No. 19-73078

IN THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

PATIENTS MUTUAL ASSISTANCE COLLECTIVE CORPORATION, DBA Harborside Health Center,

Petitioner-Appellant

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee

ON APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

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GLOSSARY

Acronym/Abbreviation	Definition
Br.	Appellant's opening brief
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
Harborside	Patients Mutual Assistance Collective Corporation, dba Harborside Health Center
MIG Br.	Amicus brief filed by the Marijuana Industry Group and Cannabis Trade Federation
NCIA Br.	Amicus brief filed by the National Cannabis Industry Association

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ON APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

STATEMENT OF JURISDICTION

The IRS sent taxpayer ("Harborside") a notice of deficiency for 2007 and 2008 on September 23, 2011 (ER475); it sent a notice of deficiency for 2009 and 2010 on September 26, 2012 (ER449); and it sent a notice of deficiency for 2011 and 2012 on March 27, 2014 (ER425). Harborside timely petitioned for redetermination in the Tax Court. (ER421-22, 446-47, 472-73.) The three Tax Court cases were consolidated for trial, briefing, and opinion. (ER7.) The Tax Court had

jurisdiction over these cases under I.R.C. (26 U.S.C.) §§ 6213(a) and 7442.

The Tax Court entered final decisions in each of the consolidated cases on October 17, 2019. (ER1-6.) Harborside timely appealed. (ER76, 509, 517, 526.) *See* Fed. R. App. P. 13(a). This Court has jurisdiction under I.R.C. § 7482(a).

STATEMENT OF THE ISSUES

1. Whether a Sixteenth Amendment challenge is properly before this Court, and if so, whether Section 280E violates the Sixteenth Amendment.

2. Whether the IRS correctly determined Harborside's allowable exclusion from income for cost of goods sold.

APPLICABLE STATUTES AND REGULATIONS

The constitutional provisions, statutes, and regulations relevant to the disposition of this appeal are included as an addendum to this brief. *See* Fed. R. App. P. 28(f); 9th Cir. R. 28-2.7.

STATEMENT OF THE CASE

A. Overview of the case and proceedings below

This appeal concerns I.R.C. § 280E, which makes marijuana dispensaries ineligible for business tax deductions. Harborside, a large

California marijuana dispensary, filed the action that gives rise to this appeal in the Tax Court to seek redetermination of tax deficiencies totaling $29,774,426 (*see* ER425, 449, 475), which the IRS determined for 2007 through 2012. The deficiencies stemmed principally from two sources: (1) the IRS's denial, under Section 280E, of more than $30 million in tax deductions that Harborside claimed on its returns; and (2) the IRS's disallowance, mainly for lack of substantiation, of more than $50 million in cost of goods sold reported on Harborside's tax returns. (ER429, 453-56, 479-82.) As explained in more detail below, cost of goods sold — essentially, the cost of items produced for sale or acquired for resale — is excluded from gross income.[1]

In the Tax Court, Harborside made two arguments that Section 280E was inapplicable — a res judicata argument and an argument that its business does not "consist of" drug trafficking within the meaning of Section 280E. (ER34-48.) And it argued that it should at

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[1] While the case was pending in the Tax Court, Harborside substantiated its costs of goods sold. (ER234-35.) And the IRS thus allowed Harborside to exclude from its gross income the amounts it paid suppliers to purchase goods. (ER95-96.) This allowance is the principal reason that the deficiency determined by the Tax Court ($11,013,236.75) is significantly lower than the $29,774,426 deficiency originally determined.

least be permitted to take tax deductions related to the non-marijuana portions of its business. (ER50-61.) Harborside also argued to the Tax Court that the portion of its claimed cost of goods sold that the IRS disallowed — certain indirect inventory costs — should have been allowed. (ER62-75.) The Tax Court resolved the disputed issues in the IRS's favor and determined a deficiency totaling $11,013,236.75 for the six years at issue. (ER1-5.)

B. Legal framework

1. Statutory framework

Under Section 280E of the Internal Revenue Code, state-licensed marijuana dispensaries cannot claim federal tax deductions and credits:

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

Marijuana is classified under Schedule I of the Controlled Substances Act. 21 U.S.C. § 812(c)(10). And operating a marijuana dispensary constitutes trafficking in controlled substances. *See, e.g., Olive v. Commissioner*, 792 F.3d 1146, 1150 (9th Cir. 2015).

Federal tax law recognizes two basic measures of income: gross income and taxable income. Generally speaking, gross income includes "all income from whatever source derived," including "income derived from business." I.R.C. § 61(a). Under the applicable regulations, businesses calculate their gross income by subtracting the cost of any goods sold from their gross receipts. *See* 26 C.F.R. § 1.61-3(a) (Treas. Reg.); *see also* Treas. Reg. § 1.162-1(a). The cost of goods sold includes both the cost of items acquired for resale and the cost of producing any items for sale, adjusted for opening and closing inventories. *See* Treas. Reg. § 1.162-1(a); *Kazhukauskas v. Commissioner*, T.C. Memo. 2012-191 at [*9].

Sections 471 and 263A of the Code, and their accompanying regulations, set the parameters for what expenses are to be included in inventory. Section 471 provides that "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." Section 263A defines, more specifically, costs that "shall be included in inventory costs" for certain taxpayers, and explains that these costs

include both direct costs of property and also the property's "share of those indirect costs (including taxes) part or all of which are allocable to such property." I.R.C. § 263A(a)(1) & (2).

For resellers of merchandise, the Section 471 regulations define inventory costs to mean the "net invoice price" of the merchandise and "transportation or other necessary charges incurred in acquiring possession of the goods." Treas. Reg. § 1.471-3(b). The Section 263A regulations define the "indirect costs" allocable to inventory property to include, *inter alia*, purchasing costs, handling costs, and storage costs. *See* Treas. Reg. 1.263A-1(e)(3)(ii)(F)-(H). Finally, the flush language of I.R.C. § 263A(a)(2) provides that "[a]ny cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph."

The "exclusion" from income of cost of goods sold is part of the regulatory definition of gross income, rather than a deduction from gross income defined in the Tax Code. As such, Section 280E does not prevent a marijuana dispensary from excluding its cost of goods sold, subject to the inventory rules set out in Sections 471 and 263A and

their accompanying regulations. *See, e.g., Alterman v. Commissioner*, T.C. Memo. 2018-83 at [*30].

Taxable income, in turn, is computed by reducing a taxpayer's gross income using deductions allowed by the Tax Code. I.R.C. § 63(a). Among these deductions are some related to the carrying on of a trade or business. Section 162(a) of the Tax Code, for example, allows taxpayers to deduct "ordinary and necessary expenses" incurred or paid during a taxable year "in carrying on any trade or business." I.R.C. § 162(a). Taxpayers also may deduct "interest paid or accrued on indebtedness properly allocable to a trade or business," I.R.C. § 163(a) & (h)(2)(A), and generally may take "as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear . . . of property used in the trade or business," I.R.C. § 167(a). But because these deductions are for the carrying on of a trade or business, they are not permitted when the business "consists of trafficking in controlled substances." I.R.C. § 280E.

2. Constitutional framework

The Constitution grants Congress broad taxing power. Article I, sec. 8, cl. 1, provides: "The Congress shall have Power To lay and

collect Taxes, Duties, Imposts, and Excises." The only limitations on that power are that "Duties, Imposts and Excises shall be uniform throughout the United States" (Art. I, sec. 8, cl. 1); "No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken" (Art. I, sec. 9, cl. 4); and "No Tax or Duty shall be laid on Articles exported from any State" (Art. I, sec. 9, cl. 5). In addition, the Sixteenth Amendment to the Constitution relieves income taxes that would otherwise be direct taxes from the apportionment requirement of Art. I, sec. 9, cl. 4. It states: "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.

C. Facts of the case and the Tax Court's decision

Harborside is a large marijuana dispensary that sells various marijuana products. (ER15, 19-21.) It complies with California law, which permits collective or cooperative cultivation of marijuana for medicinal purposes. (ER16-18.) The IRS audited Harborside's income tax returns for 2007 through 2012 and determined that Harborside was

not entitled to the income tax deductions it claimed. (ER26-27.) The IRS also denied most of the costs of goods sold that Harborside asserted. (ER27, 429, 453-56, 479-82.) The IRS accordingly determined significant deficiencies in income tax for each year under audit. (ER425, 449, 475.)

Harborside petitioned the Tax Court for a redetermination of the deficiencies. After a trial and briefing, the court issued two opinions. In the first opinion, the court determined that the IRS correctly applied Section 280E. (ER14-75.) In the second opinion, it concluded that the legal positions that Harborside took were reasonable and, therefore, that Harborside was not liable for accuracy-related penalties (ER7-13) — a determination that the Commissioner has not appealed. The court then issued decisions determining deficiencies for each year at issue. (ER1-6.)

In its first opinion, the Tax Court considered and rejected each of Harborside's arguments concerning its tax liability. The court first rejected Harborside's contention that res judicata prevented the IRS from applying Section 280E because the government dismissed a prior forfeiture action that was brought against Harborside. It explained

that res judicata does not apply because the government could not have sought to recover the tax deficiency at issue here in the prior forfeiture action. (ER34-37.) (Harborside does not challenge that determination on appeal.)

Next, the Tax Court rejected Harborside's argument that its business does not "consist of" drug trafficking under Section 280E because, although it principally sells marijuana, it also sells some non-marijuana products and engages in other activities. The Tax Court determined that Section 280E denies tax deductions to businesses that traffic in controlled substances even if they also engage in other activities. (ER38-48.) (Harborside does not challenge that determination on appeal.)

