine the deductibility of other expenses.

Similarly, the Tax Court opinion claims that "[t]he big difference between deductions and COGS adjustments is timing." *Patients Mut. Assistance Collective Corp.*, 151 T.C. at 205. This misses the significance of the difference between an exclusion from gross income and a deduction from gross income.

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[19] *Max Sobel* is cited by Harborside's counsel in arguing for taxpayer's COGS accounting methods. Petitioner's Seriatim Reply Brief at 17, II ER 89.

B. Harborside correctly determined COGS

1. Statutory requirements for tax accounting

I.R.C. § 446 provides the general rule for methods of accounting in I.R.C. § 446(a): "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books."

There is an important limit to the general rule, however—the clear reflection of income requirement: "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." I.R.C. § 446(b)

I.R.C. § 471(a) restates the rule specifically for inventories:

> Whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

I.R.C. § 471(a).[20]

These two tests are clear and they have been applied specifically in the context of inventory tax issues for over a century.[21]

2. Harborside's COGS practices followed the established rules

a. GAAP creates presumption that best accounting practice is followed

Tax accounting starts with financial statement accounting, as I.R.C. § 446 and I.R.C. § 471 make clear. Treas. Reg. § 1.446-1(a)(2) elaborates:

> It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent

[20] The rule is restated in Treas. Reg. § 1.471-2(a): "§ 471 provides two tests to which each inventory must conform: (1) It must conform as nearly as may be to the best accounting practice in the trade or business, and (2) It must clearly reflect the income."

[21] I.R.C § 471(a)(2018) is basically unchanged from 1918: "That whenever, in the opinion of the Commissioner, the use of inventories is necessary in order to clearly determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income." Revenue Act of 1918, ch. 18, § 203, 40 Stat. 1060 (1919).

> application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

Treas. Reg. § 1.446-1(a)(2).

As the Supreme Court pointed out in *Thor Power Tool v. Commissioner*, 439 U.S. 522, 532 (1979), "best accounting practice" is "a phrase that is synonymous with 'generally accepted accounting principles.'"[22]

b. GAAP rules for determining COGS

GAAP refers to the set of rules, standards and practices of the Financial Accounting Standards Board ("FASB"). The FASB Accounting Standards Codification ("ASC") is organized as a series of topics. *See* Financial Accounting Standards Board, *Accounting Standards Codification*, https://asc.fasb.org (last visited March 17, 2020).

[22] The discussion in *Thor Power* of the primacy of the second test (the clear reflection of income requirement) over the first test (the best accounting practice requirement), *id*. at 540, is not relevant to this case because there is no contention by the Commissioner that Harborside's accounting methods did not clearly reflect income.

ASC Topic 330-3-1, Inventory:

> The primary basis of accounting for inventories is cost, which has been defined generally as the price paid or consideration given to acquire an asset. As applied to inventories, cost means in principle the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location. It is understood to mean acquisition and production cost, and its determination involves many considerations.

(Fin. Accounting Standards Bd. 2009).

The definition of an inventory's cost as "the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location[,]" *id.*, does not suggest a uniform definition of inventory as each business using GAAP operates in its own industry and uses its own business model.

c. How Harborside determined COGS

Harborside followed GAAP by allocating to COGS the costs of acquiring the cannabis and preparing it for sale. There was extensive testimony at the Tax Court trial regarding the duties of the employees and allocation of floor space at the dispensary. II ER 182–218. On the basis of this testimony, floor plan exhibits, and Harborside's tax returns, trial counsel produced three appendices to his seriatim opening brief—Appendix A: Employee Wage Allocations, Appendix B: Floor Space Allocations, and Appendix C: Yearly Cost Allocation Tables. II ER 102–106, 107–111, 112–133. In addition to the "Other Items Claimed in Cost of Goods Sold" in Table I, Harborside claimed additional amounts allocable to COGS under appropriate accounting methods at trial.

d. Taxpayers comparable to Harborside determined COGS similarly

Even though Harborside is a retail store, it's not comparable to a book store where cartons of books come in the back, are unloaded, and then put on display in the front of the store. It more closely resembles a grocery store where food items come in the back of the store and are then prepared for sale. For example, a side of beef arrives at the loading dock of a grocery store. The butcher breaks down the side of beef into various cuts and then other personnel package and label the cuts, after which they are put on display in the front of the store. As described above *infra*, at 14-17, the cannabis arrives at the back of the dispensary and then there is extensive testing and preparation before it is put on display in the front.

Here's how some large grocery store chains include food preparation costs in COGS:

> 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).

> 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) (Nov. 22, 2013).

