We Know Very Little About Taxing Cryptocurrency

To the Editor:

In "Everything We Know — and Don't — About Taxing Cryptocurrency," Jesse C. Hubers asserts, "It seems likely that [convertible virtual currencies] will generally be classified as a commodity for tax purposes."[1]

If Hubers had limited his generalization to a public blockchain's native tokens, like bitcoin and ether, he'd probably be right. Those tokens are used for payments and as gas, whereby you pay a small amount to the blockchain protocol to settle a transaction.

But the vast majority of convertible virtual currencies are fractionalized interests in automated software (LP tokens), voting rights over on-chain treasuries (DAO governance tokens), and debtlike promises from financial institutions (fiat-backed stablecoins). As I've previously explained, it is far from clear that those tokens are commodities for tax purposes, and the more likely treatments — equity in a deemed entity or direct ownership of the underlying assets — raise serious issues that often make it impossible for taxpayers to know with any degree of certainty whether they are compliant.[2]

Jason Schwartz
Partner
Fried, Frank, Harris, Shriver & Jacobson LLP
Mar. 30, 2023

[1]Hubers, "Everything We Know — and Don't — About Taxing Cryptocurrency," *Tax Notes Federal*, Mar. 13, 2023, p. 1699.

[2]*See, e.g.*, Jason Schwartz, "The Taxation of Decentralized Finance," *Tax Notes Federal*, Feb. 7, 2022, p. 767; Schwartz, "Squaring the Circle: Smart Contracts and DAOs as Tax Entities," Bankless DAO, July 29, 2022; and Schwartz, "Reading the Tea Leaves — What Enforcement Actions Mean for the U.S. Taxation of Crypto," Fried Frank Regulatory Intelligence (Feb. 15, 2023).

Capitalizing Disallowed Costs: 'Releaf' for the Cannabis Industry

To the Editor:

In this example, we demonstrate that cannabis businesses may be able to recoup expenses that have been disallowed under section 280E of the Internal Revenue Code. Our reasoning provides that section 280E costs (current and historic) may be treated as capital assets under the 16th Amendment and, if permitted under the taxpayer's accounting method, amortized as a component of cost of goods sold.[1] If the taxpayer's accounting method does not allow amortization, our example provides that such costs should still be capitalized as an asset to be credited against the income from the sale of the business or deducted once cannabis is removed from the schedule of controlled substances.

Under the 16th Amendment to the U.S. Constitution,[2] the federal government is authorized to impose a tax on *income*, which is defined as a taxpayer's gain.[3] For a business, gain is calculated as gross receipts less ordinary and necessary business expenses. Because the benefit of expenses can extend over multiple tax periods, business expenses are allocated to three different timing categories: COGS, deductions, and capital expenditures. COGS are timed such that they are not available to reduce income until the good is sold, capital expenses are allocated to reduce income according to the useful life of the asset, and deductions are allowed against current income (unless subject to section 280E).

The IRC grants the IRS authority to determine which costs have to be included in COGS, and the IRS has promulgated regulations pursuant to that

[1]Cost of goods sold (COGS) are direct and indirect costs incurred in the purchase or production of goods for sale. Section 471, and the regulations thereunder, set forth those costs required to be included in COGS for different types of businesses.

[2]"The Congress shall have 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]*See Eisner v. Macomber*, 252 U.S. 189, 207 (1920) (defining income as the gain from labor and capital); *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179 (1918) (income is gain or increase arising from corporate activities); *Stratton's Independence v. Howbert*, 231 U.S. 399 (1913) (income may be defined as the gain derived from capital, from labor, or from both combined); *Davis v. United States*, 87 F.2d 323 (2d Cir. 1937) (stating that deductions for "ordinary and necessary expenses" are necessary in the computation of income).

authority.[4] But it is important to note that such authority is limited by the 16th Amendment's mandate to "clearly reflect" gain.

Because allocation of costs to COGS delays recognition of the costs for tax purposes until the good is sold, most companies prefer a deduction. However, during the war on drugs, the U.S. Congress enacted section 280E, which disallows all tax deductions (and credits) for companies that "traffic in controlled substances." Congress wanted to disallow all costs — COGS and deductions. But the congressional record states that section 280E cannot disallow COGS. The result is that cannabis industry accounting favors COGS. The industry will take what it can, but why can't Congress disallow COGS?

Before answering the question, we must point out that the results are absurd. Section 280E denies deductions for the cost of a salesperson but not for a farmworker, for the cost of selling marijuana but not for the cost of buying it for sale, for dispensary rent but not for farm rent.

The difference is timing.

For COGS, the constitutional mandate limiting the income tax to "gain" requires that the costs to produce or purchase a good be credited against the income from the sale of the good.[5] If not, the result does not clearly reflect the income produced from the good. But deductions are different. Deductions encompass those business costs which can be incurred absent any gain.

A company can build a facility, purchase products for resale, pay salaries, advertise, etc., but without any sales, there is no gain to which such costs can be allocated. The constitutional mandate to clearly reflect gain is not yet applicable.

But we are capitalists! And so our income tax code incentivizes business (other than cannabis) by providing deductions against current income for all ordinary and necessary business expenses that are not classified as COGS. Essentially, Congress exercised its "legislative grace"[6] and went beyond the Constitution to allow tax "deductions" for costs that are not yet tied to income. Otherwise, under the 16th Amendment, credit for such costs is not yet required to reflect the gain of the business.