Next, the Tax Court rejected Harborside's argument that it is engaged in four businesses — selling marijuana, selling non-marijuana products, providing therapeutic services, and brand development — and that it should be able to take tax deductions for expenses that relate to the three non-marijuana businesses. The Tax Court concluded that Harborside was actually engaged in a single business, selling marijuana, and that its other activities were just a part of that

business. (ER50-61.) (Harborside does not challenge that determination on appeal.)

Finally, the Tax Court addressed Harborside's arguments that the disputed portion of the cost of goods sold it claimed on its 2007 through 2012 tax returns should not have been disallowed. Initially, the IRS denied more than $50 million of Harborside's claimed cost of goods sold, mainly for lack of substantiation. (ER429, 453-56, 479-82.) But, during the litigation, Harborside substantiated the costs, and the IRS conceded that Harborside could exclude the amounts it paid its suppliers for goods it resold. (ER95-96, 234-35.) These direct inventory costs accounted for most of the more-than-$50 million in cost of goods sold that was initially denied. The portion of Harborside's claimed cost of goods sold that remained in dispute was the amount attributable to certain indirect costs like storage and handling. (ER19-23, 95-96.)

The Tax Court ruled that the Commissioner correctly determined that Harborside cannot include costs like testing, storage, packaging, trimming, etc. in its cost of goods sold. (ER61-75.) The court explained that these costs do not come within the meaning of inventory cost under the regulation that applies to Harborside, Treas. Reg. § 1.471-3(b).

(ER69-70, 75 & n.26.) The court also explained that Harborside could not utilize the broader I.R.C. § 263A inventory rules to include the indirect costs in cost of goods sold because Section 263A does not permit costs to be included in inventory that could not otherwise be taken into account in computing taxable income. (ER66.) And the court rejected Harborside's argument that it is a producer, rather than a reseller, for purposes of the I.R.C. § 471 inventory rules. (ER69-75.)

SUMMARY OF ARGUMENT

The only Tax Court ruling that Harborside challenges on appeal is the court's denial of Harborside's claimed cost of goods sold. Otherwise, Harborside and its amici raise new arguments on appeal that were never presented to the Tax Court. Harborside's broad Sixteenth Amendment challenge to Section 280E was not raised in the Tax Court, and accordingly is waived. And Harborside has never raised the broad Eighth Amendment challenge to Section 280E raised here only by an amicus. In any event, even if these arguments were properly before this Court, they lack merit and should be rejected. Finally, the IRS correctly applied the regulations that govern calculation of inventory to determine that Harborside may exclude from its gross income the direct

cost of the goods it sells but not its "indirect costs," that is, its purchasing, handling, and storage costs.

1. The Sixteenth Amendment is not implicated here. Congress's broad authority to impose taxes on business comes from Article I of the United States Constitution. The Sixteenth Amendment did not constrain or alter that authority in any way. What the Sixteenth Amendment did was to undo the result in *Pollock v. Farmers' Loan & Trust Co.,* 158 U.S. 601 (1895), which held that a tax on income from property is a direct tax that must be apportioned. But even *Pollock*, the Supreme Court's most aggressive interpretation of the Direct Tax Clause, makes clear that a tax on business proceeds is not a direct tax. Because the Sixteenth Amendment has no impact on Congress's authority to tax business proceeds, Section 280E would not violate the Constitution even supposing that it had the effect of imposing a tax on more than a marijuana dispensary's income.

In any event, the Sixteenth Amendment meaning of income is consistent with the Tax Code's definition of gross income. Overwhelming authority establishes that Congress is free to tax gross income and that its allowance of deductions from gross income is a

matter of legislative grace. As such, Congress is free to abolish or limit tax deductions.

2. The Tax Court also correctly determined that processing costs related to inventory, like the costs of testing, labeling, curing, storing, trimming, manicuring, maintaining, and packaging marijuana or marijuana products, are not includable in Harborside's cost of goods sold. The applicable regulation, Treas. Reg. § 1.471-3(b), defines inventory cost to mean "net invoice cost" plus "transportation or other necessary charges incurred in acquiring possession of the goods." The costs Harborside seeks to include in its cost of goods sold do not fit within that definition. And Harborside's arguments that that regulation is somehow overridden by other regulations or accounting standards is meritless.

STANDARD OF REVIEW

Whether Section 280E is unconstitutional (issue I) is a legal issue that this Court reviews *de novo*. *United States v. Schales*, 546 F.3d 965, 971 (9th Cir. 2008). Whether the Tax Court correctly determined that purchasing, handling, and storage costs are not part of inventory cost under the applicable regulation (issue II) is also a legal issue that this

Court reviews *de novo*. *Minnick v. Commissioner*, 796 F.3d 1156, 1159 (9th Cir. 2015).

ARGUMENT

I. Section 280E does not violate the Sixteenth Amendment

A. Harborside has not only waived the Constitutional argument it presents on appeal for the first time, but actually took the opposite position in the Tax Court

As an initial matter, Harborside did not argue before the Tax Court that Section 280E is unconstitutional and it did not ask the Tax Court to invalidate Section 280E. "Absent exceptional circumstances, this court will not consider an argument that was not first raised in the Tax Court." *Sparkman v. Commissioner*, 509 F.3d 1149, 1158 (9th Cir. 2007). Indeed, this Court has previously declined to consider a broad constitutional challenge to Section 280E that was not raised in the Tax Court. *Canna Care, Inc. v. Commissioner*, 694 F. App'x 570, 571 (9th Cir. 2017).

Harborside did invoke the Sixteenth Amendment before the Tax Court, but only to make a constitutional avoidance argument on the cost-of-goods-sold issue. (SER50-52.) Harborside did *not* contend before the Tax Court that Section 280E's denial of tax deductions was

unconstitutional. Indeed, Harborside took the position before the Tax Court that Congress "is empowered" under the Sixteenth Amendment to tax gross income and that "[o]nce gross income is calculated, Congress is then authorized to use its 'legislative grace' and grant discretionary deductions to this amount." (SER46-47.) Now Harborside takes a U-turn and argues that the Sixteenth Amendment does not permit taxation of gross income, contending that the well-established principle that deductions are matters of legislative grace is just erroneous dicta. (Br. 38-48.) This Court does "not allow parties to switch their positions on appeal." *Mendiola-Martinez v. Arpaio*, 836 F.3d 1239, 1250 n.13 (9th Cir. 2016).

Harborside fails to acknowledge that it is making an argument that it did not make in the Tax Court. It also avoids mentioning that the position it takes now is the opposite of what it said in the Tax Court. Not surprisingly then, Harborside fails to argue that exceptional circumstances justify excusing its waiver. This Court should adhere to its general rule prohibiting consideration of an argument raised by an appellant for the first time on appeal.

B. Harborside's Sixteenth Amendment challenge could succeed only if Section 280E imposes a direct tax that is not a tax on income

Section 280E denies to marijuana dispensaries the business tax deductions and tax credits that the Internal Revenue Code provides other types of businesses. *See* pp. 4-7, *supra*. Making businesses that "consist[] of trafficking in controlled substances" ineligible for these tax benefits does not violate the Sixteenth Amendment. The gist of Harborside's argument is that, under the Sixteenth Amendment, Congress can only tax a business's "income" and that income should be understood according to its "conventional meaning" under which expenses like "salaries, rent, licenses, interest and all the other normal costs of operating a retail establishment" must be subtracted from gross receipts. (Br. 28-29.)

Harborside is incorrect. First, the Sixteenth Amendment is far more circumscribed than Harborside believes. It does not impose any barrier at all to taxation of a business. A tax on business proceeds is an indirect tax about which the Sixteenth Amendment says nothing. Second, even supposing the Sixteenth Amendment did apply here, it permits taxation of gross income, as this Court and the Supreme Court

have recognized. In short, Harborside's Sixteenth Amendment challenge succeeds only if Section 280E imposes a direct tax that is not a tax on income. But neither requirement is met. Section 280E does not impose a direct tax and it also does not tax more than Harborside's income.

C. Section 280E does not impose a direct tax

The Sixteenth Amendment does not empower Congress to tax income. It already had that power. The amendment's role is quite limited. It eliminates the apportionment requirement that would (arguably) otherwise apply *to a certain narrow category of income: income from property*. Because the income at issue here is not income from property, the Sixteenth Amendment is inapplicable.

1. The Sixteenth Amendment is not the source of Congress's authority to tax business proceeds

The Constitution grants Congress the power "To lay and collect Taxes, Duties, Imposts, and Excises." U.S. Const. Art. I, sec. 8, cl. 1. It also provides — in the Direct Tax Clause — that "No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken." U.S. Const. Art. I, sec. 9, cl. 4; *see* Art. I, sec. 2, cl. 3 ("Representatives and direct taxes

shall be apportioned among the several states which may be included within this Union, according to their respective Numbers ....”). It is the Direct Tax Clause that the Sixteenth Amendment modifies by stating that “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. Thus, after the Sixteenth Amendment, capitations and other direct taxes remain subject to the apportionment requirement unless they are “taxes on incomes.” Of course, “taxes on incomes” that are not capitations or other direct taxes never were subject to any apportionment requirement. And so the Sixteenth Amendment has nothing to say about those.

