NO. 19-73078

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

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

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

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

REPLY BRIEF FOR APPELLANT

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I. INTRODUCTION

The Sixteenth Amendment permits Congress to directly tax income, but only after the taxpayer subtracts certain expenses so the taxable amount reflects the taxpayer's "gain." For businesses in most industries, that calculation is uncontroversial because the Internal Revenue Code and the Commissioner appropriately permit companies to assess and subtract their "cost of goods sold," or "COGS," when determining income. The Sixteenth Amendment and the Internal Revenue Code thus typically work in harmony.

When it comes to cannabis dispensaries, however, the Commissioner applies a narrow and rigid definition of COGS that excludes expenses necessary for production. He does so because expenses that do not qualify as COGS are typically handled as deductions from taxable income, but I.R.C. § 280E purports to make cannabis dispensaries ineligible for such deductions because federal law (disregarding the practical reality of how the industry lawfully operates) considers such businesses traffickers in illegal drugs. By dictating a narrow conception of COGS—excluding, for example, costs associated with acquiring or testing the raw cannabis—the

Commissioner and the Tax Court artificially inflate Harborside's taxable income in a manner that Harborside cannot then reduce through deductions.

Clever, but unconstitutional. Curtailing COGS in that manner, without the ability to later deduct those expenses from taxable income, causes Harborside's taxable income to diverge from any legal, historical, or commonsense idea of "gain." In some cases, such as 2007 for Harborside, it forces companies operating at a loss—*without* income—to nonetheless pay substantial income taxes.

The Commissioner cannot have it both ways: if he is correct that Harborside is ineligible for the COGS it assessed here, then I.R.C. § 280E violates the Sixteenth Amendment. Harborside's determination of COGS clearly reflects income and comports with well-established statutory and regulatory standards for tax inventory accounting. The Commissioner does not truly contend otherwise, pointing to no instance where Harborside used improper accounting methods or miscalculated its actual income. Foisting on Harborside a new method of accounting thus both overstepped the Constitution and misconstrued tax law.

This Court should either invalidate Section 280E of the Internal Revenue Code as unconstitutional or remand for the Tax Court to reassess Harborside's COGS.

II. SECTION 280E VIOLATES THE SIXTEENTH AMENDMENT

As a general rule, Congress may not levy direct taxes without apportioning them among the States. U.S. Const. art. I, § 2. The Sixteenth Amendment is a narrow exception: it permits Congress to levy a direct tax on "income, from whatever sources derived." Century-old precedent confirms that "income," as used in the Sixteenth Amendment, refers to "gain." Applying § 280E to Harborside results in an income tax liability that is based on gross income, not gain, and thus violates the Sixteenth Amendment.

The Commissioner makes several arguments to the contrary. He first argues that Harborside waived the argument, but waiver is no obstacle here: Harborside pursued the argument below, the Tax Court ruled on it, and at any rate, this Court should address this pure and important legal question. On the merits, the Commissioner advances a novel and unsupportable interpretation of the Sixteenth Amendment and the Internal Revenue Code, contending first that the Sixteenth

Amendment does not apply to business income, and that Congress' discretion to permit income tax deductions permits it to rewrite the Constitutionally circumscribed definition of "income." Neither assertion has merit, and the Commissioner's inability to surface relevant precedent on either point—relying instead on a hodge-podge of policy-driven commentary and strained counter-textual reading of case law—proves as much. Answering Br. at 17-24.

The inescapable reality is that the federal income tax is a direct tax that would be subject to state-by-state apportionment but for the Sixteenth Amendment, and by transforming the income tax into something other than a tax on gain, I.R.C. § 280E—as applied by the Commissioner and construed by the Tax Court—violates the Sixteenth Amendment.

A. Waiver is no obstacle to deciding this issue.

The Commissioner concedes, as he must, that Harborside "invoke[d] the Sixteenth Amendment before the Tax Court." Answering Br. at 15. He does not dispute that the Tax Court addressed whether the Commissioner's approach to calculating COGS and taxing Harborside is compatible with the Sixteenth Amendment. ER 67-69.

Nonetheless, the Commissioner argues that Harborside waived its constitutional challenge to § 280E by couching its argument below in terms of constitutional avoidance rather than constitutional deficiency. Answering Br. at 15-16. This is a distinction without a difference. *See, e.g.*, *Yee v. City of Escondido*, 503 U.S. 519, 534 (1992) ("Once a federal claim is properly presented, a party can make any argument in support of that claim; parties are not limited to the precise arguments they made below.").