C. The Tax Court misunderstands COGS

1. Tax Court decision

The Tax Court decision doesn't begin with the correct premise, namely that COGS must be determined first, then remaining expenses classified as different types of deduction as appropriate. By ignoring *Max Sobel*, the opinion goes astray.

But the error is compounded—Judge Holmes ignores the statutory framework of the two tests (clear since 1918) for a taxpayer's method of accounting, including for inventory: "(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and (2) It must clearly reflect the income." Treas. Reg. § 1.471-2(a).

Judge Holmes disregards his findings of fact regarding Harborside's elaborate systems of cannabis procurement, inspection, processing and storage, preferring a procrustean approach—the opinion flatly declares that Harborside is "a reseller for purposes of § 471 and must adjust for its COGS according to Treas. Reg. § 1.471-3(b). *Patients Mut. Assistance Collective Corp.*, 151 T.C. at 213; I ER 75. As a result, Harborside can only include in COGS "its inventory price and transportation costs." *Patients Mut. Assistance Collective Corp.*, 151 T.C. at 210; I ER 70.

2. The Tax Court improperly changed Harborside's accounting methods

a. Harborside's accounting methods, including COGS calculations, were not challenged as improper

There is no suggestion anywhere in the record of this case that Harborside's accounting methods were inappropriate. The opinion observes, "[k]eeping good books and records was one of Harborside's strengths, and the Commissioner agreed in pretrial stipulations in each of these cases that Harborside substantiated all its claimed deductions and COGS for all of the tax years at issue and that all of them were paid or incurred in a trade or business." *Patients Mut. Assistance Collective Corp. v. Comm'r*, 116 T.C.M. 570 at 6 (T.C. 2018); I ER 12.

The Commissioner doesn't understand the first requirement of "best accounting practice in the trade of business," contending:

> Petitioner cites to Generally Accepted Accounting Principles but does not show how financial accounting conventions amend the Internal Revenue Code. It provides no authority for its proposal to revamp the tax accounting of inventories by leaving to taxpayers decisions about whether an item is an expenses [sic] or an inventory cost.

I ER 98.

b. Harborside's accounting methods, including its COGS calculations, were not challenged as failing to clearly reflect income

There is no suggestion by the Tax Court or the Commissioner that Harborside's accounting methods failed to clearly reflect income.

There couldn't be a failure to clearly reflect income no matter how Harborside chooses to determine COGS—Harborside's inventory turns over constantly, so it doesn't matter whether an expense is allocated above or below the line from the perspective of matching income and expenses. If inventory turns over constantly, whether an expense is deducted now or allocated to COGS and reduces taxable income later when the item is sold is irrelevant.

3. The Tax Court improperly applied Treas. Reg. 1.471-3

a. There are other choices to reflect circumstances

The Tax Court summarily asserts Harborside must use Treas. Reg. 1.471-3(b). But obviously "inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business." Treas. Reg. § 1.471-2(b).

COGS necessarily varies—Treas. Reg. § 1.471-3(d) provides that "[i]n any industry in which the usual rules for computation of cost of production are inapplicable, costs may be approximated upon such basis as may be reasonable and in conformity with established trade practice in the particular industry." There is no reasoning given why Treas. Reg. 1-471-3(b) should apply and not Treas. Reg. 1.471-3(d).

b. It is wrong to apply Treas. Reg. 1.471-3(b) where the taxpayer is not a simple reseller

It's not apparent why Treas. Reg. § 1.471-3(b) is the correct regulation to apply to Harborside. Applying Treas. Reg. § 1.471-3(b) to the department store Montgomery Ward, the Tax Court noted that "[w]ith a few possible exceptions, Ward acquired its merchandise as finished goods in saleable condition, and sells its merchandise with or without installation or merchandise preparation charges." *Marcor, Inc. v. Comm'r*, 89 T.C. 181, 190 (1987) (footnote omitted). That is certainly not Harborside's circumstance.

The Commissioner's post-trial brief does not contend that the Treas. Reg. § 1.471-3(b) reseller regulations apply to Harborside—instead, the brief just mentions that there are several sets of inventory regulations under § 471 that could possibly apply, but never states which regulations should apply to Harborside. II ER 93.

Further, even if Treas. Reg. § 1.471-3(b) applies to Harborside, the costs it allocated to COGS were in fact for acquiring the merchandise in a condition to sell to customers.