The meaning of the Sixteenth Amendment is best understood in light of its historical context and the historical context of the Direct Tax Clause. Under the Articles of Confederation, the Continental Congress could raise revenue only through requisitions — that is, by giving states a quota and relying on the states to pay. Edwin R. A. Seligman, *The Income Tax* 542-44 (1911). This system worked poorly. *Id.* And so the need for a broad federal taxing power was a driving force in developing

the Constitution. *See* Calvin H. Johnson, *Fixing the Constitutional Absurdity of the Apportionment of Direct Tax*, 21 Const. Comment. 295, 297 (2004); Bruce Ackerman, *Taxation and the Constitution,* 99 Colum. L. Rev. 1, 6 (1999).

The concepts of apportionment and direct taxes arose out of the controversy concerning representation of enslaved persons that threatened to lead to dissolution of the Constitutional Convention. Ackerman at 8-9. Under the eventual compromise, three fifths of the number of enslaved persons were counted for purposes of representation. Seligman at 550-51. This compromise also had a tax aspect. Under the original proposal, taxation would have been in the same proportion of the population as representation (apportionment) — the idea being that southern states would have to pay for the extra representation they were getting. *Id.* But George Mason expressed concern that linking taxation to population would devolve into the failed requisition system, and so Gouverneur Morris (who had proposed linking taxation to representation) suggested limiting apportionment to direct taxes. *Id.* at 551. This final resolution is reflected in Art. I, sec. 2, cl. 3, and Art. I, sec. 9, cl. 4.

The meaning of "apportionment" is plain. It means that "each State pays in proportion to its population." *Nat'l Fed'n of Indep. Bus. (NFIB) v. Sebelius*, 567 U.S. 519, 570 (2012). For example, if Congress enacted a national yacht tax (and it was determined to be a direct tax), taxpayers from Ohio would have to pay 3.52% of the total tax (its percentage of the U.S. population[2]) even if it turned out that total yacht values in Ohio make up far less than 3.52% of the total property taxed (*i.e.*, the total value of yachts in the United States) and Ohioans accordingly had to pay a higher yacht tax rates than taxpayers in other states. *See* Dawn Johnsen, Walter Dellinger, *The Constitutionality of A National Wealth Tax*, 93 Ind. L. J. 111, 117 (2018).

But the historical accounts of the Constitutional Convention do not reveal the definition of "direct tax." In fact, James Madison's notes of August 20, 1787, reflect that Rufus King asked for "the precise meaning of direct taxation," and no one answered. Seligman at 568; *see also* Ackerman at 11 ("Given [the Direct Tax Clause's] troubled origins in the compromise with slavery, this silence is perfectly

[2] https://www.infoplease.com/us/states/state-population-by-rank (utilizing U.S. Census Bureau data).

understandable. Any effort at clarity could only threaten to undo the desperate expedient on representation and taxation [the founders had] patched together."). As the Supreme Court has explained, "[e]ven when the Direct Tax Clause was written it was unclear what else, other than a capitation (also known as a 'head tax' or a 'poll tax'), might be a direct tax." *NFIB,* 567 U.S. at 570 (citation omitted).

In *Hylton v. United States,* 3 U.S. (Dall) 171 (1796), the Supreme Court unanimously ruled that a federal carriage tax was not a direct tax. Justice Paterson recalled that the requirement of apportionment for direct taxes was intended as a resolution on the treatment of slaves, not as a restriction on Congress's taxing authority, and concluded that "[t]he rule, therefore, ought not to be extended by construction." *Id.* at 178. As the Court explained in *NFIB*, "those Justices who wrote opinions either directly asserted or strongly suggested that only two forms of taxation were direct: capitations and land taxes." *Id.* at 571.

"That narrow view of what a direct tax might be persisted for a century." *NFIB*, 567 U.S. at 571. Then, in *Pollock v. Farmers' Loan & Trust Co.,* 158 U.S. 601, 637 (1895), the Court held that a tax on income from real and personal property was a direct tax requiring

apportionment on the theory that such a tax was, in substance, a tax on the property itself. *Pollock* interpreted the Direct Tax Clause more aggressively than it had ever been interpreted previously, but the decision did not extend to "gains or profits from business, privileges, or employments." *Id.* at 635. Indeed, the Court stated that taxes on "business, privileges, or employments" had already been sustained. *Id.* The Court concluded, however, that the income tax at issue must be invalidated in its entirety because the income from property was "by far the largest part of the anticipated revenue" from the tax and it was doubtful that Congress would have enacted an income tax that did not include taxation of income from property. *Id.* at 637. But the Court reiterated that Congress was free to tax "business, privileges, employments, and vocations" if it chose to do so. *Id.* Justice Harlan, writing in dissent, noted that the Direct Tax Clause was born out of the Constitution's compromise with slavery and argued that the majority opinion imported into the clause a meaning "never contemplated by the founders of the government." 158 U.S. at 684.[3]

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[3] Justice Harlan concluded: "I have a deep, abiding conviction, which my sense of duty compels me to express, that it is not possible for (continued…)

After *Pollock*, the Supreme Court quickly returned to the far more circumscribed understanding of direct tax that had prevailed for the previous 100 years. For instance, the Court unanimously held that the estate tax is not a direct tax, quoting liberally from *Hylton*. *Knowlton v. Moore,* 178 U.S. 41, 85 (1900). Some consideration in Congress was given to the idea of just enacting another income tax and thereby challenging the Supreme Court to simply overrule *Pollock*. *See* Ackerman at 34-35. But ultimately President Taft secured a compromise under which certain members of Congress would support a corporate tax and he would ensure that the challenge to the outcome in *Pollock* would proceed via a constitutional amendment rather than a simple reenactment of the law *Pollock* struck down. Ackerman at 35-36. This compromise led first to the enactment of the Corporate Tax Act of 1909, which the Court upheld against a Direct-Tax-Clause challenge in *Flint v. Stone Tracy Co.*, 220 U.S. 107, 150 (1911). *See also*

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this court to have rendered any judgment more to be regretted than the one just rendered." *Pollock*, 158 U.S. at 664-65 (Harlan, J., dissenting). The three other dissenting justices denounced the *Pollock* majority in similarly strong terms. *See Pollock*, 158 U.S. at 695 (Brown, J., dissenting); *id.* at 706 (Jackson, J., dissenting); *id.* at 715 (White, J., dissenting)

Ackerman at 33 n.128, 35-36. And second, it led to the passage and ratification of the Sixteenth Amendment in 1913. *Id.* at 38-39.

The Sixteenth Amendment superseded *Pollock*'s determination that a tax on income from real and personal property is a direct tax that must be apportioned, stating rather that Congress may tax "incomes, from whatever source derived, without apportionment." Understood in light of *Pollock* and its historical context, the phrase "from whatever source derived" takes on a significance that might not otherwise be evident. The Amendment did not need to give Congress the power to tax income. It did not even need to give Congress the power to tax income without apportionment. Even under *Pollock* — *i.e.*, under the most aggressive (and now largely discredited) judicial interpretation of a the Direct Tax Clause — Congress was free to tax some forms of income (including wages and business revenue) without apportionment. 158 U.S. at 635-37. What the Amendment sought to accomplish is to eliminate the restriction *Pollock* placed on Congress's taxing power — *i.e.*, the requirement that taxes on income from real and personal property must be apportioned. "[F]rom whatever source derived"

eliminated the restriction, allowing Congress to tax *all* forms of income without apportionment.

In *NFIB*, the Court concluded that the shared responsibility payment (the payment the Affordable Care Act required for those who go without health insurance) was not subject to the apportionment requirement because it does not "fall within any recognized category of direct tax," explaining that it was not a capitation because it was not paid by everyone, and "is also plainly not a tax on the ownership of land or personal property." 567 U.S. at 571. Courts of appeals have likewise recognized the narrow scope of the Direct Tax Clause. *See, e.g.*, *Delaware Cty., Pa. v. Fed. Hous. Fin. Agency*, 747 F.3d 215, 221 (3d Cir. 2014) ("There are only three types of direct taxes: capitations, also known as poll taxes, which are fixed taxes levied on people, . . . taxes on real property; and taxes on personal property.") (citing *Murphy v. I.R.S.*, 493 F.3d 170, 181 (D.C. Cir. 2007)); *DeKalb Cty. v. Fed. Hous. Fin. Agency*, 741 F.3d 795, 799 (7th Cir. 2013) (explaining that the constitutional term direct taxes "now embraces just capitation taxes . . . and taxes on real and personal property"); *Liberty Univ., Inc. v. Lew*, 733 F.3d 72, 97 (4th Cir. 2013) (describing *NFIB* as "[h]aving recognized

only two types of direct taxes—those on individuals as individuals and those on property"). This Court applied the Direct Tax Clause in *Quarty v. United States*, 170 F.3d 961 (9th Cir. 1999). It explained that a direct tax is a tax levied on property itself, and it rejected the contention that retroactive application of an increased gift-tax rate to transfers of property that had already occurred amounted to the imposition of a direct tax. *Id.* at 970-71.

Taxes on business proceeds (or even gross receipts) are not direct taxes. Of course, taxes on a business are not capitation taxes or taxes on real or personal property. But the Supreme Court also directly held, before the Sixteenth Amendment was passed, that a tax on corporate income was not a direct tax. *Flint*, 220 U.S. at 150. And it also upheld a "special excise tax" calculated as a percentage of the gross annual receipts of "every person, firm, corporation, or company carrying on or doing the business of refining petroleum, or refining sugar, or owning or controlling any pipe line for transporting oil or other products." *Spreckels Sugar Ref. Co. v. McClain*, 192 U.S. 397, 410-11 (1904). The Court determined that the tax was a not direct tax and therefore was not subject to the apportionment requirement, describing this

conclusion as "inevitable from the judgments in prior cases." *Id.* at 413. The Court rejected the argument that *Pollock* required a different result, noting that *Pollock* did not call into doubt the constitutionality of a tax on business, privileges, or employments. *Id.* (citation omitted).

