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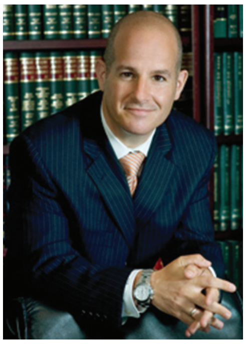
# Where the Gibson Taxpayers Went Wrong



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**Here is a motto worth remembering: The business of cannabis is business. And, as with any other enterprise, planning matters, implementation matters, safeguards matter.**

In a noteworthy decision, the United States Tax Court recently denied income tax deductions claimed by the operators of a medical marijuana dispensary. In Gibson v. Commissioner of Internal Revenue, [1] the United States Tax Court ruled that taxpayers running a medical marijuana dispensary could not deduct those ordinary and necessary business expenses normally associated with the operation of a business. Furthermore, the court ruled that bad record keeping precluded the taxpayers from taking full advantage of allowances associated with the cost of goods sold.

## When is a Business Deduction Deductible?

Generally, businesses may deduct all ordinary and necessary expenses from gross income. Business owners must keep sufficient records from which to calculate these deductions. The sufficiency of the records is important because if challenged by the regulatory auditors, the taxpayer has the burden of substantiating these deductions.

Section 280E of the Internal Revenue Code prevents businesses "trafficking in controlled substances from claiming business deductions." Marijuana, though legal in several states, is still a controlled substance for purposes of Section 280E. This means, that for federal purposes, a taxpayer operating a marijuana dispensary is not entitled to take ordinary and necessary business deductions that would otherwise be allowed.

## Only Expenses That Do Not Violate 280E Qualify

For businesses that have both a legal and illegal component, the tax court will permit the deduction of just those business-related tax claims not in violation of 280E. In the 2007 CHAMP v. Commissioner of Internal Revenue case, [2] the tax court held that a medical marijuana dispensary in California which offered legitimate counseling and caregiving services in addition to its marijuana sales could deduct its expenses related to the counseling and caregiving portion of its business. The taxpayer was still responsible for apportioning expenses pertaining to both of its businesses. However, the tax court rejected the IRS argument that the marijuana sales irreversibly tainted the taxpayer's other businesses.

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## Assessing the Cost of Goods Sold

Taxable income equals gross income less deductions. It has long been held that a taxpayer can reduce gross income by the costs expensed to generate inventory. In this sense, accounting for the costs of goods sold is not a deduction, but rather an adjustment to calculating gross income.

Because Section 280E disallows only business deductions, the tax court has held that a business otherwise subject to the 280E restrictions is allowed to account for its costs of goods sold in calculating its gross income. [3]

The Department of the Treasury has promulgated regulations for calculating costs of goods sold. Under Treasury Regulation Section 1.471, costs of goods sold equals:

- Beginning inventory plus,
- Purchase costs of additional inventory, plus,
- Costs of production, minus
- The value of the inventory on hand at the end of the tax year.

For example, a business that sells shoes has $50,000 worth of shoes on hand at that start of the tax year. During the year the business spends $12,000 to purchase additional shoes and pays its salesforce commissions of $15,000 to generate sales that year. During the year the business sells 2,000 pairs of shoes for $130,000 in total revenue. At the close of the year, the business has 900 pairs of shoes for which it paid $20 per pair. Assuming no other business deductions or offsets, the taxpayer would recognize gain on the full value of the $130,000 in sales. However, the taxpayer would be able to adjust its gross income by its cost of goods sold. Here, in this simplified example, that equates to:

$50,000 + $12,000 + $15,000 - $18,000 = $59,000

Therefore, the taxpayer's gross income would be $71,000 ($130,000 minus $59,000).

Note that the reduction of $59,000 is not a deduction taken against gross income, but rather it is a reduction in gross income itself.

## What Went Wrong for Gibson?

In the Gibson case, the taxpayers were a married couple who filed joint income tax returns. They operated a medical marijuana dispensary in Colorado and sold products such as joints, dried buds, edibles and related merchandise including pipes, smoking papers, etc.

When the IRS audited the taxpayers' 2010 and 2011 returns, it focused on the profits, losses and deductions claimed on Schedule C. The IRS determined that the company underreported gross receipts for 2010 in the amount of $24,663 and underreported gross receipts for 2011 in the amount of $8,359. It, therefore, disallowed all claimed deductions for both years under 280E. The IRS did allow costs of goods sold of $388,231 and $1,021 for 2010 and 2011, respectively.

At trial, the taxpayers conceded that they had underreported gross receipts and they accepted the numbers put forth by the IRS. The IRS, at trial, increased its allowance of costs of goods sold from $388,231 to $452,292 for 2010 and from $1,021 to $232,772 for 2011.

However, the tax court held that the taxpayer's sole business purpose was the sale of marijuana and that selling marijuana paraphernalia was not a separate business. Citing the Champ decision, the tax court still found a clear distinction between how the Gibson taxpayers and the Champ taxpayers ran their respective businesses.

The tax court went on to say that even if the taxpayers in Gibson could distinguish their marijuana business from their non-marijuana business, they failed to adequately account for and substantiate their claimed business deductions. The defendants were undone by poor record keeping.

The tax court held that the taxpayers were solely in the business of trafficking in controlled substances under 280E and all business deductions were disallowed — even those deductions taken for depreciation under Code Section 179. The court did affirm the IRS calculation of the taxpayer's cost of goods sold; however, it also found that the formula the taxpayers used to calculate its own cost of goods sold was deficient because it did not conform to the treasury regulations.

The result? Increased income taxes, interest and penalties for the taxpayers.

## Key Takeaways

The taxpayers in Gibson made several errors. Namely, they failed to keep adequate records of their business dealings and they failed to structure their businesses in a way that clearly distinguished between their non-marijuana businesses and their marijuana business. Moreover, they failed to implement accounting safeguards crucial to a cash-centric business' operation. They tried to recreate their accounting records after the fact, when it was too late.

By the time their case reached the tax court, the taxpayers had little credibility in making a case to the authorities that they were anything but a marijuana business with unreported income.

Moral of this story? Planning matters. Implementation matters. Safeguards matter.

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1 Alterman v. Commissioner, No. 13666-14, 2018 Tax Ct. Memo LEXIS 83 (T.C. June 13, 2018).
2 Californians Helping to Alleviate Med. Problems Inc. v. Commissioner, 128 T.C. 173 (2007).
3 See Olive v. Commissioner, 139 TC 19 (2012).