Harborside's constitutional argument remains fundamentally unchanged: The Commissioner's position (and now, the Tax Court's decision) violates the Sixteenth Amendment by "tax[ing] 'gains' not actually realized by a taxpayer." SER 51-52 (Harborside's Tax Court brief). Harborside cautioned the Tax Court that the Commissioner's position contravenes the Sixteenth Amendment, *id.*, but the Tax Court disagreed, expressly rejecting Harborside's argument "that limiting its COGS to 'only the actual cost used to purchase inventory' violates the Sixteenth Amendment," ER 67. Preserving the argument required nothing more—particularly because it is unclear whether the Tax Court, an Article I tribunal, even has the power to invalidate statutes as unconstitutional. *See Kuretski v. Comm'r*, 755 F.3d 929, 939-40 (D.C. Cir. 2014); *see generally* Leandra Lederman, *Restructuring the U.S. Tax Court*, 99 Minn. L. Rev. Headnotes 1 (2014).

But even if the Sixteenth Amendment issue had been waived—and it was not—the relevant legal standard nonetheless compels its review. *See Ackerman v. W. Elec. Co.*, 860 F.2d 1514, 1517 (9th Cir. 1988). The Court exercises its discretion to hear issues not raised below "when the issue presented is purely one of law and either does not depend on the factual record developed below, or the pertinent record has been fully developed" or "in the 'exceptional' case in which review is necessary to prevent a miscarriage of justice or to preserve the integrity of the judicial process." *Ruiz v. Affinity Logistics Corp.*, 667 F.3d 1318, 1322 (9th Cir. 2012) (citing *Bolker v. Comm'r*, 760 F.2d 1039, 1042 (9th Cir. 1985)). This Court's precedents strongly favor exercising that discretion.

First, the Sixteenth Amendment issue poses a pure question of law. Whether a statute violates the Constitution is a question of law that this Court reviews de novo. Opening Br. at 28; Answering Br. at 14; *Acosta v. City of Costa Mesa*, 718 F.3d 800, 810 (9th Cir. 2013)

(Ninth Circuit "analyze[s] the constitutionality of a statute de novo."). This Court frequently exercises its discretion to decide constitutional issues arguably waived below because they present issues of law and do not typically depend on the factual record. *See, e.g.*, *United States v. Dreyer*, 804 F.3d 1266, 1277–78 (9th Cir. 2015) (en banc) (exercising discretion to decide evidence suppression issue because "doing so best serves the integrity of the judicial process"); *Bastidas v. Chappell*, 791 F.3d 1155, 1061 (9th Cir. 2015) (addressing Article III issue of whether a stay-and-abey motion is a dispositive matter for purposes of a habeas petition because issue is "a purely legal one").

Second, there is no deficiency in the record relating to the Sixteenth Amendment issue. The issue turns entirely on the meaning of the word "income" in the Sixteenth Amendment, a question that does not turn on the factual record. In any event, the excerpts and supplemental excerpts of record span 595 pages and contain Harborside's tax returns from each year at issue. There is simply nothing more this Court needs to evaluate whether the Commissioner's method of taxing Harborside violates the Sixteenth Amendment.

Finally, § 280E's constitutionality as applied to a cannabis dispensary presents an issue of exceptional importance that will have cascading impacts in a fledgling industry. *See generally* Br. Amicus Curiae Nat'l Cannabis Indus. Ass'n, ECF No. 22; Br. Amicus Curiae Marijuana Indus. Grp. & Cannabis Trade Fed'n Action, ECF No. 23. The gravity of the issue, coupled with the fact that both parties have briefed it on the merits, weighs heavily in favor of addressing it. *See Dreyer*, 804 F.3d at 1277-78.

B. Section 280E violates the Sixteenth Amendment.

Harborside's Sixteenth Amendment argument is straightforward, and it is based on incontrovertible principles that cabin the federal government's taxing authority:

- The Sixteenth Amendment permits Congress to directly tax only "income," which in this context means "gain." *See Eisner v. Macomber*, 252 U.S. 189, 207 (1920) (quoting *Doyle v. Mitchell Bros.*, 247 U.S. 179, 185 (1918)).
- Section 280E, as applied by the Commissioner and construed by the Tax Court, forecloses certain reductions from

income—including COGS and other necessary business expenses—that must be considered when calculating gain.