The bottom line is this: the tax at issue in this case (the tax that results from Harborside's ineligibility for business expense deductions) unquestionably does not fit within the narrow meaning of a "direct tax" under the Constitution. Thus, even supposing that Section 280E's application here leads to a tax on something more than what the Sixteenth Amendment means by "income" (which it does not), it would nonetheless be constitutional. Because a tax on a business is not a direct tax, the Sixteenth Amendment is irrelevant. Section 280E is a valid exercise of Congress's power "To lay and collect Taxes, Duties, Imposts, and Excises." U.S. Const. Art. I, sec. 8, cl. 1.

2. Harborside incorrectly assumes that the Sixteenth Amendment limits Congress's authority to impose a tax on business

Harborside and its amicus fail to appreciate the significance of the Direct Tax Clause. Harborside states that Section 280E "results in a 'direct tax' that's not 'apportioned.' " (Br. 29.) But it fails to defend that

proposition. Indeed, Harborside correctly states that, in *Hylton*, the lead opinion concluded "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." (Br. 32 (quoting *Hylton*, 3 U.S. at 175).) Harborside then recounts the history of the *Pollock* decision, acknowledging that "public outcry" over *Pollock* led to passage of the Sixteenth Amendment. (Br. 33-34.) But Harborside fails to appreciate that *Pollock* does not stand for — indeed, directly conflicts with — the proposition that all taxes on income are direct taxes. Harborside's constitutional argument depends upon the premise that "[a]s a result of the passage of the Sixteenth Amendment in 1913, it became possible to have an income tax that was not apportioned." (Br. 34; *see also* NCIA Br. 19-20 (similarly assuming, without analysis, that income taxes are direct taxes).). As we have shown, that premise is unquestionably false.

It is true that courts considering Sixteenth Amendment arguments have sometimes skipped over the critical question whether the tax at issue is a direct tax. And some have even uncritically seemed to endorse the notion that Congress's power to tax income comes from

the Sixteenth Amendment. In *Murphy v. I.R.S. (Murphy I)*, 460 F.3d 79, 84, 92 (D.C. Cir. 2006), the court stated that "[t]he constitutional power of the Congress to tax income is provided in the Sixteenth Amendment," and it concluded that "damages received solely in compensation for a personal injury are not income within the meaning of that term in the Sixteenth Amendment." But following the government's petition for rehearing, the D.C. Circuit vacated that opinion, reinstated the appeal, and called for new briefing and argument. *See* No. 05-5139, 2006 WL 4005276 (D.C. Cir. Dec. 22, 2006). In its subsequent opinion, the court held that compensatory damages for non-physical injuries are gross income under I.R.C. § 61 and that Congress has the constitutional authority to tax those damages. *Murphy v. I.R.S. (Murphy II),* 493 F.3d 170, 171 (D.C. Cir. 2007). The court concluded that even if the damages award was "not income within the meaning of the Sixteenth Amendment, [it] is within the reach of the congressional power to tax under Article I, Section 8 of the Constitution." *Id.* at 173. The court explained that a tax on compensatory damages is not a direct tax and that, accordingly, the question whether such damages are income under the Sixteenth

Amendment is irrelevant. *Id.* at 181-86. The same is true of Section 280E's disallowance of tax deductions for marijuana dispensaries.

D. In any event, the disallowance under Section 280E of tax deductions and credits does not prevent the tax imposed on marijuana dispensaries from being a valid income tax

1. Congress has authority to tax gross income and deductions from gross income are matters of legislative grace

Although this Court need not reach the issue, it is also true that the comparatively higher tax for marijuana dispensaries that results from their ineligibility for tax deductions is still a tax on income within the Sixteenth Amendment's meaning of that term. This Court has explained that "[t]he power of Congress to tax gross income is unquestionable," and that "[t]he extent to which deductions from gross income may be made is a matter of legislative grace." *Bagnall v. Commissioner*, 96 F.2d 956, 957 (9th Cir. 1938) (*citing New Colonial Ice Co. v. Helvering*, 292 U.S. 435 (1934) and *Helvering v. Inter-Mountain Life Ins. Co.*, 294 U.S. 686, 689 (1935)). Again, in discussing ordinary and necessary business deductions under I.R.C. § 162, this Court explained that "[d]eductions (*e.g.*, for advertising costs) are a matter of legislative grace and exist only by virtue of specific legislation" and

that "Congress is free to create, abolish, or limit deductions." *Max Sobel Wholesale Liquors v. Commissioner*, 630 F.2d 670, 671 (9th Cir. 1980) (citations omitted); *see also, e.g.*, *A. Giurlani & Bro. v. Commissioner*, 119 F.2d 852, 854 (9th Cir. 1941) ("It is elementary, of course, that the extent of allowable deductions from gross income for the purpose of income taxation is dependent upon legislative grace."); *Schwabacher v. Commissioner*, 132 F.2d 516, 518 (9th Cir. 1942) (similar); *National Brass Works v. Commissioner*, 182 F.2d 526, 527 (9th Cir. 1950) (similar). Nor does this well-established rule change merely because a business happens to spend more than it earns in a particular year. *See, e.g.*, *Penn Mut. Indem. Co. v. Commissioner*, 277 F.2d 16, 20 (3d Cir. 1960) (explaining that "[d]eductions from a tax are a matter of legislative grace" and that "[t]he mere fact of intake being less than outgo does not relieve the taxpayer of an otherwise lawfully imposed tax"); *Wilson Milling Co. v. Commissioner*, 138 F.2d 249, 251 (8th Cir. 1943) (concluding that Congress may tax a particular type of income a taxpayer received "regardless of whether or not his operations as a whole for the entire taxable year result in a profit"). Harborside fails to come to grips with this Court's precedent under which ordinary and

necessary business expenses are recognized as deductions that Congress is free to limit or abolish.

Relying on these same principles, the Tenth Circuit rejected a Sixteenth Amendment challenge to Section 280E. In that case, as here, a marijuana dispensary argued that ordinary and necessary business expenses must be accounted for as part of a business's gross income and that Section 280E violates the Sixteenth Amendment because it "prevent[s] the deduction of expenses that a business could not avoid incurring." *Alpenglow Botanicals, LLC v. United States*, 894 F.3d 1187, 1200 (10th Cir. 2018), *cert. denied,* 139 S. Ct. 2745 (2019). The court rejected this argument, explaining that "[d]eductions under § 162(a) [*i.e.*, for ordinary and necessary business expenses] are matters of 'legislative grace' " that Congress has "unquestioned power to condition, limit, or deny." *Id.* at 1199-1200. It held that Section 162(a) deductions are "discretionary deductions — not mandatory exclusions — to gross income calculations," and therefore "Congress's choice to limit or deny

deductions for these expenses under § 280E does not violate the Sixteenth Amendment." *Id.* at 1202.[4]

The full Tax Court reached the same conclusion in *Northern California Small Bus. Assistants Inc. v. Commissioner*, 153 T.C. 65 (2019), in the context of an Eighth Amendment challenge to Section 280E. The court explained that the notion that Section 280E imposes a penalty for Eighth Amendment purposes is inconsistent with Congress's clear authority to tax gross income and with "[t]he overwhelming precedent establishing that deductions from gross income are a matter purely left to congressional discretion." *Id.* at 69-71.

Supreme Court precedent is fully consistent with this Court's determination in *Max Sobel* that Congress is free to eliminate Section 162(a) business-expense deductions. 630 F.2d at 671. In *Max Sobel* and the many other cases saying that tax deductions are matters of

[4] The Tenth Circuit's opinion in *Alpenglow* does not address the direct tax issue, and it could be read to suggest that the Sixteenth Amendment plays some role in policing the boundary between deductible ordinary and necessary business expenses and excludible cost of goods sold. *See* 894 F.3d at 1200. Any such suggestion is incorrect in view of the fact that business taxes are not direct taxes and taxes on a business's gross receipts are permissible. *See* pp. 17-31, *supra*.

legislative grace that Congress is free to limit or eliminate (*see, e.g.*, *Bagnall*, 96 F.2d at 957; *A. Giurlani & Bro.*, 119 F.2d at 854; *Schwabacher*, 132 F.2d at 518; *National Brass Works*, 182 F.2d at 527), this Court was relying on Supreme Court decisions that say just the same.

In *New Colonial Ice*, the Supreme Court considered whether a company could deduct the losses of a preexisting company that it had subsumed. The Court's statement that "[w]hether and to what extent deductions shall be allowed depends upon legislative grace" (292 U.S. at 440) was not some "unfortunate rhetorical flourish," as Harborside would have it (Br. 46). Rather, it was the rule under which the case was decided by reference solely to the meaning of the statute under which the taxpayer claimed the deduction. *New Colonial Ice*, 292 U.S. at 440.

In *Deputy v. du Pont*, 308 U.S. 488, 493 (1940), the Supreme Court relied on *New Colonial* and the principle that tax deductions are matters of legislative grace to reject the notion that the allowance of tax deductions turns "on general equitable considerations." Likewise, in *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992), the Court relied

on the principle that "an income tax deduction is a matter of legislative grace" to strictly construe the ordinary-and-necessary-business-expense deduction and to determine that the business expenditure at issue did not qualify for the deduction and must instead be treated a capital expenditure. *Id.* at 83-90. And in *Independent Life Ins.*, the Court ruled that "[u]nquestionably Congress has power to condition, limit, or deny deductions from gross income in order to arrive at the net that it chooses to tax." 292 U.S. at 381.

