FIVE STRIKES — YOU'RE OUT[250]

Facts. The petitioners, a married couple, were residents of California. The wife conducted a farming operation in Mexico for which she reported a net loss on Schedule F for every year from 2007 to 2014. She began raising chickens to sell for meat in 2007. However, she could not recall selling any of the chickens through 2011 and only had one sale of anything during that timeframe — a $264 loss on the resale of livestock. She switched to raising chickens for egg production but soon determined that the venture would not be profitable due to an increased cost of feed. She sold what eggs had been produced for $1,068 and switched back to selling chickens for meat in 2012. She did not sell any chickens in 2012 or 2013 and her plan to begin selling chickens in 2014 was thwarted when the flock was destroyed by wild dogs.

During 2007–2011, she attempted to grow various fruits and vegetables, but the activity was discontinued because the soil was not capable of production due to a nearby salt flat. As a result, she had no sales revenue, only expenses that she deducted. She tried to grow peppers in 2012 but insects destroyed the crop and there was no marketable production. Later that year, she acquired three cows and three calves in hopes to "make the calves big, sell them, impregnate the mothers… repeat." She had to sell the cows in 2013 for $4,800 because there was insufficient forage on the 6,500-acre tract. The $4,800 was the only farm activity income reported for 2013. In 2012 and 2013, the taxpayers reported deductible business expenses on their Schedules C and Schedule F, later reaching an agreement with the IRS that the Schedule C expenses should have been reported on Schedule F.

Position of the IRS. The IRS disallowed the deductions, determining the wife did not conduct a trade or business activity for profit and because the business had not yet started during either 2012 or 2013.

Tax Court's Analysis. The Tax Court agreed with the IRS, concluding that the farming activities never moved beyond experimentation and investigation into an operating business. Although the Tax Court reasoned that some of the wife's farming activities could have constituted an active trade or business, costs were not segregated by activity. The Tax Court noted that income from the sale of eggs was an incidental receipt that was only realized after the wife had abandoned that venture. There was also no itemization of costs or basis in the cattle activity to allow for an estimation of any deductible loss.

HEMP AND MARIJUANA

IRC §280E limits income tax deductions for businesses that traffic in controlled substances to COGS as an adjustment to gross receipts.[251] Because hemp is no longer a Schedule I controlled substance, the §280E limitations do not apply. While hemp producers and resellers must follow the inventory costing methods of Treas. Reg. §1.471, they are not subject to the uniform capitalization rules if average gross receipts are $26 million or less (inflation-adjusted for years beginning after 2017) for the three preceding tax years and the business does not fall within the definition of a tax shelter. Likewise, if these tests are met, the business need not calculate an IRC §263A adjustment.

While hemp is not a Schedule I controlled substance, marijuana is (for purposes of federal law). In some states, marijuana is legal under state law for either medical or recreational purposes. Presently, 36 states authorize medicinal marijuana and 18 of those states also allow recreational use. In the other states, marijuana remains illegal at the state level. In those states where marijuana is a legal substance, the Tax Court has been presented with the issue of the application of §280E to such businesses. In those cases, the Tax Court determined that §280E bars a deduction for business-related expenses and that COGS must be adjusted to include indirect expenses in accordance with §263A.[252] This is the result, the Tax Court concluded, because the businesses were dealing in a controlled substance under federal law.

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250. *Costello v. Comm'r,* TC Memo 2021-9 (Jan. 25, 2021).

251. See also CCA 201504011 (Dec. 12, 2014).

252. See e.g., *Purple Heart Patient Center, Inc. v. Comm'r,* TC Memo 2021-38 (Mar. 29, 2021); *Alternative Health Care Advocates, et al. v. Comm'r,* 151 TC No. 225 (2018); *Loughman v. Comm'r,* TC Memo 2018-85 (Jun. 18, 2018).