- Section 280E thus causes the federal income tax apparatus to exceed Congress's limited power under the Sixteenth Amendment to levy a non-apportioned income tax.

The upshot is that Harborside and other cannabis dispensaries pay income taxes on amounts far greater than their gain; indeed, in some years they pay income taxes despite operating at a loss. It should come as little surprise that this scheme is not constitutional.

The Commissioner responds with a novel construction of the Sixteenth Amendment, arguing that it does not apply to business proceeds, Answering Br. at 18-31, and that gross income, and not gain, is the baseline for Congress's power to tax income (and correlatively, its power to grant discretionary deductions from that tax), *id.* at 31-49. Those arguments ignore constitutional text, contravene longstanding precedent, contort and overread non-binding authority, and defy common sense.

1. The Sixteenth Amendment applies equally to business income.

The Commissioner leads with a neutered conception of the Sixteenth Amendment. It applies, he argues, only to income derived from property, and has nothing to say about taxing business income because business income is not a direct tax. That novel understanding of the Sixteenth Amendment (and the Direct Tax Clause that it modifies) finds no support in text or precedent, only in policy-driven secondary literature. *See, e.g.*, Dawn Johnsen & Walter Dellinger, *The Constitutionality of a National Wealth Tax*, 93 Ind. L.J. 111 (2018).

The overriding problem with the Commissioner's argument is textual. He acknowledges, as he must, that the Sixteenth Amendment (1) was enacted specifically to modify Article I's Direct Tax Clause, and (2) permits Congress to collect without apportionment "taxes *on incomes*" (emphasis added). Answering Br. at 18-19. The clear import is that the Sixteenth Amendment categorically views income taxes as direct taxes, not (as the Commissioner argues) that only some income taxes are direct taxes, and (the argument continues) that the Sixteenth Amendment applies only to taxes that are neither direct nor on income. The source of income simply does not matter in this context.

Historical circumstances corroborate that conclusion. The income tax is based on the "great argument" and "fundamental principle" that "individuals will be taxed according to their ability to pay." *Comm'r v. Obear-Nester Glass Co.*, 217 F.2d 56, 61 (7th Cir. 1954). "There is no rational connection between the source of the taxpayer's gain and his ability to pay. The question is: has he realized an economic gain, from whatever source, which leaves him better able to contribute to the support of his government?" *Id.*

Precedent erases any ambiguity the Commissioner attempts to read into the Sixteenth Amendment's text. The Supreme Court construed the Sixteenth Amendment shortly after ratification: "the whole purpose of the Amendment was to relieve *all income taxes* when imposed from apportionment from a consideration of the source whence the income was derived." *Brushaber v. Union Pac. R.R. Co.*, 240 U.S. 1, 17-18 (1916) (emphasis added). "[T]he Constitution, as a result of the Amendment, in express terms excludes the criterion of source of income." *Id.* at 19; *accord Obear-Nester*, 217 F.2d at 61.

That understanding extinguishes the Commissioner's argument that only income taxes stemming from property fall under the Sixteenth

Amendment. All income taxes are direct taxes subject to the Sixteenth Amendment; that is why, in *Brushaber* and another case decided shortly thereafter, the Supreme Court unanimously held that the Sixteenth Amendment applies to corporate income taxes. *Brushaber*, 240 U.S. at 19-20; *Stanton v. Baltic Mining Co.*, 240 U.S. 103, 112 (1916). And it is why the Tenth Circuit and the Tax Court analyzed § 280E squarely under the Sixteenth Amendment (though they reached the wrong conclusion). *See Alpenglow Botanicals, LLC v. United States*, 894 F.3d 1187, 1198-1202 (10th Cir. 2018); ER 67-69.

The Commissioner's position also relies on a crabbed reading of the Supreme Court decision that led to the Sixteenth Amendment. In *Pollock v. Farmers' Loan & Trust Co.*, the Supreme Court held that an income tax was a direct tax and therefore unconstitutional because it was not apportioned. 158 U.S. 601, 634 (1895). The Sixteenth Amendment was a response to the resulting public outcry advocating a federal income tax. *See* Erik M. Jensen, *The Taxing Power, the Sixteenth Amendment, and the Meaning of "Incomes"*, 33 Ariz. St. L.J. 1057, 1094-1123 (2001).