Moreover, the Supreme Court, has explained that the definition of gross income "extends broadly to all economic gains not otherwise exempted." *Commissioner v. Banks*, 543 U.S. 426, 433 (2005). The Court has not indicated that the Tax Code's definition of gross income is circumscribed by some narrower meaning of income embodied in the Sixteenth Amendment. To the contrary, it has explained that Section 61(a)'s definition of gross income "is based upon the [Sixteenth] Amendment and the word 'income' is used in its constitutional sense." *See Glenshaw Glass*, 348 U.S. 426, 432 n.11 (1955); *see also Lukhard v. Reed*, 481 U.S. 368, 375 (1987) (plurality) (explaining that the word income is commonly defined "to mean 'any money that comes in,'

without regard to any related expenses incurred and without any requirement that the transactions producing the money result in a net gain.") (citations omitted).

2. Harborside's arguments that Congress may not tax gross income are unavailing

Harborside argues (Br. 35-51) that income means gain, by which Harborside seems to mean net gain — or at least something much narrower than gross income under Section 61. This argument is meritless. The cases Harborside relies on either do not support the proposition that income equals net gain, or have been superseded, or both.

a. Harborside relies on *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179 (1918), for the proposition that "[f]rom the very start, income was gain." But *Doyle* conflicts with that proposition, at least insofar as "gain" is taken to mean that all of a business's expenses must be subtracted from its proceeds to arrive at income. Read in context, the passage from *Doyle* that Harborside quotes (Br. 35) merely states that a subtraction for the cost of goods sold is inherent in the idea of income. The Court explained, in the two sentences preceding Harborside's block quote, that although no "express provision" of the law "allows a merchant to deduct

[from income] the cost of the goods that he sells," the law did not intend to treat as income "the entire proceeds of a mere conversion of capital assets." 247 U.S. at 184. Moreover, the Court explained just after the passage Harborside quotes that, after subtracting the cost of goods sold and arriving at "gross income," the next step in applying the tax law there at issue was to determine "the authorized deductions" and thereby "arrive at 'net income.' " *Id.* at 185. And the Court also noted that the deductions "authorized" by the tax law there at issue were "only such as expenses of maintenance and operation of the business and property, rentals, uncompensated losses, depreciation, interest, and taxes." *Id.* at 184.

In other words, *Doyle* determined that an exclusion for cost of goods sold was implied by the word "income," but the expense of maintaining and operating a business was not. That expense was deductible only because Congress expressly authorized the deduction. What *Doyle* really reveals is that just prior to the Sixteenth

Amendment's ratification, the Court understood the income of a business to include, absent authorized deductions, business expenses.[5]

b. Next, Harborside relies on *Eisner v. Macomber*, 252 U.S. 189 (1920). Though Harborside discusses the case at length (Br. 36-38, 41-44), it relies mainly on one quote, which *Macomber* takes from *Doyle*: "Income may be defined as the gain derived from capital, from labor, or from both combined." (*See* Br. 38 (quoting *Macomber*).) This passage does not mean what Harborside thinks it means. Indeed, this Court's precedent demonstrates that the fact that income "may be defined as gain" does not mean that business expense deductions are constitutionally required. In *Grimes v. Commissioner*, 806 F.2d 1451, 1453 (9th Cir. 1986), this Court quoted the *Doyle*/*Macomber* definition of income and then went on to explain, in the same paragraph, that "deductions are a matter of legislative grace existing only by virtue of specific legislation."

[5] *Doyle* construed the Corporate Tax of 1909, which predated the Sixteenth Amendment. 247 U.S. at 180. Thus, while it is generally relevant, it obviously did not determine the Sixteenth Amendment meaning of income.

On its own terms, the *Macomber* decision was a narrow one — the decision rested on the Court's determination that a stock dividend does not produce any gain because along with the increase in the number of shares allotted to each shareholder comes a corresponding decrease in the value of the shares. 252 U.S. at 210-11. Moreover, the Supreme Court later rejected the notion that *Macomber* imposes a limitation on what counts as income in other contexts. In *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), the Court held that, in enacting the federal income tax, Congress "applied no limitations as to the source of taxable receipts," but taxed "all gains except those specifically exempted." *Id.* at 429-30. The Court rejected the taxpayer's bid to use *Macomber* to limit what counts as income. It explained that the *Macomber* definition of income focused on the cost-of-goods-sold concept: its purpose was to "demonstrate a distinction between a return on capital and 'a mere conversion of capital assets.' " *Id.* at 430 n.6. The Court explained that, while the *Macomber* definition of income "served a useful purpose" in the context of that case, "it was not meant to provide a touchstone to all future gross income questions." *Id.* at 431 (citations omitted).

This Court and other courts of appeals have also declined to interpret *Macomber* broadly and have noted the preeminence of *Glenshaw Glass*'s definition of income. *See Vukasovich, Inc. v. Commissioner*, 790 F.2d 1409, 1414 (9th Cir. 1986) (explaining that, though the *Macomber* definition of income was the basis for the Supreme Court's later determination that cancelation of indebtedness was not income, that determination, and that definition of income, were later superseded); *see also, e.g.*, *Union Elec. Co. v. United States*, 363 F.3d 1292, 1302 n.11 (Fed. Cir. 2004) (stating that the "continued viability" of *Macomber* "is open to question"); *Collins v. Commissioner*, 3 F.3d 625, 630 (2d Cir. 1993) (explaining that the *Macomber* definition of income "created more problems than it solved," that the Supreme Court soon "began to steer away from it," and that the Court finally "cast aside [*Macomber's*] definition of income" in *Glenshaw Glass*).

c. Harborside concedes that *Glenshaw Glass* broadened the *Macomber* definition of gross income, but argues that it did not alter the fact "that income necessarily requires gain." (Br. 44 n. 17.) Here again, Harborside fails to explain why including in income the idea of gain means that business-expense deductions are mandatory. Harborside

takes gain to mean net income for a taxable year. But the word "gain" applies at least as naturally to a particular transaction as to the aggregate of all transactions in a year. That is the sense in which the word is used in *Glenshaw Glass*. The Court said that Congress intended "to tax all gains," and later explained that that means "instances of . . . accessions to wealth." *Glenshaw Glass*, 348 U.S. at 430-31; *see also Doyle*, 247 U.S. at 185 (noting that the conversion of a capital asset produces income if sold for more than cost and loss if sold for less than cost).

Because this is the sense in which "gain" is used to define income, it makes perfect sense that the idea of income has been understood to account for cost of goods sold but not business expenses. In ordinary language, a car dealership's gain or income on the sale of a car would be understood to be the car's sales price minus its cost. It would be unusual for someone to refer to the gain from the sale of a car and mean, instead of sales price minus cost, sales price minus cost and a proportional share of the dealership's business expenses for the year. And, indeed, it would be common to say that a car dealership that sold a thousand cars for the year at an average of $5,000 above cost gained (or

made) $5 million. This is "income" in the sense in which it is used in the Sixteenth Amendment: that is, gross income. *See Glenshaw Glass*, 348 U.S. at 433 n.11 (explaining that Section 61(a)'s definition of gross income "is based upon the 16th Amendment and the word 'income' is used in its constitutional sense") (quoting the House Report to the 1954 Tax Code).

The Tax Code confirms that "gain" should not be understood as the equivalent of net income. The Tax Code defines "gain" from the sale of property as amount realized minus adjusted basis. I.R.C. § 1001(a). That same gain is also included in gross income. *See* I.R.C. § 61(a)(3). But, of course, gains from the sale of property, along with other items of gross income are reduced via available exclusions, deductions, and credits to determine taxable income. And, in fact, some of those exclusions, deductions, and credits may relate specifically to the gain from a property sale. *See, e.g.*, I.R.C. § 121 (exclusion from taxable income of gain from the sale of a principal residence); I.R.C. § 217 (deduction for moving expenses).

d. A similar misunderstanding of the meaning of gain is baked into the example that Harborside relies on (*see* Br. 48-49) from Judge

Gustafson's dissenting opinion in *Northern California Small Business Assistants*. In this hypothetical example, the dissent posits a widget seller who purchased 100 widgets for $600 and sold them for $900, but also paid $200 in rent and $200 in wages. *Northern California Small Bus. Assistants*, 153 T.C. at 83. The dissent concluded that "[n]o one would propose that this seller had any gain." *Id.* But in reality, it would be perfectly natural to say that the widget seller who sold 100 widgets at $3 above cost gained $300. That is the widget seller's gross income. We can then ask what the widget seller's net income is. We can also ask what the widget seller's taxable income is. And whether the widget seller's taxable income is closer to its gross income or closer to its net income will depend entirely upon how much of the widget seller's business expenses Congress has decided to permit the widget seller to deduct.