If Congress then exercises its legislative grace and denies deductions for ordinary and necessary business expenses, the constitutional requirement to tax no more than "gain" still applies. The expenses don't disappear — they are ordinary and necessary business expenses that must be accounted for at some point in the future of the business in order to reflect the gain of the business. Costs relating to future business gain are generally capitalized into COGS or as a separate capital asset.[7] For the cannabis industry, absent the right to capitalize the costs into COGS, the costs can be capitalized as a tax asset so to clearly reflect the future income from the business.

And if the costs can be capitalized, it then follows that they can be amortized and included in COGS if allowed under the taxpayer's accounting method. If the accounting method does not permit amortization, the costs can still be capitalized and recovered when the business is sold or terminated as required to reflect the final gain from the business.

Our position that disallowed section 280E costs may be capitalized harmonizes the federal tax system[8] and proves that section 280E *is* constitutional. Currently, there is an ongoing battle between the cannabis industry and the IRS regarding section 280E's compliance with two pillars of our federal income tax system — "gain" and "legislative grace."[9] The industry argues that it is being taxed in excess of its gain, and the IRS

[4] Sections 446 and 471(a).

[5] *See Alpenglow Botanicals LLC v. United States*, 894 F.3d 1187, 1199 (10th Cir. 2018) ("To ensure taxation of income rather than sales, the 'cost of goods sold' is a mandatory exclusion from the calculation of a taxpayer's gross income.").

[6] *New Colonial Ice Co. v. Helvering*, 292 U.S. 435 (deductions are a matter of legislative grace that can be granted or denied by the U.S. Congress).

[7] *Davis*, 87 F.2d 323 ("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.").

[8] *See United States v. Olympic Radio and Television*, 349 U.S. 232, 236 (1955) (the tax code should be interpreted to give "as great an internal symmetry and consistency as its words permit").

[9] *See Lord v. Commissioner*, T.C. Memo. 2022-14; *Patient's Mutual v. Commissioner*, 151 T.C. 176 (2018), *aff'd*, 995 F.3d 671 (9th Cir. 2021); *San Jose Wellness v. Commissioner*, 156 T.C. No. 4 (2021); and other cases cited herein.

argues that the federal government has exercised its valid legislative grace to deny the deductions of cannabis companies. Can both be true?

They should. Recognizing that disallowed section 280E costs can be capitalized honors the right of Congress to disallow a deduction and respects the constitutional definition of gain. The courts (and Congress) have not yet said what happens to ordinary and necessary business expenses that are disallowed under section 280E. Thus, there is room to accept that our proposal is correct without overruling the precedent of reported decisions or redefining the concepts of legislative grace or gain.

Finally, one area that does not seem to be harmonized (but is) by our proposal involves another kind of disallowed deduction for things like bribes, 50 percent of meals and entertainment, offsetting losses, etc. As discussed in *Davis*, these types of expenditures are not ordinary and necessary business expenses and thus are not necessary for the computation of gain. Section 280E costs are different.

It is unclear how the IRS and courts will treat the position articulated above. Nevertheless, it appears clear that section 280E costs cannot be permanently disallowed under section 280E. As such, cannabis companies should be able to capitalize such costs and realize them at some point. We suggest that immediate recognition may be possible under certain accounting methods.

The result is dope for cannabis industry businesses.[10]

Nick J. Richards
Greenspoon Marder LLP
Mar. 23, 2023

[10]The positions set forth herein have not yet been proven in a court of law. There is no guarantee that we are correct, but we are confident in our reasoning. This Greenspoon Marder LLP article is issued for informational purposes only and is not intended to be construed or used as general legal advice nor a solicitation of any type. Please contact the author(s) or Greenspoon Marder LLP if you have any questions regarding the currency of this information. The hiring of a lawyer is an important decision. Before you decide, ask for written information about the lawyer's legal qualifications and experience.

An Independent Look Back At the Appeals Officer

To the Editor:

To be "independent" is not to:

- be subject to control by others; or
- require or rely on someone else.

In 2012 the IRS Office of Appeals released a new set of protocols, titled "Appeals Judicial Approach and Culture" (AJAC),[1] with the self-stated goals of "returning Appeals to a quasi-judicial approach in the way it handles cases" and "enhancing internal and external customer perceptions of a fair, impartial and independent Office of Appeals."[2]

Before Independence

Back in 1985 the New York Appeals Office was, as I have previously written,[3] deluged with the cases of investors and partners in virtually all tax shelters imaginable. Such disputes were in both non-docketed and docketed status.

I joined New York Appeals in late 1984, coming directly from a then-large case banking group as a revenue agent (RA) team member. I brought to the large case group several tax shelter investor cases with instructions from management to get those cases closed out of my inventory so I could work the banking cases full time.

All of my fellow trainee Appeals officers (AOs) had come to Appeals from Exam. As experienced RAs, we were well aware of Appeals' reputation as the "gift shop" and not as a function that needed to be more independent. It would take some time, but ultimately, we would learn to think and behave as AOs.

AO vs. RA in a Nutshell

An RA is charged with getting the facts and applying the law to a given matter and to then

[1]*See* William D. Hartsock, "How to Avoid New Issues or a Reopened Case in Tax Appeals," The Tax Lawyer blog, Aug. 26, 2017.

[2]*See* AP-08-0713-03.

[3]*See* Joel G. Cohen, "The Raising of New Issues by Appeals," *Tax Notes Federal*, Oct. 17, 2022, p. 424; Cohen, "Is the Appeals Pre-Conference Meeting Fair to the Exam Team?" *Tax Notes Federal*, Nov. 15, 2021, p. 955; and Cohen, "A View From the Cube," *Tax Notes Federal*, Oct. 18, 2021, p. 341.