The Commissioner insists that *Pollock* was really only about income taxes derived from property, so the Sixteenth Amendment is too. Answering Br. at 22-26. As discussed above, that argument is textually indefensible. The Supreme Court erased any doubt:

> [T]he Amendment was drawn for the purpose of doing away for the future with the principle upon which the Pollock Case was decided; that is, of determining whether a tax on income was direct not by a consideration of the burden placed on the taxed income upon which it directly operated, but by taking into view the burden which resulted on the property from which the income was derived, since in express terms the Amendment provides that income taxes, from whatever source the income may be derived, shall not be subject to the regulation of apportionment.

Brushaber, 240 U.S. at 18.

The tax scheme at issue here, which is deliberately codified as part of the Internal Revenue Code's income tax section, unquestionably imposes an income tax on businesses. *See* Answering Br. at 31. It therefore implicates the Sixteenth Amendment. That removes it from the ambit of the excise tax cases that the Commissioner claims support his position, which at any rate predate the Sixteenth Amendment. Answering Br. at 27-28; *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911) (holding that an excise tax was an indirect tax not subject to *Pollock*);

Spreckels Sugar Refin. Co. v. McClain, 197 U.S. 397 (1904) (same). What's more, § 280E is not a discrete tax like in *Flint* and *Spreckels*; it forms part of an elaborate income tax structure, which applies to the determination of *all* taxable income in the Internal Revenue Code—individuals' as well as corporations'.

The other cases relied upon by the Commissioner, Answering Br. at 26-27, 30, addressed different types of taxes, not income taxes, so their holdings are not germane. *See Nat'l Fed'n of Indep. Bus. v. Sebelius*, 567 U.S. 519, 571 (2012) (penalty for not having health insurance); *Quarty v. United States*, 170 F.3d 961, 970-71 (9th Cir. 1999) (retroactively imposed estate tax); *Delaware County v. Fed. Hous. Fin. Agency*, 747 F.3d 215, 223-24 (3d Cir. 2014) (real property transfer tax); *DeKalb County v. Fed. Hous. Fin. Agency*, 741 F.3d 795, 799 (7th Cir. 2013) (same); *Murphy v. IRS*, 493 F.3d 170, 186 (D.C. Cir. 2007) (excise tax); *Liberty Univ., Inc. v. Lew*, 733 F.3d 72, 97 (4th Cir. 2013) (employer penalty for not providing health insurance).

2. Section 280E taxes more than "gain" and thus violates the Sixteenth Amendment.

The Commissioner next contends that § 280E comports with the Sixteenth Amendment because the statute merely limits the available deductions from gross income. Answering Br. at 31-49. That framing says it all: the Sixteenth Amendment permits non-apportioned taxes on *gain*, not on *gross income*. The income tax scheme oversteps constitutional bounds by taxing more than gain (such as gross income).

a. "Income" in the Sixteenth Amendment refers to "gain," not "gross income."

"[T]he settled doctrine is that the Sixteenth Amendment confers no power upon Congress to define and tax as income without apportionment something which theretofore could not have been properly regarded as income." *Taft v. Bowers*, 278 U.S. 470, 481 (1929). The seminal case interpreting the meaning of "income" as used in the Sixteenth Amendment remains *Eisner v. Macomber*, 252 U.S. 189 (1920). *Macomber* limits Congress with respect to income taxes to taxing only income, defining income as "the gain derived from capital, from labor, or from both combined." *Id.* at 207. Certain critical business expenses (whether viewed under the tax code as COGS or deductions) must, as a matter of constitutional law, be excluded when deriving income, or gain. *Davis v. United States*, 87 F.2d 323, 324-25 (2d Cir. 1937).

The Commissioner cites various cases as support for the proposition that the *Macomber* definition of income for purposes of the Sixteenth Amendment is outmoded. The Supreme Court specifically declined a request to overrule *Macomber* in *Helvering v. Griffiths*, 318 U.S. 371, 372 (1943), and cited it with approval in *National Federation of Independent Business v. Sebelius*, 567 U.S. 519, 571 (2012). Moreover, there are two problems with the Commissioner's cases.