Indeed, the dissent conceded that Congress may limit or disallow particular business deductions and that "a constitutional challenge to the statutory disallowance of a particular business deduction will seldom succeed." *Northern California Small Bus. Assistants*, 153 T.C. at 83. The dissent's conclusion that Section 280E's disallowance of all

business deductions is nonetheless unconstitutional is difficult to comprehend. If Congress may disallow any particular business deduction and still tax "incomes" within the meaning of the Sixteenth Amendment, it would seem to follow that it may disallow all business deductions. The dissent does not explain how the sum of numerous business deductions that Congress is free to eliminate can be an aggregate deduction that is constitutionally mandated.

e. Harborside's best case would appear to be *Davis v. United States*, 87 F.2d 323 (2d Cir. 1937). There the court classified, in addition to cost of goods sold, "ordinary and necessary expenses incurred in getting the so-called gross income; depreciation, depletion, and the like" as "inherently necessary as a matter of computation to arrive at income." *Id.* at 324-25. But because the court concluded that the deduction there at issue was not "inherently necessary," and instead was part of the class of deductions that Congress was free to limit, the court's determination that certain deductions are inherently necessary is dicta. This dicta is incorrect and goes against the overwhelming weight of authority that establishes that tax deductions, including business deductions, are matters of legislative grace. *See* pp. 31-36,

supra. Harborside does not cite any case that actually holds that certain business deductions are constitutionally required.

f. One of Harborside's amici, the National Cannabis Industry Association (NCIA), argues (NCIA Br. 21) that *Bowers v. Kerbaugh-Empire, Co.*, 271 U.S. 170 (1926), supports the proposition that "Congress can't constitutionally tax a loss." In *Kerbaugh-Empire*, the Supreme Court determined that the reduction of indebtedness through a devaluation of the foreign currency used to repay it was not income and was thus not taxable. *Id.* at 173-75. But this Court has explained that *Kerbaugh-Empire* "is no longer good constitutional law." *Vukasovich*, 790 F.2d at 1414. This Court noted that *Kerbaugh-Empire* relied on the narrower definition of income set out in *Macomber* and that that definition was expanded by *Glenshaw Glass*. *Id.* As this Court also explained in *Vukasovich*, the Supreme Court, in a later case, "show[ed] that an increase in net worth from the discharge of indebtedness for less than the amount loaned is income." *Id.* at 1415 (*citing United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931)); *see also Preslar v. Commissioner*, 167 F.3d 1323, 1332 (10th Cir. 1999)

(describing *Kerbaugh-Empire* as "a decision implicitly repudiated in subsequent years") (*citing Glenshaw Glass* and *Kirby Lumber*).

g. Finally, we observe that Harborside does not actually define its position on what the Sixteenth Amendment requires. Harborside focuses on the 2007 tax year in which it allegedly sustained a net loss, and argues that Section 280E should not be permitted to manufacture a gain by excluding certain losses. This argument proves too much. It is plainly the case that any elimination or diminishment of a tax deduction will result in some taxpayers being taxed on a gain where they would have had a recognizable loss under the prior system. In other words, at least some taxpayers who would have a loss for tax purposes if they could take the deduction will have a gain if they cannot. It is far from clear why such a taxpayer is in any different position vis-à-vis the Constitution than a taxpayer who merely would have had a smaller gain for tax purposes if they could take the deduction but will have a larger gain if they cannot.

It is already the case that not every expense a business incurs can be used to reduce its taxable income. The Tax Code permits most businesses to deduct many expenses from taxable income. But it does

disallow deduction of some business expenses. *See, e.g.*, I.R.C. § 280G (disallowing deductions for compensation of former employees that meet the definition of an "excess parachute payment"); I.R.C. § 276(a) (disallowing deductions for amounts incurred for advertising in certain political publications and at certain political events). To the extent Harborside is arguing that the Constitution requires business expenses to be deductible, it is unclear how these provisions could pass muster. To the extent Harborside's position is that the Constitution mandates deductions for certain business expenses but not for others, it should explain where the line is between business expenses that, as a constitutional matter, must be deductible and business expenses not covered by this constitutional protection. And it should explain why all of the deductions it attempted to take from 2007 to 2012 fall into the constitutionally protected category.

In reality, tax deductions are not constitutionally compelled: they are matters of legislative grace. As such, making marijuana

dispensaries ineligible for tax deductions does not mean taxing more than their income.[6]

II. The IRS correctly determined Harborside's allowable exclusion from income for cost of goods sold

Most of the deficiency in this case is attributable to the IRS's denial of the more-than-$30,000,000 in business tax deductions

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[6] Finally, this Court should decline to consider the argument raised by one of Harborside's amici (NCIA Br. 27-34) that Section 280E violates the Eighth Amendment. Harborside has not raised this argument at any stage of the litigation, and this Court normally does "not consider on appeal an issue raised only by an amicus." *United States v. Gementera*, 379 F.3d 596, 607 (9th Cir. 2004); *see also Orr v. Plumb*, 884 F.3d 923, 932 (9th Cir. 2018) ("The usual rule is that arguments . . . omitted from the opening brief are deemed forfeited."); *Canna Care*, 694 F. App'x at 571 (declining to consider an Eighth Amendment challenge to Section 280E that was not raised in the Tax Court). In any event, because tax deductions are entirely within Congress's prerogative, its decision to limit eligibility for a deduction, or a group of deductions, is not punishment for an offense and thus is not a fine for Eighth Amendment purposes. *See United States v. Bajakajian*, 524 U.S. 321, 327-28 (1998) (quoting *Browning-Ferris*, 492 U.S. at 265). Indeed, in rejecting an Eighth Amendment challenge to Section 280E, the Tax Court noted that it was "not aware of[] any case where the disallowance of a deduction was construed as a penalty." *Northern California Small Bus. Assistants*, 153 T.C. at 71; *see also Louis v. Commissioner*, 170 F.3d 1232, 1236 (9th Cir. 1999) (*citing Little v. Commissioner*, 106 F.3d 1445, 1454 (9th Cir. 1997)) (determining that additions to tax liability based on negligence and fraud "are not subject to review under the Excessive Fines Clause").

(continued…)

Harborside claimed on its 2007 through 2012 income tax returns, and which, as explained above, the IRS correctly and constitutionally denied under Section 280E. A smaller portion of the Tax Court's deficiency determination (roughly $1 million) flows from the IRS's disallowance of Harborside's attempt to include certain purchasing, handling, and storage costs in its cost of goods sold.[7] The IRS initially denied more than $50 million of Harborside's claimed cost of goods sold mainly for lack of substantiation. (ER441, 457, 489.) But Harborside later substantiated the costs, and the IRS allowed it to exclude from gross income the amounts it paid suppliers to purchase goods for resale. (ER95-96, 234-35) These direct inventory costs comprised the overwhelming majority of the cost of goods sold that Harborside had reported on its tax returns.[8]

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[7] The amount of tax attributable to the IRS's disallowance of this portion of Harborside's costs of goods sold is readily determinable based upon the parties' stipulated Rule 155 calculations, with reference to the notices of deficiency. But only the stipulated decisions, and not the stipulated calculations upon which the decisions are based, are included in the record.

[8] Indeed, the IRS's allowance of those costs almost completely accounts for the difference between the tax liability the IRS determined in Harborside's notices of deficiency (totaling $29,774,426, *see* ER425,

(continued…)

The Commissioner did not allow Harborside to include purchasing, handling, and storage costs related to the goods it purchased for resale ("indirect costs") — costs like testing, labeling, curing, storing, trimming, manicuring, maintaining, and packaging the marijuana, or marijuana products — in its cost of goods sold. (*See* Br. 16-18.) These costs would be inventory costs if I.R.C. § 263A applied. The Section 263A regulations state that purchasing costs, which include testing and "maintenance of stock assortment and volume," handling costs, which include "costs attributable to processing, assembling, repackaging and transporting goods, and other similar activities," and storage costs, which include "the costs of carrying, storing, or warehousing property," must be included in inventory cost. Treas. Reg. § 1.263A-1(e)(3)(ii)(F)-(H); Treas. Reg. 1.263A-3(c)(3). The regulation classifies these costs as "indirect costs," distinguishing them from "direct costs," which, for resellers of goods, means the cost of acquiring goods for resale. Treas. Reg. § 1.263A-1(e)(2) & (3). These "indirect costs" are inventory costs for taxpayers covered by Section 263A; but, as

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449, 475) and the $11,013,236.75 deficiency the Tax Court ultimately determined (ER1-5).

explained below, they are not inventory costs for taxpayers not covered by Section 263A.

A. Because Harborside disclaims any reliance on Section 263A, its argument depends entirely on whether it may include purchasing, handling, and storage costs in its cost of goods sold under Section 471 and its accompanying regulations

Harborside does *not* argue that it may include indirect costs like testing, repackaging, storing, etc., in cost of goods sold under Section 263A or Treas. Reg. § 1.263A-1(e)(3)(ii)(F)-(H). Indeed, Harborside states that it claimed only a relatively small amount of its cost of goods sold under the authority of Section 263A and, furthermore, that it "is willing to concede" the IRS's disallowance of that amount. (Br. 69.)

Harborside instead relies only on Section 471 and its accompanying regulations, taking the position that, under that framework, its purchasing, handling, and storage costs can be included in its cost of goods sold. (Br. 51-68.) That is incorrect. But before explaining why it is incorrect, it is important to understand why Harborside is relying only on Section 471, a provision that (as we will explain momentarily) does not permit inclusion of indirect costs in inventory, and is not relying on Section 263A, a provision that (as we

have just seen) actually does require certain taxpayers to include indirect costs in inventory. The reason Harborside does not rely on Section 263A is that Section 263A provides that "[a]ny cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph." I.R.C. § 263A(a)(2). The indirect costs that Harborside wants to include in its cost of goods sold are costs that it could not, under any authority other than Section 263A, take "into account in computing taxable income."

