Marijuana Business in Tax Court

Ms. Laurel Alterman filed 2010 and 2011 returns as Married Filing Jointly with Mr. William A. Gibson. These returns each included a Schedule C reporting income and expenses connected with a Colorado medical-marijuana business. During these years it was not illegal to use marijuana medically or for a medical-marijuana business to sell marijuana in Colorado. However they were both illegal under Federal law.

During 2009, Ms. Alterman created Altermeds LLC as a single member LLC. As such the entity is disregarded for tax purposes and its income reported on Ms. Alterman's Schedule C. Altermeds opened a retail store and maintained regular hours. The store sold smokable marijuana, either as prerolled marijuana cigarettes or as dried marijuana buds. It also sold marijuana in edible form such as brownies and cakes and orally-consumed tinctures (a liquid containing marijuana). It also sold products that contained no marijuana, such as pipes, papers, and other items used to consume marijuana. Altermeds did not provide any services, just sales.

Altermeds originally did not produce any property on its own but instead purchased all of its products from third parties. However due to a Colorado law change requiring medical-marijuana businesses to grow at least 70% of the marijuana sold, Altermeds started growing its own in a "grow site". It hired three of the people it formerly purchased marijuana from to work at the "grow site". Altermeds also had other employees who worked at the "grow site", the store, or at both locations. Ms. Alterman testified that workers at the store also trimmed marijuana by removing stems, seeds, and twigs to make it saleable. Records were produced by Ms. Alterman to show how much time (and subsequent pay) was devoted to the "grow site" activities verses the store.

The original 2010 return showed 894K of gross receipts, 464K of cost of goods sold, and 385K of expenses. The original 2011 return showed 657K of gross receipts, 253K of cost of goods sold, and 385K of other expenses. In both years the sale of marijuana came to over 95% of the gross receipts. The beginning inventory each year was $0. The ending inventory amount was 12K at the end of 2010, and 0 at the end of 2011. (No answer was given as to why the 2010 ending inventory was not carried to 2011's beginning inventory.)

IRS conducted an audit covering the 2010 & 2011 returns. IRS found unreported income of 24K and 8K respectively. At audit IRS denied a large portion of the cost of goods sold, but conceded higher amounts of 452K and 232K by allowing rent, utilities, wages, depreciation, testing, and additional purchases connected to the "grow site" to be included in cost of goods sold. IRS denied all other expenses citing IRC Section 280E which denies deductions for expenses related to an illegal activity.

NOTE: "Gross income" as defined in Regulation 1.61-3 is gross receipts less cost of goods sold. Expenses for a business fall under IRC Section 162. The denial under IRC Section 280E applies to expenses, not cost of goods sold.

The taxpayers argued expenses should be allowed in connection with the sales of items that did not include marijuana, such as the pipes and papers. IRS disagreed stating these sales came to less than 5% of the total gross receipts, therefore these sales were incidental to the marijuana dispensing activity and not a separate activity on their own.

The taxpayers argued that more of the expenses should be moved to the cost of goods category. However they failed to show what expenses should be cost of goods sold. Their bookkeeping systems and records did not provide sufficient evidence for many of the expenses. Their failure to maintain inventories was determined by the Court to be an improper method of accounting.

IRS assessed the 20% accuracy related penalty under IRC Section 6662(a).

Tax Court agreed with all IRS results.

Ms. Laurel Alterman & Mr. William A Gibson, TC Memo 2018-83 This case can be found by going to www.ustaxcourt.gov, clicking on the Opinion Search tab, and entering Alterman in the Case Name Keyword box.

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