First, none of them are about business income and expenses necessary to produce that income. Rather, they address personal injury awards (*Lukhard v. Reed*, 481 U.S. 368 (1987)), contingency-fee litigation awards (*Comm'r v. Banks*, 543 U.S. 426 (2005)), antitrust damages (*Comm'r v. Glenshaw Glass*, 348 U.S. 426 (1955)), and compensatory emotional distress awards (*Murphy v. IRS*, 493 F.3d 170 (D.C. Cir. 2007)). Those specific, discrete accessions to wealth—events that occur at a single instant and leave the recipient clearly better off than before—differ dramatically from income taxation and § 280E. Harborside does not, and cannot, know whether it has income (gain) until its sales and critical expenses are periodically aggregated and measured, and § 280E undermines any ability to assess that gain.

Second, the cases concern the meaning of "income" for purposes of I.R.C. § 61(a)—not the Sixteenth Amendment. In *Murphy*, for instance, then-Chief Judge Ginsburg concluded that Murphy's award was part of her "gross income" as defined in § 61(a), but the tax on it was an excise tax and thus fell outside of the Sixteenth Amendment. *Murphy*, 493 F.3d at 172-73. "Gross income" in the Internal Revenue Code is not the same as "income" in the Sixteenth Amendment. *Id.* at 178-79. The Commissioner's insistence that "the Sixteenth Amendment meaning of income is consistent with the Tax Code's definition of gross income," Answering Br. at 13, is simply untrue.

b. "Legislative grace" is beside the point.

The Commissioner bangs the drum of "legislative grace," Answering Br. at 31-37, but legislative grace cannot expand legislative power. Nobody questions Congress' discretion to grant certain deductions from taxable income. The Constitution circumscribes that discretion, however, by limiting Congress' tax power to "income," which, as discussed above, means "gain." Put differently, Congress' "grace" cannot and does not include unconstitutional taxation.

Here, Congress and the Commissioner seek to weaponize the legislative grace underpinning discretionary deductions to broaden what constitutes "income" in the Sixteenth Amendment, and thus to expand their income tax power. That they cannot do. That was Judge Gustafson's point in his thorough dissent in *Northern California Small Business Assistants Inc. v. Commissioner*: although Congress may limit or disallow a deduction, disallowing *all* deductions results in a tax on something other than income. 153 T.C. 65, 83-85 (2019).

An overreliance on "legislative grace" largely explains the Tenth Circuit's decision in *Alpenglow*, 894 F.3d at 1198-1202. The court correctly understood that "[t]o ensure taxation of income rather than sales, the 'cost of goods sold' is a mandatory exclusion from the calculation of a taxpayer's gross income." *Id.* at 1199. But it erred by treating the necessary business expenses as permissive deductions, subject to Congress' "legislative grace," rather than as COGS inherent in the constitutional conception of income. *Id.* at 1200-01. And although the taxpayer also argued that the "IRS improperly denied it an exclusion from income for [COGS]," both the district court and the

Tenth Circuit declined to address the merits, rejecting the issue as inadequately pleaded. *Id.* at 1202.

Seventy-seven years ago, Dean Griswold warned against the uncritical invocation of "legislative grace" as a substitute for more thoughtful analysis. Erwin N. Griswold, *An Argument Against the Doctrine that Deductions Should Be Narrowly Construed as a Matter of Legislative Grace*, 56 Harv. L. Rev. 1142, 1144 (1943). "Taken literally," he pointed out, "it would mean that Congress may deny all deductions and impose a tax on gross income." *Id.* That is precisely the position taken by the Commissioner, and it is incorrect.

3. Conclusion

Section 280E is unique in the Internal Revenue Code in its sweep. The Code contains no other provision near as ambitious as § 280E's dramatic inflation of taxable income beyond the measure of income embodied in the Sixteenth Amendment, so § 280E must be invalidated as unconstitutional.[1]

[1] The amicus brief filed by the National Cannabis Industry Association raises important issues concerning § 280E's status under the Excessive Fines Clause of the Eighth Amendment.

III. HARBORSIDE PERMISSIBLY CALCULATED COGS.

The Commissioner does not dispute the central premises of Harborside's COGS argument:

1. The bedrock requirements for inventory accounting methods are that they (a) conform to the best practices in the trade or business and (b) clearly reflect income, I.R.C. §§ 446, 471;
2. Harborside met both of those requirements; and
3. Harborside is not subject to I.R.C. § 263A.