For most taxpayers who are subject to Section 263A, the costs that that provision requires to be included in inventory are costs that would otherwise be deducted under I.R.C. § 162, which permits a deduction of "the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." These taxpayers must include indirect costs like storage and handling in their inventory cost because those costs, in the absence of Section 263A, could "be taken into account in computing taxable income" under Section 162. But this is not true of marijuana dispensaries. Because Section 280E makes marijuana dispensaries ineligible for tax deductions, marijuana

dispensaries, unlike other businesses, could not otherwise take into account purchasing, handling, and storage costs in computing taxable income by deducting those expenses under Section 162. The bottom line here is that, because of Section 280E, Section 263A does not help Harborside. Presumably because it recognizes this, Harborside only argues that Section 471 allows it to include indirect costs in its cost of goods sold.

And because Harborside relies only on Section 471, its cost-of-goods-sold argument has nothing to do with Section 280E. If Harborside could establish that Section 471 permits it to include indirect costs in its cost of goods sold, Section 280E would not prevent that result, as that section only bars Harborside's claim to *deductions*. If Harborside cannot establish that Section 471 allows for exclusion of these costs from gross income, the disallowance of these costs is predicated upon Section 471, not Section 280E.[9]

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[9] Because Harborside does not rely on Section 263A, this case is not a vehicle for addressing the alleged inequity of interpreting Section 280E to restrict cost of goods sold pursuant to Section 263A(a)(2) for marijuana dispensaries as compared to other taxpayers. (*See generally* Marijuana Industry Group Brief (MIG Br.).) Section 280E would have that impact if and only if the sole way that a taxpayer could take (continued…)

B. The Section 471 framework does not allow the purchasing, handling, and storage costs at issue here to be included in cost of goods sold

The only question relevant here is: Can Harborside include the purchasing, handling, and storage costs at issue here in its inventory cost (and thus cost of goods sold) under the Section 471 framework? And the answer is no.

Section 471 itself does not answer the question. It states that when the Secretary of the Treasury determines that "the use of inventories is necessary in order clearly to determine" income, inventories must be taken "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." So the statute provides broad authority for regulations that

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indirect inventory costs "into account in computing taxable income" apart from Section 263A is by deducting them under Section 162. One can imagine a case in which a marijuana dispensary concedes that indirect costs are not includible in inventory under Section 471 and argues that they nonetheless are includible in inventory under Section 263A, making an argument that Section 280E's impact on marijuana dispensaries should not be considered for purposes of Section 263A(a)(2). But that is not this case. Here, Harborside disclaims reliance on Section 263A and lets its argument rise or fall on the claim that the Section 471 framework permits it to include indirect costs in inventory.

specify how inventories are to be taken. The regulation that applies here is Treas. Reg. § 1.471-3(b). It provides, in relevant part:

> Cost [*i.e.*, inventory cost] means:
>
> In the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods. * * * For taxpayers acquiring merchandise for resale that are subject to the provisions of section 263A, see §§ 1.263A-1 and 1.263A-3 for additional amounts that must be included in inventory costs.

The plain language of this regulation excludes from inventory cost under Section 471 the indirect costs (purchasing, handling, and storage costs) that Harborside is seeking to include in its cost of goods sold.

First, the word "means" indicates that what follows is exclusive rather than illustrative. The Supreme Court has explained that "[a]s a rule, a definition which declares what a term 'means' . . . excludes any meaning that is not stated." *Burgess v. United States*, 553 U.S. 124, 130 (2008) (quoting *Colautti v. Franklin,* 439 U.S. 379, 392-393, n.10 (1979)). The best reading of the regulation therefore is that inventory cost *means* "the invoice price [of merchandise] less trade or

other discounts" plus "transportation or other necessary charges incurred in acquiring possession of the goods." *See* 2 Mertens Law of Fed. Income Tax'n § 16:23 (paraphrasing Treas. Reg. § 1.471-3(b) as follows: "For goods purchased during the year, cost is the invoice price less trade and other discounts, plus transportation and other costs incurred to acquire the goods"). Thus, inventory cost, in the context of the Section 471 framework, is limited to the direct costs of acquiring inventory.

Other textual clues confirm this reading of the regulation. The regulation defines "other necessary charges *incurred in acquiring* possession of the goods" as part of inventory cost. Treas. Reg. 1.471-3(b) (emphasis added). The costs of testing, labeling, curing, storing, trimming, manicuring, maintaining, and packaging marijuana or marijuana products are costs incurred *after* acquisition of goods. The regulation's use of the phrase "incurred in acquiring possession" to define inventory cost excludes charges incurred after the goods have been acquired.[10]

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[10] As discussed pp. 60-66, *infra*, the focus of Harborside's argument is its contention that Section 1.471-3(b) is somehow

(continued…)

Additionally, the fact that the applicable Section 471 regulation directs taxpayers subject to Section 263A to the Section 263A regulations "for *additional amounts* that must be included in inventory costs" indicates that these costs are not included in inventory for Section 471 purposes. Treas. Reg. § 1.471-3(b) (emphasis added). The Section 263A regulations confirm this. Under Treas. Reg. § 1.263A-1(e)(1) and (2)(ii), taxpayers subject to Section 263A must include in inventory "all direct cost . . . allocable to . . . property acquired for resale," and that means that resellers must capitalize their acquisition costs, which "is the cost described in § 1.471-3(b)." Section 1.263A-1(e)(3) then goes on to define "indirect costs" and, as we have already seen, includes within "indirect costs" purchasing, handling, and storage costs. Thus, the clear picture one gets from the two regulations is that,

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overridden by more general regulatory provisions and accounting standards. But Harborside's argument (Br. 66) that the costs here at issue meet the Section 1.471-3(b) definition of inventory cost because they were "for acquiring merchandise in a condition to sell to customers" also fails. The regulation includes in cost "charges incurred in acquiring possession of the goods," not costs incurred to get already-acquired goods into a condition to sell to customers. Notably, Harborside has not made an alternative argument (here or in the Tax Court) that the IRS improperly disallowed particular pre-acquisition charges.

for resellers of goods, Section 1.471-3(b) defines inventory cost to mean the direct cost of acquiring goods, while Section 1.263A-1(e)(3) defines inventory cost to mean direct costs and certain indirect costs. This picture is inconsistent with the notion that indirect costs like storage and handling costs, which are covered by Section 1.263A-1(e)(3), can be included in cost of goods sold under Section 1.471-3(b).

Another textual clue comes from the next part of Treas. Reg. § 1.471-3. In Section 1-471-3(c), the part of the regulation that addresses inventory cost for "merchandise produced by the taxpayer," the regulation expressly includes in inventory cost the "indirect production costs incident to and necessary for the production of the particular article." That Section 1.471-3(c) expressly includes indirect costs within the meaning of inventory cost strongly suggests that Section 1.471-1(b)'s omission of any mention of indirect costs was intentional and meant to exclude indirect costs from Section 471 inventory cost. *See Russello v. United States*, 464 U.S. 16, 23 (1983) ("Where Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally

presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.") (citations omitted).

Section 1.471-3(c) also illuminates the meaning of Section 1.471-3(b) in another way. Section 1.471-3(c) instructs us to "[s]ee §§ 1.263A-1 and 1.263A-2 for more specific rules regarding the treatment of production costs." This language indicates that Section 1.471-3(c) addresses all of the production costs taxpayers are to include in inventory, but that the Section 263A regulations provide more specific rules about these same costs. Compare that to Section 1.471-3(b)'s instruction that taxpayers subject to Section 263A should see the Section 263A regulations "for additional amounts that must be included in inventory costs." Section 1.471-3(b), unlike Section 1.471-3(c), is saying that Section 263A requires covered taxpayers to include in inventory costs not already included in the Section 1.471-3(b) definition of inventory cost.

C. Harborside's arguments fail

Harborside argues principally that other Section 471 regulations somehow override Section 1.471-3(b)'s definition of inventory cost. (Br. 62-65.) More specifically, Harborside focuses on the general Section 471

requirements that valuation of inventories conform to accepted accounting practices and clearly reflect income. (Br. 62 (citing Treas. Reg. § 1.471-2(a).) It argues that it met these requirements and seems to argue that it need not comply with Section 1.471-3(b) because Section 1.471-2(b) recognizes that "inventory rules cannot be uniform" and Section 1.471-3(d) allows for inventory costs to be approximated under certain circumstances. This argument is meritless.

Certainly, Section 1.471-2(a) articulates the broad goal of Section 471: inventories must conform to the best accounting practice in the trade or business and clearly reflect income. But those goals do not negate the remainder of the Section 471 regulations. Moreover, in construing statutes and regulations, the specific governs the general. *See Perez-Guzman v. Lynch*, 835 F.3d 1066, 1075 (9th Cir. 2016) ("[A] narrow, precise, and specific statutory provision is not overridden by another provision covering a more generalized spectrum of issues.") (citation and internal quotation marks omitted). So Harborside's argument that it has complied with the overarching goals of Section 471, and therefore need not comply with the specific requirements of the Section 471 regulations, should be a nonstarter.

Section 1.471-2(b) actually confirms this point. Harborside stresses (Br. 64) that provision's statement that "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." Harborside seems to think this means that the specific regulatory requirements are unimportant as long as inventory valuation is done in accordance with accepted accounting principles and accurately reflects income. That is incorrect. Actually, the statement that "inventory rules cannot be uniform" is an explanation of why the regulatory provisions that follow, Treas. Reg. §§ 1.471-3 through 1.471-11, include numerous methods of determining inventory cost, many of which are industry-specific. *See, e.g.*, Treas. Reg. § 1.471-5 (dealers in securities); Treas. Reg. § 1.471-6 (farmers); Treas. Reg. § 1.471-7 (certain mining operations). Moreover, Section 1.471-2(b) directly provides that inventory practices must be "in accord with §§ 1.471-1 through 1.471-11."