As discussed above *infra*, at 14-17, Harborside had employees acquiring specific strains of cannabis and engaging in cannabis inspection, testing, trimming, manicuring and curing. II ER 140–142, 158, 160–161. Employees had job titles such as Purchasing Manager, Purchasing Assistant Manager, and Purchasing Assistant, spending 100% of their time acquiring inventory. II ER 102–103, 185–186. Other employees had job titles such as Inventory Managers and Inventory Associates, spending 100% of their time managing inventory, checking weights, moving inventory, and storing it. II ER 103. Still other employees had the job title Processing Associate—they spent 100% of their time devoted to making "raw" cannabis ready for resale, including further trimming, weighing, packaging and stickering. II ER 103–104.

All of the above expenses should be allocated to COGS, but are barred from being included in inventory costs by the Tax Court's interpretation of the Treas. Reg. § 1.471-3(b) regulations. Another way of looking at the issue is to pose the question—is Kroger a reseller or not? Does Treas. Reg. § 1.471-3(b) apply to it or not? It doesn't really matter, because Kroger calculates its cost of goods sold using "costs of acquiring products and making them available to customers in stores." The Kroger Co., Annual Report (Form 10-K) 50 (Apr. 3, 2018).

Kroger's COGS calculations are entirely appropriate for its business—this is why the Commissioner doesn't challenge Kroger or Whole Foods or any other similar business, and he should leave Harborside alone, too.

4. In case of conflict between using proper COGS methods and applying Treas. Reg. 1.471-3, COGS methods prevail

This Court takes an expansive view of the items appropriately allocated to cost of goods sold. The Tax Court's opinion in *Max Sobel* discussed the issue of allocating to cost of goods sold an item of expense that could be disallowed as a deduction due to illegality:

> Depending on the nature of the business, the cost of goods sold may include material, labor and overhead. There may be certain expenses of a dual character which may be chargeable either to overhead in the cost of goods sold or deducted as an administrative or sales expenses. A typical example would be a bribe given for the purpose of obtaining goods or for the purpose of expediting its delivery to the taxpayer for manufacture and resale.

Max Sobel at 485.

In discussing this possibility, this Court pointed out that "[w]e doubt the existence of such a category (see the final sentence of Treas. Reg. § 1.471-3(b), but in any event hold that if the regulations purport to extent to the items in the present case, they are invalid to that extent." *Max Sobel Wholesale Liquors v. Comm'r*, 630 F.2. 670, 673 (9th Cir. 1980).

The fundamental nature of the exclusion from income of cost of goods sold means that Harborside should be permitted to use appropriate methods to calculate COGS.[23]

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[23] In I.R.S. Chief Counsel Memorandum 201504011, the Commissioner advances the theory that "[a] taxpayer trafficking in a Schedule I or Schedule II controlled substance determines COGS using the applicable inventory-costing regulations under I.R.C. § 471 as they existed when enacted." I.R.S. Chief Counsel Memorandum 201504011 from Matthew A. Houtsma, Associate Area Counsel to W. Thomas McElroy, Jr. (Jan. 23, 2015), https://www.irs.gov/pub/irs-wd/201504011.pdf. As one commentator pointed out, "explicitly requiring the use of regulations in effect in 1982, CCA 201504011 requires that individuals in the marijuana industry must be knowledgeable regarding tax laws from more than thirty years ago as they appeared in the 1954 version of the Code." Debra Sanders and Susan Gill, *Guidance on Inventory Methods for Medical and Recreational Marijuana Businesses*, 122 J. Tax'n 218, 220 (2015). Even if this peculiar theory is valid, it does not affect Harborside's determination of COGS.

5. § 263A Does Not Apply

Much was made in the proceedings below of the potential applicability of I.R.C. § 263A to Harborside's allocations to COGS. § 263A is unimportant to the tax deficiency assessments being appealed, however. There are six tax years at issue here, and in only one—the tax year ended July 31, 2010—did Harborside claim any amount under § 263A. The notice of deficiency disallows Harborside's § 263A deduction for that year in the amount of $55,511. IV ER 431. That's the only § 263A amount at issue here, and taxpayer is willing to concede this disallowance.

D. Conclusion

Harborside respectfully requests that this Court reverse, as Section 280E violates the Sixteenth Amendment and its attendant prohibition on the taxation of income that does not represent gain. Alternatively, this Court should reverse and remand with instructions that the Tax Court determine Harborside's COGS under the approach described in this brief, namely, relying on the taxpayer's accounting methods for allocation of costs to COGS.

Dated: May 26, 2020

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CERTIFICATE OF COMPLIANCE

Pursuant to Fed. R. App. P. 32(a)(7)(C), I certify that:

This brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B) because this brief contains 12,255 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(f).

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 2016, Century Schoolbook 14-point font.

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CERTIFICATE OF SERVICE

I hereby certify that on May 26, 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.

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