The COGS issue thus turns on the application (or lack thereof) of I.R.C. §§ 446 and 471 and the accompanying regulations.

Ignoring the undisputed reality that Harborside's accounting methods clearly reflect income, the Commissioner places his eggs in one basket: Treas. Reg. § 1.471-3(b), which he and the Tax Court interpret to forbid Harborside's allocation of COGS. Answering Br. at 55-60; ER 75. That tees up two issues: does § 1.471-3(b) apply to Harborside, and if so, does it usurp the other applicable statutes and regulations that confer to Harborside discretion in calculating its COGS? The Commissioner prevails, and the Tax Court was correct, only if the answer to both questions is yes. The answer to both questions is no.

A. Harborside's COGS calculation complies with the statutory requirements, so the Commissioner cannot force it into a specific approach.

There is no dispute—from the Tax Court or the Commissioner—that Harborside met the statutory requirements of I.R.C. §§ 446 and 471. This is a critical concession. Harborside's method of accounting clearly reflects income, so the Commissioner cannot force it into a different method.

The Commissioner has great discretion in determining whether a method of accounting clearly reflects income, but he must make that initial finding before he may force a taxpayer to change its accounting method. *See, e.g.*, *Thor Power Tool Co. v. Comm'r*, 439 U.S. 522, 531-33 (1979); *Lucas v. Am. Code Co.*, 280 U.S. 445, 449 (1930); *Asphalt Prods. Co. v. Comm'r*, 796 F.2d 843, 847 (6th Cir. 1986), *rev'd on other grounds*, 482 U.S. 117 (1987). There are *no* cases in which a taxpayer has been forced from a method of accounting that clearly reflects income. To the contrary, when the Commissioner attempted to force a business to follow the strictures of Treas. Reg. § 1.471-1, this Court held that the Commissioner lacked the power to do so because the taxpayer's existing accounting method clearly reflected income. *Jim Turin & Sons, Inc. v. Comm'r*, 219 F.3d 1103, 1107 (9th Cir. 2000).

So too here: Harborside determined COGS using acceptable accounting methods that clearly reflect income. That is all that the Internal Revenue Code requires, I.R.C. §§ 446(a), 471(a), and the Commissioner cannot force Harborside into a different method.

That is what *Max Sobel Wholesale Liquors v. Commissioner*, 630 F.2d 670 (9th Cir. 1980), stands for. The Ninth Circuit held that to the extent Treas. Reg. § 1.471-3(b) conflicts with a permissible determination of COGS, the regulation is invalid. *Id.* at 673. It reasoned that the definition of gross income "has been thought to mandate the exclusion of certain amounts (e.g., the cost of goods sold) from that figure, even in the absence of specific statutory authority for such exclusion." *Id.* at 671. The Tax Court reached the same conclusion. *Max Sobel Wholesale Liquors v. Comm'r*, 69 T.C. 477, 485 (1977).

The Commissioner responds to *Max Sobel* only by pointing out that the order of operations—determining COGS before deductions—is irrelevant here. Answering Br. at 65-66. The order matters because it reflects the importance of COGS: gross income must be determined before any deductions can be applied. That is why the cornerstone regulation allowing for business expense deductions requires that COGS comes first: "No such item shall be included in business expenses, however, to the extent that it is used by the taxpayer in computing the cost of property included in its inventory . . . ." Treas. Reg. § 1.162-1.

B. Even under the regulations, Harborside properly determined COGS.

Simply put, Harborside's calculation of COGS is consistent with the regulations implementing I.R.C. § 471.

1. The § 471 regulations reflect the statute's priorities: conforming to best practices and clearly reflecting income.

"Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." I.R.C. § 446(a). Where calculating income requires consideration of inventory, the Secretary of the Treasury may issue regulations for calculating inventory. *Id.* § 471(a). Those regulations must "conform[] as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income." *Id.*

The overarching regulation is § 1.471-2, which provides:

> (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.

In sum, the regulation ties back to the statutory requirements of I.R.C. § 471, acknowledging that while inventory rules cannot be uniform, all taxpayer inventory methods must adhere to the best accounting practice and clearly reflect income.