Section 1.471-3(d) does supply a kind of backstop for producers of goods to whom none of the specific inventory rules apply. It states 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." But this provision does not apply to Harborside. First, the costs that Harborside wants to include in its cost of goods sold are not costs of production. They are indirect costs related to property that has been acquired for resale. Indeed, Treas. Reg. § 1.263A-3(c)(1) confirms this, explaining that "[t]he indirect costs most often incurred by resellers are purchasing, handling, and storage costs" — the very categories covering the costs Harborside seeks to include in its cost of goods sold. Second, Harborside offers no support for the notion that the marijuana industry is an industry "in which the usual rules for computation of cost of production are inapplicable." And third, Section 1.471-3(d) is a regulatory provision that permits certain taxpayers to approximate cost of goods sold. Harborside is not seeking to approximate its cost of goods sold; it is seeking to include in its cost of goods sold specific costs that do not fall into the applicable (Section 1.471-3(b)) definition of inventory cost.

In the Tax Court, Harborside argued that it was a producer and therefore that Treas. Reg. §§ 1.471-3(c) and 1.471-11, rather than

Section 1.471-3(b), define the rules for determining its inventory costs. (*See* ER69-75 (rejecting this argument).) Here Harborside states that "[i]t's not apparent why Treas. Reg. § 1.471-3(b) is the correct regulation to apply to Harborside" and follows that up by saying that it is unlike the Montgomery Ward department store. (Br. 65.) But Harborside does not argue, as it did below, that the producer regulations apply (*i.e.*, Treas. Reg. §§ 1.471-3(c) & 1.471-11), and, as explained above, its contention that Section 1.471-3(d) applies is meritless. Harborside contends (Br. 66-67) that "[i]t doesn't really matter" whether it is a reseller to which Section 1.471-3(b) applies because, like Kroger, it calculates its cost of goods sold using an accepted financial accounting method and in a way that accurately reflects its income. But, as we have already explained, taxpayers who satisfy Section 471's broad requirements of industry-appropriate accounting that accurately reflects income do not thereby acquire a free pass that permits them to ignore the specific rules the Section 471 regulations provide about the meaning of inventory cost.

Next, Harborside complains that "the Commissioner doesn't challenge Kroger or Whole Foods or any other similar business," and

"should leave Harborside alone, too." (*See* Br. 61, 66-67.) But those nationwide grocery chains are almost certainly producers, and therefore subject to different inventory rules than Harborside even under the Section 471 framework. Beyond breaking down sides of beef, they have their own store brands of pasta sauce, yogurt, cereal, etc. And even supposing that they were relevantly similar, the analogy would not help Harborside. Whether they are resellers or producers, Kroger and Whole Foods are certainly subject to Section 263A. Thus, those taxpayers must, under Section 263A, include in inventory the indirect costs that Harborside wants to include in inventory. But Harborside does not claim that Section 263A allows (or requires) it to include its costs of testing, labeling, curing, storing, trimming, manicuring, maintaining, and packaging marijuana or marijuana products in its costs of goods — and for good reason, as we have explained.

Finally, Harborside contends (Br. 53-55) that the government's position depends on determining deductions before cost of goods sold and that this conflicts with *Max Sobel*. In fact, this timing question is irrelevant: the relevant question is whether the purchasing, handling, and storage costs at issue here are part of inventory cost under the

Section 471 framework that Harborside relies on — a topic *Max Sobel* did not address.[11]

[11] The Marijuana Industry Group brief argues that this Court should apply Sections 471, 263A, and 280E broadly and allow the indirect costs at issue here to be included in Harborside's costs of goods sold in order to avoid a result that violates the Sixteenth Amendment. (MIG Br. 19-21.) This argument is not raised by Harborside itself and this Court should thus not consider it. *Gementera*, 379 F.3d 596, 607 (this Court normally does "not consider on appeal an issue raised only by an amicus"). In any event, as explained above, pp. 17-31, *supra*, the Sixteenth Amendment does not impact Congress's authority to tax business receipts. And even supposing that the Sixteenth Amendment did have some application here, the MIG brief cites no authority that supports the notion that purchasing, handling, and storage costs are constitutionally compelled exclusions from income.

CONCLUSION

This Court should affirm the decision of the Tax Court.

Respectfully submitted,

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SEPTEMBER 2020

STATEMENT OF RELATED CASES

Pursuant to Ninth Circuit Rule 28-2.6, counsel for the Commissioner respectfully inform the Court that they are not aware of any cases related to the instant appeal that are pending in this Court.

ADDENDUM

U.S. Const. art. I, § 8, cl. 1 69

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Treas. Reg. § 1.471-2 (excerpt) 73

Treas. Reg. § 1.471-3 (excerpt) 73-74

Constitution of the United States of America:

Article I, Section 8, Clause 1:

The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States

Article I, Section 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.

Amendment XVI:

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.

Internal Revenue Code of 1986 (26 U.S.C.):

I.R.C. § 61. Gross income defined (excerpt):

(a) General definition.--Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

> (1) Compensation for services, including fees, commissions, fringe benefits, and similar items;
>
> (2) Gross income derived from business;
>
> (3) Gains derived from dealings in property;
>
> * * *.

I.R.C. § 162. Trade or business expenses (excerpt):

(a) In general.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *.

I.R.C. § 263A. Capitalization and inclusion in inventory costs of certain expenses

(a) Nondeductibility of certain direct and indirect costs.--

(1) In general.--In the case of any property to which this section applies, any costs described in paragraph (2)--

(A) in the case of property which is inventory in the hands of the taxpayer, shall be included in inventory costs, and

(B) in the case of any other property, shall be capitalized.

(2) Allocable costs.--The costs described in this paragraph with respect to any property are--

(A) the direct costs of such property, and

(B) such property's proper share of those indirect costs (including taxes) part or all of which are allocable to such property.

Any cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph.

* * *.

I.R.C. § 280E. Expenditures in connection with the illegal sale of drugs

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

I.R.C. § 471. General rule for inventories:

(a) General rule.--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.

* * *.

Treasury Regulations on Estate Tax (26 C.F.R.):

Treas. Reg. § 1.61-3. Gross income derived from business (excerpt):

(a) In general. In a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. * * *.

Treas. Reg. § 1.162-1. Business expenses (excerpt):

* * * The cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income. * * *.

Treas. Reg. § 1.263A-1. Uniform capitalization of costs (excerpt):

(e) Types of costs subject to capitalization—(1) In general. Taxpayers subject to section 263A must capitalize all direct costs and certain indirect costs properly allocable to property produced or property acquired for resale. This paragraph (e) describes the types of costs subject to section 263A.

* * *

(2)(ii) Resellers. Resellers must capitalize the acquisition costs of property acquired for resale. In the case of inventory, the acquisition cost is the cost described in § 1.471–3(b).

(i) In general. (A) Indirect costs are defined as all costs other than direct material costs and direct labor costs (in the case of property produced) or acquisition costs (in the case of property acquired for resale). Taxpayers subject to section 263A must capitalize all indirect costs properly allocable to property produced or property acquired for resale. * * *

(F) Purchasing costs. Purchasing costs include costs attributable to purchasing activities. See § 1.263A–3(c)(3) for a further discussion of purchasing costs.

(G) Handling costs. Handling costs include costs attributable to processing, assembling, repackaging and transporting goods, and other similar activities. See § 1.263A–3(c)(4) for a further discussion of handling costs.

(H) Storage costs. Storage costs include the costs of carrying, storing, or warehousing property. See § 1.263A–3(c)(5) for a further discussion of storage costs.

* * *.

Treas. Reg. § 1.471-2. Valuation of inventories (excerpt):

(a) Section 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.

(b) It follows, therefore, that 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. In order to clearly reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is in accord with §§ 1.471–1 through 1.471–11.

* * *.

Treas. Reg. § 1.471-3. Inventories at cost:

Cost means:

(a) In the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods.

(b) In the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods. But see § 1.263A–1(d)(2)(iv)(C) for special rules for certain direct material costs that in certain cases are permitted to be capitalized as additional section 263A costs by taxpayers using a simplified method under § 1.263A–2(b) or (c) or § 1.263A–3(d). For

taxpayers acquiring merchandise for resale that are subject to the provisions of section 263A, see §§ 1.263A–1 and 1.263A–3 for additional amounts that must be included in inventory costs.

(c) In the case of merchandise produced by the taxpayer since the beginning of the taxable year, (1) the cost of raw materials and supplies entering into or consumed in connection with the product, (2) expenditures for direct labor, and (3) indirect production costs incident to and necessary for the production of the particular article, including in such indirect production costs an appropriate portion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit. See §§ 1.263A–1 and 1.263A–2 for more specific rules regarding the treatment of production costs.

(d) In 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. Among such cases are:

(1) Farmers and raisers of livestock (see § 1.471–6);

(2) Miners and manufacturers who by a single process or uniform series of processes derive a product of two or more kinds, sizes, or grades, the unit cost of which is substantially alike (see § 1.471–7); and

(3) Retail merchants who use what is known as the "retail method" in ascertaining approximate cost (see § 1.471–8).

* * *.

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

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