2. Harborside correctly determined its COGS under Treas. Reg. § 1.471-3.

Treas. Reg. § 1.471-3 addresses how to calculate cost as to certain types of inventory, but subsection (b), which the Tax Court applied, extends only to "merchandise purchased" by Harborside. Other regulatory provisions were better fits for Harborside and the inventory at issue here.

The Commissioner fails to respond to Harborside's brief citing the illustrative case directly construing Treas. Reg. § 1.471-3(b): *Marcor, Inc. v. Commissioner*, 89 T.C. 181 (1987). The Tax Court held there that Treas. Reg. § 1.471-3(b) applies to Montgomery Ward because that department store acquired its merchandise as finished goods and only resold them without further preparation. Certainly, *Marcor* does not stand for an expansive reading of Treas. Reg. § 1.471-3(b). There is no reason to believe that a regulation that applies only to taxpayers engaged in reselling merchandise should apply to Harborside, which does not resell raw cannabis.

Treas. Reg. § 1.471-3(d) is a better fit than subsection (b). It provides the general rule 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." The Commissioner's response is simply to reassert, in several different turns of phrasing, its one and only argument with respect to COGS—

Harborside, must, it really must, fit into the rules for resellers. The Commissioner does not cite any authority, or indeed provide any analysis, of why Harborside is solely a reseller. Harborside isn't a reseller like Montgomery Ward in *Marcor*, however, as it incurs costs for acquisition and processing the raw cannabis as detailed in the Tax Court's findings of fact.

The Commissioner suggests that the cannabis industry follows the "usual rules for computation of cost of production," and thus that Harborside is ineligible for the individualized treatment under subsection (d). Answering Br. at 63. If common sense does not explain why accounting practices diverge in an industry that is largely legal at the state level but federally prohibited, the Commissioner himself went out of his way to do so earlier in his brief. *Id.* at 52-54. And he has himself to blame for the lack of expert evidence on that topic: the Commissioner successfully moved to exclude the expert testimony and report from Harborside's expert accounting witness. ER 168-73.

3. Even if Treas. Reg. § 1.471-3(b) applies to Harborside, the Tax Court misapplied it.

In addition to misconstruing subsection (b)'s role in the greater regulatory and statutory scheme, the Tax Court flat out misapplied it.

Even if it were the correct and exclusive regulation that applies to Harborside's calculation of COGS, it instructs Harborside to include "transportation or other necessary charges incurred in acquiring possession of the goods." Treas. Reg. § 1.471-3(b).

Harborside's opening brief summarizes the findings of fact regarding the extensive costs it incurred acquiring the raw cannabis. Opening Br. at 13-19. The Tax Court correctly found that Harborside had extensive costs for acquiring the cannabis, including:

- acquiring clone plants, ER 19;
- acquiring specified types of cannabis, ER 20-21; and
- acquiring cannabis-containing products, ER 21-22.

Even if subsection (b) governs Harborside's COGS calculation, Harborside properly allocated these acquisition costs to COGS, but they were disallowed by the Tax Court. Harborside pointed out that error, Opening Br. at 66, but the Commissioner ignored it.

C. Harborside should have its COGS correctly determined on remand.

Looking outside the appellate record, the Commissioner suggests that the COGS issue implicates inconsequential amounts. Answering Br. at 49-51 & nn.7-8. Harborside disputes that unsupported assessment, which dramatically understates which amounts properly constitute COGS.

But what matters here—as the Commissioner concedes, *id.* at 50 n.7—is that the record on appeal does not permit this Court to perform that calculation. Accordingly, if the Court determines that § 280E is constitutional, it should remand for the Tax Court to correctly allocate COGS under the standards of *Max Sobel* and I.R.C. §§ 446 and 471. *See Slone v. Comm'r*, 810 F.3d 599, 607-08 (9th Cir. 2015) ("Because the tax court applied the wrong legal standard . . . , it failed to make findings relating to the relevant factors . . . . The tax court should make these determinations in the first instance."); *Lewis v. Comm'r*, 560 F.2d 973, 978 (9th Cir. 1977) (similar, in the context of deductions).

CERTIFICATE OF COMPLIANCE

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

This brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B) and Circuit Rule 32-1 because this brief contains 5,172 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(f).

This brief complies with the typeface requirements of Fed R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because this brief has been prepared in a proportionately spaced typeface using Microsoft Word 2016, Century Schoolbook 14-point font.

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